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TAX & EXCHANGE CONTROL **ALERT**

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New tax legislation proposed for REITS

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Proposed changes regulating the anti-avoidance provisions for intra-group transactions

The perennial drive for efficiency in business and evolving demands of the commercial landscape often require corporate groups to dispose of parts of their commercial undertaking, acquire strategic businesses, or to reorganise to achieve a set of commercial goals, such as securing external financing, attracting equity investment or entering into new partnerships.

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The 2020 National Budget Speech (Budget) delivered by the Minister of Finance (Minister) contained various tax policy proposals including those aimed at refining the Real Estate Investment Trusts (REITs) tax regime. The proposals included clarifying the definition of REITs and the meaning of a share in the definition of REITs. For an overview of these proposals see our Special Budget Alert of 26 February 2020. The Budget also proposed amending the provisions regarding the taxation of foreign dividends received by REITs which we discussed in a little more detail in our Tax Alert published on 13 March 2020.

On 31 July 2020, National Treasury (Treasury) and the South African Revenue Service (SARS) published for public comment, amongst others, the 2020 Draft Taxation Laws Amendment Bill (Draft TLAB) which included the relevant proposals relating to REITs in the current legislative amendment cycle. This article provides an overview of the proposed amendments.

Amending the participation exemptions in respect of REITs

Section 10B(2) of the Income Tax Act 58 of 1962 (Act) contains what is generally referred to as the "*participation exemption*". Section 10B(2) provides that any foreign dividend received by or accrued to a person must be exempt from normal tax if that person (whether alone or together with any other company forming part of the same group of companies as that person) holds at least 10% of the total equity shares and voting rights in the company declaring the foreign dividend.

Currently, where a REIT holds at least 10% of the equity shares and voting rights in a foreign company and foreign dividends are received by the REIT in respect of those shares, the foreign dividend will be included in the gross income of the REIT but will be exempt from normal tax as it will fall within the "*participation exemption*" in terms of section 10B(2). Furthermore, when the REIT makes a distribution to its shareholders of the foreign dividend income, the distribution will constitute a qualifying distribution, and will thus be deducted from its income in terms of section 25BB(2).

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New tax legislation proposed for REITS*...continued*

Treasury now proposes that in order to address this mismatch, whereby a REIT or controlled company gets a full deduction when it on-distributes profits from exempt foreign dividends, a REIT or controlled company should not qualify for the *"participation exemption"* in respect of foreign dividends in terms of section 10B(2).

With reference to the Draft TLAB, Treasury now proposes that in order to address this mismatch, whereby a REIT or controlled company gets a full deduction when it on-distributes profits from exempt foreign dividends, a REIT or controlled company should not qualify for the "*participation exemption*" in respect of foreign dividends in terms of section 10B(2).

Interestingly, while Annexure C in the Budget made no mention of the corresponding "*participation exemption*" in respect of foreign capital gains, the proposal in the Draft TLAB extends the amendment to foreign capital gains ordinarily disregarded in terms of paragraph 64B of the Eighth Schedule to the Act. In this manner, it is proposed that REITs shall not qualify for the capital gains tax "*participation exemption*" on the disposal of shares in foreign companies.

Clarifying the meaning of a share in the definition of a REIT

In order to qualify as a REIT, the shares of the company must be listed on an exchange (e.g. the JSE) as defined in the Financial Markets Act 19 of 2012 (FMA) and licensed under section 9 of the FMA. Treasury has identified that some REITs are considering issuing and listing preference shares on a recognised exchange, which Treasury indicates is against the policy rationale of the REITs tax dispensation. The explanatory memorandum on the Draft TLAB states that this is due to the fact that holders of preference shares were never intended to benefit from the REITs tax dispensation because preference shares are mainly used for financing, and not to provide full equity exposure to investors.

Treasury therefore proposes that clarification be provided by specifically excluding non-equity shares from the shares that must be listed on a recognised exchange for purposes of the REITs special tax dispensation.

In accordance with the Annexure C Budget proposals, the Draft TLAB also proposes amending the definition of a REIT by changing the approval of listing requirements by the appropriate authority under the FMA. Previously the definition referred to consultation with the Minister and it is now proposed that the Minister will be substituted by the Director General of National Treasury in order to ease the administrative burden on the Minister. Lastly, a further amendment is proposed to the definition of REIT to bring it in line with the "*Twin Peaks*" model of financial sector regulation in South Africa.

New tax legislation proposed for REITS*...continued*

Treasury now proposes that changes be made to both section 11(j) and section 11(jA) so that taxpayers applying IFRS 9 for financial reporting purposes are allowed doubtful debt allowances in respect of lease receivables that have accrued to them but not in respect of future lease amounts.

Clarifying the tax treatment of doubtful debts for taxpayers conducting a leasing business and applying IFRS 9 for financial reporting

Currently all taxpayers conducting a leasing business and applying International Financial Reporting Standard 9 (IFRS 9) for financial reporting purposes cannot claim a doubtful debt allowance by virtue of the fact that lease receivables are specifically excluded from the doubtful debt provision in section 11(j) of the Act. The explanatory memorandum on the Draft TLAB explains that this exclusion was initially inserted on the basis that IFRS 9 lease receivables include all lease receivables even to the extent that the amount has not been received by or accrued to the lessor. There would therefore be an anomaly in that one would be able to claim a doubtful debt allowance in respect of an amount that had not been received or accrued for tax purposes, albeit that it had been impaired for accounting purposes.

However, the explanatory memorandum to the Draft TLAB explains that lease payments (in arrears) are in fact similar to other amounts that qualify for a doubtful debt allowance in terms of the provisions of section 11(j) of the Act. In addition, taxpayers not applying IFRS 9 for financial reporting purposes are able to claim a doubtful debt allowance in respect of in arrears lease payments, depending on the period that it has remained unpaid.

Treasury now proposes that changes be made to both section 11(j) and section 11(jA) so that taxpayers applying IFRS 9 for financial reporting purposes are allowed doubtful debt allowances in respect of lease receivables that have accrued to them but not in respect of future lease amounts.

REITs generally should not have any significant taxable income given their conduit nature, and therefore the section 11(j) doubtful debt allowance would generally not be of much significance. However, the proposed amendment may assist REITs under certain circumstances.

Public consultation process

The proposals set out in the Draft TLAB and explained in the explanatory memorandum thereto are still in draft form and must still undergo the standard public consultation process. The deadline for public comments on this round of the draft bills is upon us, being 31 August 2020.

Jerome Brink

Proposed changes regulating the anti-avoidance provisions for intra-group transactions

The importance of corporate agility to economic activity has been recognised in the corporate rollover relief provisions largely contained in Part III of Chapter Two of the Income Tax Act 58 of 1962.

The perennial drive for efficiency in business and evolving demands of the commercial landscape often require corporate groups to dispose of parts of their commercial undertaking, acquire strategic businesses, or to reorganise to achieve a set of commercial goals, such as securing external financing, attracting equity investment or entering into new partnerships.

The importance of corporate agility to economic activity has been recognised in the corporate rollover relief provisions largely contained in Part III of Chapter Two of the Income Tax Act 58 of 1962 (Act). The roll over relief provisions allow corporate groups to reorganise without bearing the immediate income tax and capital gains consequences associated with certain intra-group transactions. This tax neutrality is, however, subject to certain prerequisite conditions and anti-avoidance rules.

The Draft Taxation Laws Amendment Bill, 2020 (Draft TLAB), proposes changes to the intra-group transaction provisions contained in section 45 of the Act.

The Draft TLAB proposes inserting a new subsection into section 45, to avoid anomalous consequences which arise from the application of certain anti-avoidance rules, where an intra-group transaction is funded by debt or the issue of non-equity shares.

Intra-group transactions

An intra-group transaction under section 45 allows one company to transfer an asset to another company forming part of the same group, on a tax neutral basis and to defer the tax liability that would have ordinarily been incurred. Section 45 however, contains anti-avoidance provisions aimed at preventing the abuse of the tax relief afforded to companies through intra-group transactions.

The proposed amendments in the Draft TLAB deal with the interaction between the "*De-Grouping Charge*" contained in section 45(4) of the Act and the "*Zero Base Cost Rule*" contained in section 45(3A) of the Act.

Proposed changes regulating the anti-avoidance provisions for intra-group transactions*...continued*

Ordinarily, the De-Grouping Charge would apply and *"reverse"* the tax deferral benefit obtained.However, the Zero Base Cost Rule in this scenario has the effect that the holder still remains with a nil base cost in respect of the debt or non-equity shares.

Intra-group anti-avoidance provisions

The De-Grouping Charge provides that if the transferor and the transferee companies cease to form part of the same group within six years of the implementation of the intra-group transaction, then any deferred tax benefit obtained from the transaction is triggered in the hands of the transferee. This is aimed at discouraging companies from implementing the intra-group transaction (thereby benefiting from the tax deferral) but then ceasing to form part of the same group soon thereafter.

The Zero Base Cost Rule applies, in summary and subject to further considerations, where an asset is transferred by the transferor to the transferee in exchange for debt or non-equity shares and deems the debt or non-equity shares to have been acquired by the holder for nil expenditure. The rule implies that debt and non-equity shares issued as consideration under an intra-group transaction are deemed to have a zero base cost in the hands of the transferor. Further, any repayment (capital repayment in respect of debt, or redemption of the non-equity shares) will not give rise to any income or gain in the hands of the holder of the shares or debt, provided the companies form part of the same group of companies when the repayments are made.

However, to the extent that the holder disposes of the debt or non-equity shares to a person outside of the group, tax must be accounted for on this disposal, having regard to the nil base cost of the debt and non-equity shares. This is aimed at adding a tax cost where companies engage in debt or non-equity share funded intra-group transactions, and then subsequently transfer the debt or non-equity shares outside of the group.

The anomaly

In certain instances, an intra-group transaction can be implemented in a manner where the transfer of an asset is funded by the issue of debt or non-equity shares by a group company, and a de-grouping subsequently occurs within a period of six years. Ordinarily, the De-Grouping Charge would apply and *"reverse"* the tax deferral benefit obtained. However, the Zero Base Cost Rule in this scenario has the effect that the holder still

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Proposed changes regulating the anti-avoidance provisions for intra-group transactions*...continued*

The Draft TLAB containing the proposed amendments discussed here has been published by National Treasury and SARS for public comment until 31 August 2020.

remains with a nil base cost in respect of the debt or non-equity shares. Essentially, this creates a "*double whammy*" in effect, namely the reversal of the tax benefit in terms of the De-Grouping Charge and a greater capital gain on the disposal of the debt or non-equity shares in terms of the Zero Base Cost Rule.

Proposed changes

To address this issue, the Draft TLAB proposes inserting a subsection which applies where the De-Grouping Charge rule has been triggered in respect of an intra-group transaction where the Zero Base Cost rule was applied. The effect of the proposed subsection will be that the tax attributes of the debt or non-equity shares will be reinstated to reflect those that would have existed on the date of that de-grouping, had tax deferral not applied at all. This means that a debt or non-equity share in respect of which the Zero Base Cost Rule applied, should be deemed to have a base cost equal to its market value on the date of the intra-group transaction less any repayments made prior to the de-grouping.

Comment

The Draft TLAB containing the proposed amendments discussed here has been published by National Treasury and SARS for public comment until 31 August 2020. Once the Draft TLAB is tabled in Parliament, it will be subject to a further public participation process.

Taxpayers should welcome the resolution of the anomalous result brought about by the application of the two anti-avoidance rules discussed in this article. The amendments proposed in the Draft TLAB appear to be aimed at striking a fairer balance between the need to prevent abuse and the agility provided to corporate groups through the corporate roll over relief provisions, including intra-group transactions.

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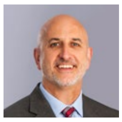

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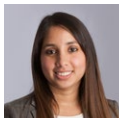

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Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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