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TAX & EXCHANGE CONTROL **ALERT**

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Welcome clarification of the rules relating to the vesting of income in a resident beneficiary by a foreign trust

On 2 March 2021 SARS published IN 114 to clarify the interaction and application of sections 7(8) and 25B(1) to provide taxpayers with guidance on how to correctly apply the aforementioned provisions.

Section 7(8) of the Income Tax Act 58 of 1962 (Act) was introduced by the Revenue Laws Amendment Bill, 2004 as an anti-avoidance measure aimed specifically at ensuring South African taxpayers who made use of foreign trusts were subject to tax in South Africa on the income they received from those trusts. Prior to the introduction of the section, South African tax residents were able to artificially shift assets offshore (sometimes to low tax jurisdictions), and exclude income derived from those assets from the South African tax net.

Over the years, changes to anti-avoidance provisions which deal with, *inter alia*, the controlled foreign company rules and the attribution of income from foreign structures have resulted in some uncertainty as to the correct application of section 7(8) when read together with section 25B(1) of the Act.

On 2 March 2021, the South African Revenue Service (SARS) published Interpretation Note 114 (IN) to clarify the interaction and application of sections 7(8) and 25B(1) to provide taxpayers with guidance on how to correctly apply the aforementioned provisions.

Section 7(8) and section 25B(1) apply when income received by or accrued to a foreign trust by reason of or in consequence of a donation, settlement or other disposition by a South African tax resident, is vested in a South African tax resident beneficiary by the trustees of the foreign trust.

When a foreign trust derives income in consequence of a donation, settlement or other disposition by a donor and the trust vests that income, or a portion of it, in a resident beneficiary, a conflict arises because the amount is potentially economically taxed twice – herein lies the uncertainty as to how the provisions interact with each other.

Section 25B(1) provides that –

> *Any amount received by or accrued to or in favour of any person...in his or her capacity as the trustee of a trust, shall, subject to the provisions of section 7, to the extent to which that amount has been derived for the immediate or future benefit of any ascertained beneficiary who has a vested right to that amount during that year, be deemed to be an amount which has accrued to that beneficiary, and to the extent to which that amount is not so derived, be deemed to be an amount which has accrued to that trust.*

SARS states in the IN that the words "*subject to the provisions of section 7*" can be read to have the effect that if there is a conflict, inconsistency, or incompatibility between section 25B(1) and section 7(8), section 7(8) is given dominance and must prevail.

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Welcome clarification of the rules relating to the vesting of income in a resident beneficiary by a foreign trust

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In the instance that no conflict arises, (i.e. when the amount derived by the trust is not attributable to a donation, settlement or other disposition) the remaining amount must be dealt with under section 25B(1).

It accordingly becomes critical to correctly assess whether there is indeed a conflict, inconsistency or incompatibility between the provisions in order to understand whether section 7(8) must prevail (in the instance both provisions potentially apply), or whether section 25B(1) can be applied without regard to section 7(8).

By way of example, in the instance where a South African tax resident has advanced an interest free loan to a foreign discretionary trust, and the foreign trust has utilised the loan to make an interest bearing investment, vesting that interest income in a South African resident beneficiary (in the same tax year of assessment), then the tax consequences are as follows according to the IN (assuming the interest derived by the foreign trust is fully attributable to the interest free loan) and considering only how sections 7(8) and 25B(1) would apply in this context –

- as the trust is a separate person for income tax purposes, a determination needs to be made whether the interest derived by the trust is taxable in South Africa;
- consideration must be given to whether section 7(8) and section 25B both apply;
- in this instance, both provisions may potentially apply because for purposes of –
    - section 7(8), an amount has, by reason of or in consequence of a donation, settlement or other disposition by a donor, been received by a non-resident and had that non-resident been a resident the amount of interest would have constituted income as defined; and
    - section 25B, an amount has been received by a trust, which section 25B(1) potentially deems to accrue to the trust or to a beneficiary.
- a conflict therefore arises in this example as both provisions potentially apply and, if both sections are applied, the amount is potentially economically taxed twice given that –
    - section 7(8) requires that any amount received by or accrued to the foreign discretionary trust, which would have constituted income had the trust been resident, be included in the donor's income; and
    - section 25B(1) deems the amount vested in the beneficiary to have accrued to the resident beneficiary and therefore it would be included in the resident beneficiary's gross income.

In a scenario like the example above, the IN provides that section 7(8) must be applied in the first instance. Therefore, section 25B(1) is disregarded to the extent that the amount is attributable to a donation, settlement or other disposition and is included in the donor's income despite the fact that it may, subsequent to its receipt or accrual, have been vested in a resident beneficiary in the same year of assessment in which it was received by or accrued to the foreign discretionary trust.

In the instance that no conflict arises, (i.e. when the amount derived by the trust is not attributable to a donation, settlement or other disposition) the remaining amount must be dealt with under section 25B(1).

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South African taxpayers with foreign trusts should take cognisance of the guidance issued by SARS to avoid any unintended tax consequences.

The position set out in the IN ensures that no economic double taxation occurs in the event that the trust has vested the relevant amount of income in a South African resident beneficiary, because to the extent that section 7(8) applies, section 25B(1) will not apply. In other words, to the extent that the amount of income has been attributed to the donor, it is not taxed in the hands of a resident beneficiary in whom it has been vested.

South African taxpayers with foreign trusts should take cognisance of the guidance issued by SARS to avoid any unintended tax consequences. To the extent that South African taxpayers do not apply the provisions in accordance with the IN, it may create future tax issues that will potentially be costly and time-consuming to rectify.

Keshen Govindsamy

Restructuring Rules – Binding Private Ruling 360 rules on rollover relief applying to group consolidation and empowerment investment

The rollover relief provisions in Part III of Chapter 2 of the Income Tax Act 58 of 1962 (Act) facilitate the consolidation or division required to appropriately organise a corporate group.

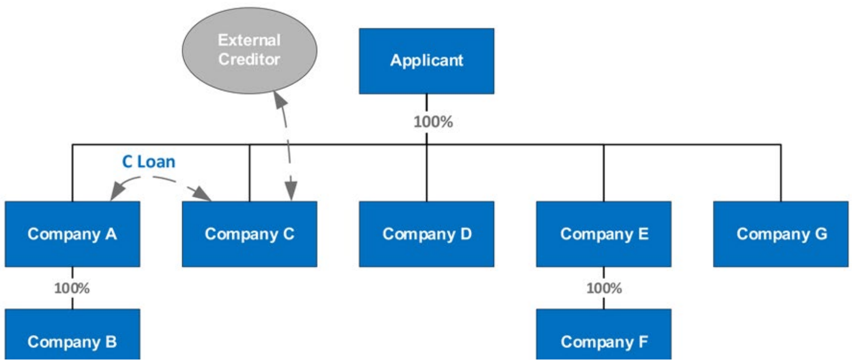
The organic growth of a corporate group can lead to valuable businesses or assets being tucked into hard-to-reach corners. Management or potential investors may also find it most appropriate to only invest in specific parts of a group. Rearranging the ownership structure or where value lies in a corporate group can enable investors to target their investments into parts of the group which are most attractive.

The rollover relief provisions in Part III of Chapter 2 of the Income Tax Act 58 of 1962 (Act) facilitate the consolidation or division required to appropriately organise a corporate group. These provisions provide mechanisms to conduct intra-group transfers of assets, by deferring the ordinary income and capital gains tax consequences that would otherwise arise from such transfers between distinct taxpayers.

Binding Private Ruling 360 (BPR360) is a good example of the value of flexibility in corporate groups, in enabling targeted investment. Here, a listed holding company (Applicant) – as part of its B-BBEE initiative and to protect and enhance its commercial position – sought to consolidate certain companies operating in the same sector under an intermediate holding company and to sell a 25% interest in the intermediate holding company to an empowerment investor.

The focus of BPR360 is on the asset-for-share & intra-group transactions consolidating the operating companies under the intermediate holding company, in anticipation of an empowerment investment. Here we will briefly cover how the consolidation was achieved and the specific rulings contained in BPR360.

Rationale of the transaction



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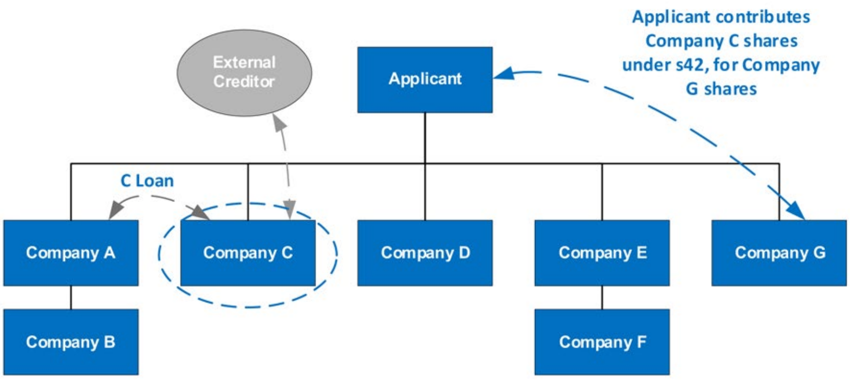
Restructuring Rules – Binding Private Ruling 360 rules on rollover relief applying to group consolidation and empowerment investment*...continued*

An asset for share transaction meeting the definition in section 42, benefits from deferred tax consequences that would otherwise be triggered immediately where an asset is transferred in exchange for the issue of shares.

The Applicant for the purposes of BPR360 owned 100% of five companies directly, two of which each 100% owned a subsidiary. The rationale for the transaction was to consolidate Company B and Company C, under Company G. Company G, being the intermediate holding company owning the relevant operating companies would then be the target of investment by the empowerment investor.

The section 42 asset for share transaction



The first step of the transaction would see the Applicant contributing the shares it owned in Company C to Company G, in exchange for shares issued by Company G. This was to be done as an asset-for-share transaction (AFS) under section 42 of the Act.

An AFS meeting the definition in section 42, benefits from deferred tax consequences that would otherwise be triggered immediately where an asset is transferred in exchange for the issue of shares. Section 42 applies to deem the transferor and issuer to be one and the same person, as regards the tax characteristics of the asset transferred – including, the date and cost of acquisition. The shares issued are similarly deemed to have been acquired on the same date and for the same expenditure as the asset transferred was initially acquired.

A precursor to the AFS here was to settle outstanding debt owed by Company C to an external creditor, to be funded by the issue of additional shares in Company C. BPR360 ruled that the subscription price for these shares would constitute contributed tax capital, as defined in section 1 of the Act, and expenditure actually incurred as used in paragraph 20(1)(a) of the Eighth Schedule to the Act (Eighth Schedule), for the purposes of determining the shares' base cost. BPR 360 states that the contributed tax capital is attributable to the additional shares in Company C.

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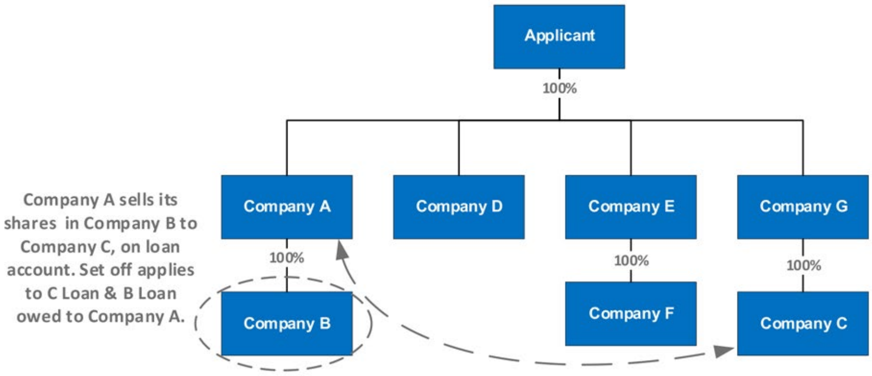
BPR360 ruled that the sale of Company B to Company C would constitute a section 45(1)(a) intra-group transaction. Under which Company A is deemed to have disposed of the Company B shares for an amount equal to their base cost. Company C will further be deemed to be one and the same person as Company A as regards the tax characteristics of the Company B shares.

BPR360 ruled that the AFS was a section 42 transaction. Meaning Company G is deemed to step into the shoes of the Applicant as regards the tax characteristics of the Company C shares and the Applicant would be deemed to have received the Company G shares issued at the same base cost and time as the Applicant initially acquired the Company C shares transferred.

This achieves the first leg of consolidation, with Company G becoming an intermediary holding company of Company C rather than held directly by the Applicant.

The section 45 intra-group sale of Company B



The second step of the consolidation relied on another rollover provision – intra-group transactions under section 45 of the Act. This step saw Company A selling its entire shareholding in Company B to Company C, with the purchase price partially being set off against an existing intra-group loan and the remainder left outstanding as a new intra-group loan.

An intra-group transaction meeting the definition in section 45, will also benefit from tax consequence deferrals. Where a resident company disposes of a capital asset to another resident company forming part of the same group of companies, then:

- the transferor company is deemed to have disposed of the asset for an amount equal to the base cost, and
- the transferee company is deemed to have acquired the asset at the same base cost and on the same date as the transferor initially acquired the asset.

BPR360 ruled that the sale of the Company B shares to Company C would constitute a section 45(1)(a) intra-group transaction. Under which Company A is deemed to have disposed of the Company B shares for an amount equal to their base cost. Company C will further be deemed to be one and the same person as Company A as regards the tax characteristics of the Company B shares.

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Paragraph 12A of the Eighth Schedule, dealing with concessions or compromise of debt, was similarly ruled to not find application to the set off caused by this step of the transaction.

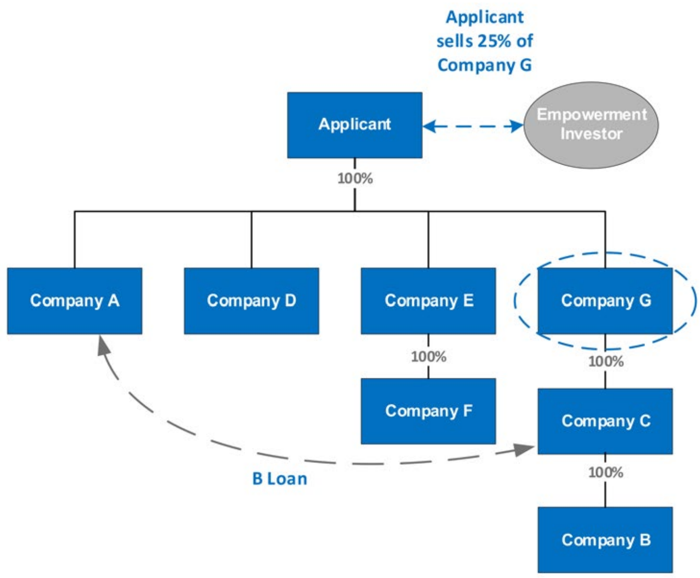
The transaction is funded partially by set off of a pre-existing loan owed by Company A to Company C and partially by a new loan from Company C to Company A. BPR360 therefore had to rule on the application of section 45(3A)(b)(i) and the debt forgiveness provisions in the Act.

BPR360 ruled that with the application of section 45(3A)(b)(i), the B loan will be acquired by Company C for nil expenditure and therefore nil base cost. Further, section 45(3A)(c) will apply to the set off and any attendant capital gains or taxable income will be disregarded.

Paragraph 12A of the Eighth Schedule, dealing with concessions or compromise of debt, was similarly ruled to not find application to the set off caused by this step of the transaction.

Section 45 as a restructuring tool here enables Company A to dispose of a subsidiary to another group company, in a manner which further consolidates the target companies under the intermediate holding of Company G, but without the immediate tax cost which this would otherwise cause. Further, a commercially useful inversion of the debt relationship between Company A and Company C is also achieved, with Company A becoming a creditor of Company C after the implementation of the step.

Empowerment into final structure



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Restructuring Rules – Binding Private Ruling 360 rules on rollover relief applying to group consolidation and empowerment investment*...continued*

BPR360 provides an excellent example of how agility in the structure of a corporate group can unlock value for potential investors.

With the Applicant's corporate group having been appropriately consolidated under the previous steps of the transaction, the empowerment investor is then able to invest into the appropriate part of business held by Applicant – being the intermediary Company G.

BPR360 contains rulings which are important to the successful implementation of the empowerment transaction. These include rulings that:

- Despite the recent acquisition of Company G shares by the Applicant, that the sale of Company G shares to the empowerment investor would be the disposal of a capital asset for the purposes of the Eighth Schedule;
- In determining the base cost of these shares, section 9C(6) would not apply. Rather, paragraph 32(3)(a) requires each share to have its base cost specifically identified;
- The discount to be applied to the investment by the empowerment partner would not constitute a donation under section 55 of the Act, nor would it be appropriate for the Commissioner to exercise his power under section 58 to adjust the pricing of the transaction as a deemed donation; and
- The de-grouping charge under section 45(4)(b) will not apply to any of the steps of the transaction.

Comment

BPR360 provides an excellent example of how agility in the structure of a corporate group can unlock value for potential investors. The rollover relief rules create this agility, by facilitating certain "*tax free*" transactions in a group context. These include the transfer of assets – including debt – within a group, the injection of assets into new group companies, the unbundling of a junior subsidiary into a par ranking subsidiary within a listed group, and the winding up and distribution of assets owned by companies which are no longer necessary or useful to the corporate structure.

Tsanga Mukumba

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BBBEE STATUS: LEVEL TWO CONTRIBUTOR
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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