

# TAX & EXCHANGE CONTROL ALERT

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INCORPORATING  
KIETI LAW LLP, KENYA

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### *Capital vs Revenue: Swapping assets doesn't swap their nature*

Section 42 of the Income Tax Act 58 of 1962 (ITA) is a cornerstone of the so called 'corporate rules' in the ITA. Should certain conditions be met, this section provides roll-over relief to a taxpayer where that taxpayer exchanges an asset for shares in a company.



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## Capital vs Revenue: Swapping assets doesn't swap their nature

Section 42 of the Income Tax Act 58 of 1962 (ITA) is a cornerstone of the so called 'corporate rules' in the ITA. Should certain conditions be met, this section provides roll-over relief to a taxpayer where that taxpayer exchanges an asset for shares in a company.

The application of section 42 to multiple transactions concluded back-to-back has been the subject of previous South African Revenue Service (SARS) binding private rulings (BPRs), such as BPR 288 (discussed [here](#)) where SARS decided that an asset transferred in terms of a section 42 transaction can again be transferred in terms of another section 42 transaction and the second transaction will still enjoy roll-over relief. The issue also arose in BPR 328.

Recently in BPR 393, SARS again ruled on the question of back-to-back section 42 transactions. While not expressly stated in the ruling, one of the key questions addressed is the question of whether the successive nature of these transactions in the context of a group restructure alters the capital or revenue nature of assets transferred, specifically as a result of the second section 42 transaction.

### Section 42 of the ITA

In short, section 42 of the ITA provides that where a taxpayer holds an asset as a capital asset and disposes of this asset to a company in exchange for that company issuing

the taxpayer equity shares, then the taxpayer will be deemed to dispose of that asset for proceeds equivalent to the base cost at which the taxpayer held that asset. The company will then be deemed to acquire that asset from the taxpayer for consideration equal to the base cost at which the taxpayer held the asset (hence the term roll-over relief – the base cost rolls over from taxpayer to company). The effect then is that no capital gain (and thus no capital gains tax) is realised on the transaction.

*Inter alia*, in order for section 42 to apply, the taxpayer must hold at least 10% of the equity shares in the company to which the taxpayer transfers the asset following the transaction (if the company is an unlisted company). Further, the company cannot dispose of the asset acquired within 18 months of the transaction without incurring a tax liability. It was this point covered in BPR 288 where SARS clarified that a second section 42 transaction within 18 months of the first would still qualify for roll-over relief, based on the facts of that particular ruling.



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Section 42 also provides that where a taxpayer holds an asset as a capital asset, the company acquiring that asset in exchange for issuing shares to the taxpayer will acquire that asset as a capital asset. However, should the company again dispose of that asset in terms of another section 42 transaction shortly after acquiring it (perhaps even envisaging the subsequent disposal in terms of section 42 when acquiring it in terms of section 42 in the first place), it becomes questionable whether the back-to-back nature of these transactions will alter the capital nature of the asset.

### Facts of BPR 393

In BPR 393, the applicant company operated a financial services business and an insurance business. In order to separate these two businesses into individual corporate vehicles, this company incorporated a

holding company below it. It then incorporated two more subsidiaries (SubCo 1 and SubCo 2), each wholly owned by the holding company. The restructure of the applicant company's interests in the two businesses comprised a series of steps, two sets of these steps being relevant here.

The first relevant set of steps involved the applicant company transferring its financial services business assets to the holding company in terms of section 42 of the ITA. The holding company then transferred these to SubCo 1 in terms of section 42.

The second relevant set of steps involved the company transferring its insurance business assets to the holding company in terms of section 42 of the ITA. The holding company then transferred these to SubCo 2 in terms of section 42.

Therefore, this restructure involved two instances where section 42 was used in back-to-back transactions in respect of the same assets – the insurance business assets and the financial services business assets. It was undisputed that the applicant company in the first instance held both the financial services business and insurance business assets as capital assets. The question, however, was whether the holding company held these assets as capital assets in light of the fact that it contemplated transferring them to the two subsidiaries in terms of section 42 immediately after receiving them in terms of a section 42 transaction.

### SARS' decision

In relation to the relevant sets of steps, SARS ruled that:

- firstly, the transactions between the holding company and subsidiaries would constitute section 42 transactions and enjoy roll-over relief (this being consistent with the decision in BPR 288); and

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- secondly, the holding company will receive, hold and then transfer the financial services business and insurance business assets as capital assets, despite holding them for a very short period of time and intending to dispose of them when receiving them, this meaning that the subsidiaries will receive and hold these assets as capital assets and not trading stock.

SARS' decision is consistent with the purpose behind section 42, and the 'corporate rules' more broadly, in that it recognises the commercial need for taxpayers to change the immediate control/holding of certain assets, without relinquishing an interest in these assets. As always, however, SARS' decision must be understood within the correct context, as it was made with specific reference to the facts before SARS in this matter, and is not of general application to all transactions.

Therefore, despite similar rulings in BPR 288, 328 and 393, it is unlikely that one can argue that this constitutes a practice generally

prevailing. It is therefore advisable that taxpayers seek advice from a tax practitioner regarding any specific transaction or restructure which they intend to implement, in particular where the potential tax consequences are uncertain. It is important to appreciate that in terms of section 42 of the ITA, the requirement for the parties to hold the assets and shares acquired under a section 42 transaction for 18 months after the transaction does not apply only if the consecutive transaction is concluded in terms of section 45, 46 or 47 of the ITA. If the consecutive transaction (involving the same shares and assets) is concluded in terms of section 42, there is a risk that the 18-month holding period requirement can be contravened, which would result in adverse tax consequences. In BPR 393, SARS held that the 18-month holding period requirement in section 42(7) still applies to the second set of section 42 transactions between the new holding company and the two subsidiaries.

Nicholas Carroll



Cliffe Dekker Hofmeyr

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**Emil Brincker** ranked by  
**Chambers Global 2003 - 2023**  
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**Gerhard Badenhorst** was awarded  
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Tax: Indirect Tax.

**Mark Linington** ranked by  
**Chambers Global 2017 - 2023**  
in Band 1: Tax: Consultants.

**Stephan Spamer** ranked by  
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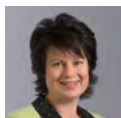
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