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TAX

WERKSMANS TAX BRIEF

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By Ernest Mazansky, Head of Tax Practice, Werksmans Attorneys

TAX AMENDMENTS 2019

The Rates and Monetary Amounts and Amendment of Revenue Laws Bill, 2019, the Tax Administration Laws Amendment Bill, 2019 and the Taxation Laws Amendment Bill, 2019 (of which mainly the last-mentioned is discussed herein) were all tabled in Parliament by the Minister of Finance on 23 October 2019, when he presented his medium term Budget policy statement. The Bills have been passed by the National Assembly.

As has been the trend in recent years, the number of significant amendments in each year has been reduced, and, as before, the vast majority in number of the amendments are of a highly technical or esoteric nature, many of which are more of interest to tax professionals than to business people in general. Accordingly we limit our discussion to those amendments which are likely to be of interest in the general business environment.

Somewhat unusually, amendments were made to the Bill by the Standing Committee on Finance in Parliament arising out of a gross error in the drafting of amendments to section 8E of the Income Tax Act, 1962 (the Act), an error which caused widespread alarm in the business and banking industry and which, fortunately, has been corrected in time.

Except as otherwise stated, amendments will take effect on promulgation of the relevant Amendment Act.

CORPORATE TAXPAYERS

Pre-sale dividends – avoidance of CGT

In 2017 Paragraph 43A of the Eighth Schedule to the Act (as well as its counterpart, in relation to shares held as trading stock, section 22B of the Act) was amended to bring a stop to the arrangement where CGT could be avoided by a company which sold shares (typically) in a subsidiary. This was achieved by the holding company entering into an arrangement with the acquirer such that, instead of the acquirer purchasing the shares, thereby triggering CGT, the acquirer would subscribe for new shares in the target company, and the latter would repurchase the seller's shares, the receipt being a tax-exempt dividend.

The amendment also targeted pre-sale dividends designed to strip out the value of the company and reduce the value of the shares, which would then be sold. Accordingly the amendment provided that any dividends received within eighteen months prior to the disposal, together with dividends received as part of the disposal, that, in short, exceeded 15% of the market value of the shares (extraordinary dividends), were deemed to be proceeds on disposal subject to CGT.

The immediate remedy was to extract the dividend and have the acquirer subscribe for a large number of new shares to provide funds to pay the dividend, which diluted the existing shareholders to a minimal shareholding, but who retained their shares for a little over eighteen months, before selling same. To counter this, and, very importantly, with effect from 20 February 2019, further amendments are now made as follows:

- If a new shareholder subscribes for shares in a company (the target company) and as a result any company which already holds equity shares in the target company suffers a dilution, in the sense that its effective interest in the target company's equity shares is reduced by reason of the new subscription, there is a deemed disposal.

- The percentage of shares deemed disposed of is calculated as being equal to the percentage by which the effective interest holding in the target company has been reduced by reason of the new shares issued.

It will be noted that this deemed disposal does not in and of itself trigger any CGT. This is merely a deemed disposal for the purpose of the provision, in order to establish whether or not, within the past eighteen months, any extraordinary dividend has been received by the existing shareholder. Thus if there have been no extraordinary dividends within the previous eighteen months, this deemed disposal will have no tax effect.

It will also be noted that the calculation is made only if the existing (company) shareholder's effective interest in its equity shares in the target is reduced. This could only happen if the target company itself issues new equity shares. If it issues vanilla preference shares, say, to a bank, provided they are not convertible into equity shares, this will not trigger the application of the amendment.

If the amendment does apply, because there is an extraordinary dividend, the dividend is, unfortunately, not taken into account as proceeds, against which base cost will be allocated, to determine the capital gain. Rather the extraordinary dividend itself is the capital gain. The legislation goes on to state that where the company at a later stage actually disposes of shares that are treated as being disposed of, the amount of the extraordinary dividend cannot be taken into account a second time, ie this is to avoid double taxation on the same extraordinary dividend.

Hybrid equity instruments

As most readers are aware, section 8E of the Act, in short, requires redeemable preference shares (and even equity shares with characteristics similar to redeemable preference shares) effectively to remain in existence for at least three years, failing which the dividends will cease to be tax-exempt. This is achieved, in brief, by ensuring that neither the issuing company can be obliged to redeem within three years, nor that the holder has the option to require the shares to be redeemed within three years.

A practice developed in terms of which the preference shares were not redeemed within the three-year period, but substantial returns of paid-in capital (whether as a dividend or return of capital) were paid to the holder, thereby enabling the annual coupon to be reduced, but the actual redemption took place only after the three years had expired.

In order to counter this practice, and with effect from 21 July 2019, a share will become a hybrid equity instrument not only if the issuer is obliged to redeem the share, or the holder has an option to have it redeemed, within three years, but also if either the issuer is obliged to distribute an amount constituting a return of the issue price of the share, in whole or in part; or the holder of the share may exercise an option in terms of which the issuer must distribute an amount constituting a return of the issue price, in whole or in part.

The term "issue price" means the amount which was received by the company in respect of the issue of the shares.

We suspect that this amendment will not be sufficient, as it would not be too difficult to arrange affairs to get around the amendment, while still achieving the same objective, and one can look forward to further amendments to tighten up this anti-avoidance amendment.

Trading stock

Since the trading stock valuation rules were first enacted in the predecessors to the Act, it has always been the understanding of taxpayers and SARS that, in bringing to account closing stock at the lower of cost and market value, one looked at the stock on a line-by-line basis. So, simplistically speaking, if there were in total five items of stock of which the market value of three were above cost and the market value of the remaining two were below cost, the three items were brought into account at cost and the two items were brought to account at the lower market value.

Following the Supreme Court of Appeal decision in the *Volkswagen* case, where the court held that valuing stock for IFRS purposes was not acceptable for the purposes of the Act, the court nevertheless came to a rather startling conclusion in regard to the valuation provisions in section 22 of the Act. The court held that, applying the test of lower of cost and market value, one looked at the closing stock in its totality. Consequently, in the example above, if the aggregate of the market values in excess of cost of the three items (ie the unrealised profit) exceeded the unrealised loss on the two items, then all five items must be brought to account at cost, because it is only if the market value on an aggregate basis is less than the aggregate cost, that the provision must be made.

To restore the provision to what it has always been understood to mean, an amendment to section 22 now states that, in determining any diminution in the value of trading stock, no account must be taken of the fact that the value of some items of trading stock of the taxpayer may exceed their cost price.

This amendment applies in respect of tax years commencing on or after 1 January 2020.

Interest incurred to acquire subsidiaries

In terms of section 24O of the Act, where a company acquires shares in an operating company (as defined), which is an operating company at date of acquisition, such that the holding company/acquirer and the operating company form part of the same group (for tax purposes), any interest incurred by the holding company on any loan used to finance the acquisition of the shares will be deductible, notwithstanding the normal rule that such interest is not deductible (because dividends are exempt from tax).

This concession applies not only where the shares are acquired directly in an operating company, but also where, say, the shares are acquired in a holding company where, say, its wholly-owned subsidiary is the operating company.

In terms of section 24O, as soon as inter alia any of the shares are disposed of, the deduction ceases. The deduction is also applicable only in respect of those shares actually acquired. However, in order to facilitate a rationalising of the group which was acquired, if the acquiring company purchased a holding company with an operating subsidiary, and it is decided that the holding company should either unbundle the shares in the subsidiary under section 46 of the Act, or distribute the shares in the subsidiary as a liquidation distribution under section 47 of the Act, section 24O will continue to apply to allow the interest to be deducted, notwithstanding the fact that the shares are now held in the operating subsidiary directly, rather than in its former holding company.

This amendment has been made retroactive to 1 January 2019, and applies to tax years commencing on or after that date.

Corporate reorganisation rules

The general principle in relation to the corporate reorganisation or restructuring rules, contained in sections 41 to 47 of the Act, is that roll-over relief is obtained by means of transferring assets at their base costs, so as not to realise any gains or losses. On the other hand, the transferee company "inherits" these base costs and generally the transferor's tax "profile" in relation to the assets, for the purposes of the transferee's future transactions. The same rule applies in relation to certain provisions transferred, such as depreciation, provisions for doubtful debts, provisions for future expenditure under contracts, and the like.

To achieve this, section 41 of the Act provides that the corporate restructuring rules override all the other provisions of the Act, save those specifically mentioned (such as, for example, the application of the general anti-avoidance rule, or the GAAR).

An amendment has been made this year excluding two other provisions in the Act, so that roll-over or deferral will not occur. These are as follows:

- Foreign exchange gains and losses are determined under section 24I of the Act. The general principle is that, save in the case of exchange items, such as debts, between connected persons, one brings to account annually both realised and unrealised gains and losses on foreign exchange. In the case of debts between connected persons, the usual rule is that the gains and losses are brought to account only on realisation. Hitherto, where, say, a debt was transferred in a corporate reorganisation transaction there would be no realisation of any unrealised gain or loss occurring, and rather the transferee company would realise that gain or loss. Section 24I has now been excluded from the ambit of the restructuring rules, with the result that there will be an actual disposal of the debt, resulting in a realisation, with the consequence that the transferor company will trigger an exchange gain or loss at that point in time of the realisation. In the case of debts between connected persons, these will be the total gains and losses, while in the case of others, these will be those that have arisen since the beginning of the tax year. This means that the transferor, and not the transferee, must account for the gain or loss, even though, in the case of connected persons, no funds have flowed from the debtor to the creditor.
- Along similar lines, section 24J of the Act, dealing with interest, has been excluded from the corporate restructuring rules, but only to the extent that there is an adjusted gain or loss on transfer or redemption of an instrument. In short, there will be such an adjusted gain or loss if the transfer price or redemption payment differs from, what might be called, the carrying value of the debt, which would be the amortised value having regard to the initial issue price of the debt, plus the yield to maturity accruals of interest, less the payments in respect of the debt. This adjusted gain or loss could be of a capital or revenue nature, depending upon the circumstances. Once again, by excluding these from the ambit of the corporate restructuring rules, any such gain or loss will be realised upon transfer, and must be taken into account by the transferor company, and will not be carried over to the transferee company, to be dealt with by it in its future tax returns.

INTERNATIONAL TAX

Controlled foreign companies

The controlled foreign company (CFC) rules are governed by section 9D of the Act.

The general principle is that the CFC's profit is effectively taxed in the South African shareholder's hands, with credit being given for any foreign tax paid by CFC. The two major exemptions from this rule, ie where the shareholder is not taxed, are where either (1) there is a qualifying business establishment, ie proper premises, management, staff, equipment, out of which the CFC operates, or (2) the so-called high tax exemption applies where, very broadly stated, the CFC pays tax in its country in an amount of at least 75% of the amount it would have paid had it been a South African company (so, by way of a simplistic example, if the method of determining taxable profits in the foreign country is identical to determining taxable income in South Africa, the foreign tax rate is at least 75% of 28% = 21%).

As is well known, corporate tax rates around the world have been falling, but, unfortunately, owing to South Africa's parlous economic position, we have been unable to follow suit. Recognising this, and in order not to result in an unnecessary and undue compliance burden for both taxpayers and SARS, the minimum has been reduced from 75% to 67.5% (so in the simplistic example above, the tax rate has been reduced from 21% to 18.9%).

There has also been some tightening up of the so-called diversionary rules, which provide that, where, although sales of goods and services by a CFC are attributable to the foreign business establishment, and therefore exempt, they are nevertheless still used to erode the South African tax base, the profits attributable to those sales remain taxable in the shareholder's hands. This tightening up is achieved by applying the diversionary rules not only to certain direct sales, but also to certain indirect sales.

The amendments apply to tax years commencing on or after 1 January 2020.

Transfer pricing

The transfer pricing rules are contained in section 31 of the Act. These rules seek to ensure that arm's length prices are paid or charged when connected persons, (as defined) are dealing with each other cross-border, failing which it could result in an erosion of the South African tax base.

As stated, the rules only apply where the transacting parties are connected persons as defined in section 1 of the Act.

It has been decided to broaden the reach of section 31 by adding a further class of persons to which the transfer pricing rules will apply, and these are "associated enterprises" as defined in the Model OECD double tax agreement. This definition essentially refers to the situation where a company in one country participates directly or indirectly in the management, control or capital of a company in another country, or the same persons participate directly or indirectly in the management, control or capital of the enterprises of companies in both countries.

This amendment will only apply to tax years commencing on or after 1 January 2021. The purpose of the delay is to give SARS time to issue guidance on the effect of this amendment.

Withholding taxes

As readers will be aware, when a company distributes a dividend there is a 20% withholding tax, whether paid to a local or foreign shareholder, unless there is an exemption for a local shareholder (such as being another resident company) or, in the case of a foreign shareholder, there is a reduction in the rate under a relevant double tax agreement (DTA). Similarly, there are withholding taxes at the rate of 15% on interest and royalties paid to foreigners, which can also be reduced under a relevant DTA.

In order for the dividend to be exempt from the tax, or in order for the dividend, royalty or interest to be subject to the lower rate of tax under a DTA, it is necessary for the recipient to submit a prescribed declaration and undertaking to the payor stating that it is exempt or that it is a resident of the relevant foreign country and is entitled to the benefits under the relevant DTA, and undertaking to advise the payor should circumstances change.

This has always been a one-off declaration. The relevant legislation has now been amended to make it clear that these declarations and undertakings are no longer valid after five years, obviously therefore requiring them to be renewed.

The amendment comes into operation on 1 July 2020, thereby giving companies (and CSDPs) until then to obtain fresh declarations and undertakings.

There is an exception to the five-year limitation in the case of interest and dividends only (ie not in the case of royalties) if the relevant person making the payment is subject to the provisions of (a) the Financial Intelligence Centre Act, 2001 (b), the agreement between South Africa and the USA in relation to the implementation of FATCA, or (c) the regulations for the purposes of paragraph (a) of the definition of "international tax standard" in section 1 of the Tax Administration Act, 2011, with regard to the foreign person to or for whose benefit the

payment is made, and takes account of these provisions in monitoring the continued validity of the declaration. In such case, no renewal is necessary.

INDIVIDUAL TAX

Venture Capital Company

With effect from 21 July 2019 the extent of deductions obtainable by investing in venture capital companies will no longer be unlimited.

The deductions are now capped. These caps are:

- in the case of an individual or trust, R2.5 million; and
- in the case of a company, R5 million.

VAT

The most interesting amendment is that made to section 72 of the Value-Added Tax Act, 1991 (the VAT Act), the section under which SARS could issue a ruling in order to "overcome difficulties, anomalies or incongruities" arising out of the manner in which a vendor or class of vendors conducts business. In these circumstances SARS could give a ruling as to the manner in which the provisions of the VAT Act would be applied, or the calculation of the payment of VAT, or of any exemption contained in the VAT Act.

Believing that there are constitutional issues with the current wording of the section, it has been amended. An important requirement is now that not only must the specific vendor or class of vendors seeking the ruling find themselves burdened with the difficulty, anomaly or incongruity, but there must be similar difficulties, anomalies or incongruities that have arisen or may arise for any other vendor or class of vendors of the same kind or who make similar supplies of goods or services.

As before, any such decision must not have the effect of reducing on increasing the liability for tax levied under the VAT Act, but, in addition, the decision must also not be "contrary to the construct and policy intent of [the VAT] Act as a whole or any specific provision in [the VAT] Act".

The amendment is effective from 21 July 2019 and applies to all applications made on or after that date.

Any decisions made under section 72 in respect of an application made before that date will cease to be effective on or before 31 December 2021. The decision may be reconfirmed by SARS on application by the vendor, subject to certain conditions.



Ernest Mazansky

Director, Werksmans Tax (Proprietary) Limited

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