23 November 2020

To: The National Treasury
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The South African Revenue Service
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Via email: National Treasury (2020AnnexCProp@treasury.gov.za)
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RE: ANNEXURE C: CORPORATE TAX TECHNICAL WORK GROUP

We attached the Annexure C proposals from the SAIT Corporate Tax Technical Work Group as it pertains to Domestic Business Tax and related matters. We value the opportunity to participate in the legislative process and would welcome further engagement where appropriate.

Please do not hesitate to contact us should you need further information.

Yours sincerely,

SAIT Corporate Tax Technical Work Group

All references are to legislation are to the Income Tax Act, No. 58 of 1962, unless otherwise indicated.

1. DIVIDEND STRIPPING AS APPLIED TO CASH LIQUIDATING DISTRIBUTIONS

[Applicable provision: Section 22B and paragraph 43A of the Eighth Schedule]

1.1 Background

1.1.1 Section 22B and paragraph 43A of the Eighth Schedule are mainly designed to impose tax when a company seeks to disguise the sale of subsidiary shares via two-step schemes that either involve share buybacks or extraordinary dividends. In both schemes, the purchaser infuses cash into the target subsidiary. This cash obtained from the purchaser is routed back to the company seller via a share buyback or an extraordinary cash dividend.

1.1.2 Current law provides relief for dividends *in* specie that are part of either a section 47 liquidation or a section 46 unbundling distribution. Both forms of dividends are not problematic because both forms of distributions cannot be used as a disguised cash-out by the seller company. In the case of a section 47 liquidation, the seller controls 70 per cent or more of the subsidiary, and hence, a potential purchaser never obtains control of either the target subsidiary or the target subsidiary company assets.

1.2 Legal nature of the problem

1.2.1 <u>Problem #1</u>

1.2.1.1. There does not appear to be any policy justification for limiting the relief to *in specie* distributions in the case of liquidations (note that the *in specie* limitation can remain for unbundlings because unbundlings are always *in specie* distributions). The target subsidiary can never be indirectly purchased by a potential purchaser if the subsidiary will be liquidated with 70 per cent or more of the value of reverting to the seller.

1.2.1.2. The current exclusion of cash means that a liquidating subsidiary with excess cash cannot liquidate tax-free to a controlling parent company via section 47 even if no potential purchaser is present. Excess cash often arises if the liquidating subsidiary enters into a taxable sale of a large portion of its assets for cash prior to the liquidation. Excess cash liquidations especially arise when the controlling parent company is a holding company.

1.2.2 <u>Problem #2</u>

1.2.2.1. Section 47 does not appear to apply when all assets of the liquidating subsidiary are cash. Cash is simply not an “asset” under the company reorganisation rules. The net result is that the parent company will be taxed on the liquidating shares if the liquidating company has converted all assets to cash prior to liquidation. The end result can be a trap for the unwary.

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1.3 General recommendation

1.3.1 The proviso to the definition of "extra-ordinary dividend" should be extended under section 22B and paragraph 43A of the 8th Schedule to exclude cash dividends distributed by a company in anticipation of a liquidation or deregistration. Section 47 should also be clarified to cover liquidations involving a subsidiary whose sole assets are cash prior to the liquidation.

2. ANTI-AVOIDANCE RULES UNDER SECTION 8G ADVERSELY IMPACTING NORMAL FOREIGN INVESTMENT

[Applicable provision: Section 8G]

2.1 Background

2.1.1 Section 8G is designed to prevent the artificial creation (i.e. duplication) of CTC by foreign investors utilising a share contribution structure. More specifically, section 8G applies to transactions in terms of which:

- a company (the issuing company) issues shares to a non-resident company (the subscribing company) that forms, after the transaction, part of the same group of companies as the issuing company; and
- the consideration for those shares consists of or is used, directly or indirectly to acquire, shares in another company that is a resident company (the target company) that forms part of the same group of companies as the subscribing company.

2.1.2 In terms of section 8G(2), the amount of the CTC of the issuing company will not increase by the consideration given in return for the issue of shares, but will be determined with reference to the CTC of the target company. In effect, the rule is designed to prevent a foreign investor from making a non-section 42 contribution of shares to a South African company solely to bump-up CTC by the market value of the shares contributed (without tax because foreign investors are not generally subject to capital gains tax).

2.1.3 The problem is that section 8G has an adverse impact on a normal double dropdown of investment. For example, assume a foreign company invests R200 million by transferring this amount to a pre-existing South African holding company. The South African holding company then reinvests the same R200 million amount to purchase all of the remaining shares of a partially owned South African Operating Subsidiary. Assume the South African Operating Subsidiary was previously held 51 per cent by the South African holding company. The R200 million is used to acquire the remaining 49 per cent of South African Operating Company.

2.1.4 In the normal course, the CTC of the pre-existing South African company should be increased by the R200 million of cash contributed. However, the R200 cash contribution must be ignored because the foreign originated funding "is used, directly or indirectly to acquire" any shares in a South African company that already forms part of the same group. The CTC of the South African holding company is increased instead on a formula based on the pre-existing CTC of the South African target subsidiary.

2.2 General recommendation

2.2.1 The impact of the anti-avoidance of section 8G goes beyond the share-for-share cross-border abuse identified. Foreign cash investment into South Africa should be fully recognised as CTC. It is suggested that section 8G should either not apply to cash contributions or limited solely to share contributions.

3. INTEGRATION OF SHARE-VALUE MISMATCHES OF SECTION 24BA AND SECTION 42 ROLLOVERS

[Applicable provisions: Section 24BA, 40CA and 42]

3.1 Background

3.1.1 Section 24BA addresses value mismatches when assets are transferred to a company in exchange for shares. If the value of the asset transferred to the company exceeds the value of shares issued, capital gain arises. If the value of the shares exceeds the value of the asset transferred, dividend treatment arises.

3.1.2 Asset-for-share transfers to companies may be taxable or tax-free. The tax cost of assets received in a taxable transfer are covered under section 40CA. The tax cost of assets received in a tax-free rollover are covered under section 42.

3.1.3 The base cost of assets received in a taxable asst-for-share transaction are fully covered under section 40CA. If the value of the asset exceeds the shares, the capital gain charge is added to the base cost of the asset transferred to prevent double taxation of the same gain (section 40CA(a)(ii)).

3.1.4 However, if a similar value mismatch arises in terms of section 42 rollovers, no similar base cost adjustment exists. The rollover base cost of section 42 rollovers simply does not take into account any tax caused by section 24BA into account.

3.2 General recommendation

3.2.1 Any capital gain triggered as part of a section 24BA value mismatch in a section 42 rollover should be reflected in the tax cost of assets transferred. The base cost bump up should mirror the tax cost bump for taxable asset-for-share transfers in section 40CA.

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4. UNCERTAIN AUDITOR CERTIFIED RELIEF FROM HYBRID INTEREST RELIEF

[Applicable provisions: section 8F(3)(f)]

4.1 Background

4.1.1 Section 8F deems certain forms of interest to be a non-deductible dividend subject to a series of exclusions. One exclusion relates to auditor certification of subordinated debt. More specifically, section 8F(3)(f) envisages the exclusion of debt subject to subordination if a registered auditor has certified that "the payment, by a company, of an amount owed in respect of that instrument has been or is to be deferred by reason of the market value of the assets of that company being less than the amount of the liabilities of that company".

4.1.2 The current rule fails to properly account for the role of audits in the accounting system. The "market value" of assets is typically not included in the scope of an audit or review of a taxpayer's audited financial statements. The key for accounting is "fair value".

4.2 General recommendation

4.2.1 The connection of section 8F(3)(f) needs to be clarified. The term should best be referred to as accounting "fair value". Alternatively, the rules need to be more clearly linked to disclosures within Audited Financial Statements via an explicit legislative change or via interpretation.

5. SECTION 24I CURRENCY GAINS AND LOSSES FOR NON-TRADING COMPANY ACTIVITIES

[Applicable provision: Section 24I]

5.1 Background

5.1.1 In terms of section 24I, a company must fully take into account foreign currency exchange differences. Section 24I applies regardless of whether a company trades of otherwise.

5.1.2 At issue is the application of section 20. Section 24I itself would allow companies to deduct foreign company currency losses regardless of the trading requirement. However, section 24I contains no carryover loss provisions for excess loss while section 20 only allows for excess losses to be carried over if those losses stem from a trade.

5.1.3 The net result is that excess non-trading currency losses of a company cannot be carried over. This problem typically arises when the company at issue is a holding company containing non-trade cash or liquid assets. The result can be extremely unfair because the volatility of currency means that net currency income will often arise in one year, followed by a net currency loss in the next. Net currency income in a particular year will be fully taxed, but net currency losses will be discarded. In the end, the overall net currency amount over multiple years may result in a net loss, but tax may still arise due to the lack of loss carryovers. The purpose of the income tax act is to tax net economic income – not to selectively tax gains without taking into account corresponding net economic losses.

5.2 General recommendation

5.2.1 Carryovers of net section 24I losses should be allowed even if not part of trading income. This outcome can be achieved in a number of ways. One option would be to enact something similar to section 11A. Under this approach, non-trading currency losses should be carried forward, but ring-fenced against future currency gains.

6. BAD DEBTS ON FOREIGN CURRENCY LOANS

[Applicable provision: Section 24I]

6.1 Background

6.1.1 As a general matter, foreign currency gains and losses are taxed on a notional mark-to-market basis. The net result is that currency gains and losses are taken into account regardless of realization (e.g. actual disposal).

6.1.2 Currency changes for bad debts conversely require an actual realization. Section 24I(4) specifically readjusts the tax effect of foreign exchange gains and losses for credit interests in bad debts. Section 24I(4) allows for bad debts on foreign currency loans to be taken into account only to the extent of realisation, meaning an affirmative waiver or cancellation (much like section 19 or paragraph 12A of the 8th Schedule).

6.1.3 This realization requirement within an otherwise notional section 24I mark-to-market system is anomalous. This result is even more anomalous when one takes into account the bad debt rules of section 11(i). Under section 11(i), bad debts are potentially deductible under common law principles that are typically associated with an accounting write-off. Bad debts mostly do not require an affirmative waiver or cancellation.

6.1.4 We note that the common law bad debt write-off of section 11(i) largely matches the common law found in the various Commonwealth jurisdictions. Write-offs (full and doubtful) relate to practical collectability – not to legal waiver or cancellation.

6.2 General recommendation

6.2.1 The removal of mark-to-market principles for bad debts does not go far enough. As stated above, a bad debt often arises long before actual cancellation or waiver. Section 24I should apply the moment the debt becomes bad (e.g. is written off) in-line with the principles of section 11(i).

7. TECHNICAL OMISSION IN THE DEBT (INTEREST) CANCELLATION RULES OF SECTION 24J AND 19

[Applicable provision: Sections 19 and 24J]

7.1 Background

7.1.1 Section 24J is the primary provision within the Income Tax Act governing stated and implied interest on debt in terms of both the borrower and creditor. The rules fully take into account amounts arising on the "redemption" of a debt instrument. A "redemption" is defined as the discharging of <u>all liability</u> to pay all amounts in **terms** of the instrument.

7.1.2 Section 24J(4A)(b) takes into account adjusted gain, including an amount representing interest that the taxpayer has deducted during the current or previous year of assessment. However, this cancelled interest will only be taken into account as adjusted gain, <u>to the extent that the amount is not taken into account in terms of section 19</u>.

7.1.3 At issue is the impact of the group relief under section 19. Section 19(8)(e) specifically provides that section 19 must not apply to a debt benefit in respect of a debt owed to a company that forms part of the same "group of companies" (as defined in section 41) and the debt is reduced or settled, directly or indirectly, by means of shares issued. The net impact is that cancelled group debt will "not be taken into account", only to find that the cancelled interest owed will be taxed under section 24J(4A)(b).

7.2 General recommendation

7.2.1 It is proposed that section 24J(4A)(b) is amended to exclude amounts specifically exempt under section 19(e)(8). This change will ensure that amounts exempt under section 19(e)(8) will remain exempt under section 24J.

8. 2019 DENIAL OF ROLLOVER TREATMENT FOR SECTION 24J AND 24I

[Applicable provision: Sections 24I, 24J, and 41]

8.1 Background

8.1.1 The provisions of section 41(2) were amended in 2019 to deny rollover treatment for section 24I currency gains and losses as well as 24J gains and losses. The apparent theory for this denial is that section 24J "deemed interest" and section 24I currency gain and loss are akin to daily operating items. The transferor should be taxed on these amounts applicable to the period before the rollover, and the transferee should be taxed on the amounts applicable to the period after the rollover. Rollover treatment for many of these items also really only amounts to a small timing difference because the "deemed interest" and the currency gain / loss must be taken into account by the end of the year in any event. Under the revised approach, these amounts are calculated at the time of the rollover as well as year-end.

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8.1.2 While the above approach is largely true, the amendments made in 2019 are counterproductive, especially if the items would not normally be taken into account but for the rollover. For instance, under the revised approach, the corporate reorganisation now triggers an "adjusted gain / loss" event. This gain / loss event not only takes into account deemed interest but the valuation of the underlying loan capital (which could be impaired). The currency gain / loss resulting from the reorganisation also triggers gain / loss for long-term liabilities between groups (and connected persons) that would not otherwise be triggered.

8.1.3 In the both cases, this 'realisation' is not matched by actual cash flow that would be the case where payment of debt would normally arise. The charge instead falls on a non-cash where the transferor would typically receive only equity shares, thereby being forced to unnecessarily withdraw cash elsewhere to pay tax on the non-cash movement of debt caused by the reorganisation event

8.2 General recommendation

8.2.1 As stated above, we believe that the 2019 amendments went too far. Not all section 24J and 24I instruments should fall outside reorganisation relief.

8.2.2 In terms of section 24I, the reorganisation should be viewed as a deemed year-end for the transferor without triggering adjusted gain / loss on transfer. In other words, section 24J should trigger a deemed interest charge at the point of the reorganisation solely for imputed interest without regard to the value of any changes in the value of the underlying loan capital. In terms of currency items, the provisions of section 41 should allow for the tax-free transfer of instruments between a transferor and transferee where the transferee themselves would qualify for the application of section 24I(10A) or (7) of the ITA after the transaction.

8.2.3 It is important that this more limited rollover relief should apply to both gains and losses (without cherry-picking). Hence, rollover relief can protect the fiscus against artificial losses (as well as protecting taxpayers against artificial gains).

8.2.4 It should be borne in mind that the limited 24J and 24I items discussed can be quite substantial. Without this relief, the tax cost can be prohibitive, thereby rendering certain business-driven reorganisations as non-viable from 2019 when such reorganisations could safely proceed before.

<u>End</u>

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