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National Treasury

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For attention: Jeanne Viljoen

Dear Madam/ Sir

INVITATION TO COMMENT: DRAFT TAXATION LAWS AMENDMENT BILL, 2008, EXPLANTORY MEMORANDUM AND MEDIA STATEMENTS

1 We refer to the above matter as well as the Draft Taxation Laws Amendment Bill, 2008 released for public comment on 20 February 2008.

2 The prelude to the Draft Taxation Laws Amendment Bill, 2008 invites members of the public to provide comments to National Treasury and the Parliamentary Committee on Finance on the amendments proposed in the Bill.

3 In response to the invitation above, we hereby provide you with our comments to the Draft Taxation Laws Amendment Bill, 2008 and the Explanatory Memorandum and media statements thereto.

4 All references to 'section' and 'paragraph' in this document refers to sections in Income Tax Act 58 of 1962 ('the Act') and to paragraphs in the Eighth Schedule to the Act, unless specifically indicated otherwise.

Clause 26 – amendment to section 45 intra-group relief provisions

Proposed amendment

5 The first proposed amendment to section 45 is to limit the roll-over relief provided by section 45 to instances where assets are transferred for:

5.1 no consideration; or

5.2 against the issue of a debt instrument.

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6 It is therefore proposed that the transfer of assets for cash consideration, which are currently within the scope of the relief in section 45, be excluded.

7 It is further proposed that section 45 dealing with intra-group transactions be amended to provide as follows:

> *"(3A) If a transferor company disposes of an asset to a transferee company in terms of an intra-group transaction in exchange for the issue of a debt instrument, the transferor company is deemed to have acquired the debt instrument for a cost equal to the lesser of-*
>
> *(a) the market value of the asset at the time of the disposal; or*
>
> *(b) (i) if the asset disposed of is a capital asset, any expenditure in respect of the asset incurred by the transferor company that is allowable in terms of paragraph 20 of the Eighth Schedule and to have incurred that cost at the date of incurral by the transferor company of the expenditure; or*
>
> *(ii) if the asset is so disposed of as trading stock, the amount taken into account in respect of the asset in terms of section 11(a) or 22(1) or (2),*
>
> *which cost must be, if the debt instrument is acquired as-*
>
> *(aa) a capital asset, be treated as expenditure actually incurred and paid by the transferor company in respect of the debt instrument for purposes of paragraph 20 of the Eighth Schedule; and*
>
> *(bb) trading stock, be treated as the amount taken into account by the transferor company in respect of the debt instrument for purposes of section 11(a) or 22(1) or (2)."*

Comments

8 The reason for the proposed amendment to the section 45 intra-group relief provisions is stated in a Media Statement dated 21 February 2008 relating to the Taxation Laws amendment Bills, 2008 ('the Media Statement').

9 In terms of the Media Statement, section 45 has in the past been used by taxpayers to artificially cash-out subsidiary operations (i.e. sell shares in subsidiary companies) wholly free from tax. The Media Statement further provides that section 45 was

never intended to apply in respect of this cashing-out, it was merely intended to allow for the deferral of gain/ loss when assets are moved within a single group.

10 Whilst we appreciate that there may well be circumstances where the provisions of section 45 is applied in situations which it was not intended for (as indicated in the Media Statement), we are concerned that the effects of the proposed amendments to section 45 may be far-reaching and consequently lead to unintended results. Our concern is that the proposed amendments will also curb legitimate intra-group business transactions where section 45 is used, thereby undermining the effectiveness of section 45. We elaborate on this in more detail below.

11 In the first instance, there is in our opinion no rationale for excluding intra-group purchases settled in cash from the relief provided in section 45, particularly where a group company merely sells an asset to another group company for a cash consideration and where there is no change in the shareholding of such companies. This clearly illustrate the fact that the proposed amendments to section 45 will result in unintended consequences in that it will disallow relief for completely commercial and common intra-group transfers.

12 Effectively, the roll-over relief in section 45 is denied for the above transactions, thus triggering a tax cost for intra-group transfers and negating a relief explicitly provided for in the legislation, by reference to a wholly commercial and normal transaction which is not intended to avoid tax. For example, in the instance where a group company sells an asset (carrying an inherent gain) to a fellow-subsidiary for cash and for entirely commercial reasons, such disposal will trigger an immediate capital gain for the selling company, as section 45 relief will be denied as a result of it being a cash transaction. Such capital gain will be realised notwithstanding that the group have not made a commercial gain as the asset still resides within the group. This is clearly against the whole purpose and tenor of section 45 which was inserted specifically to prevent such a result.

13 Secondly, the effect of the proposed section 45(3A) is that where a debt instrument is issued in exchange for assets transferred in terms of section 45, the base cost of the instrument for the seller of the assets is in effect limited to the base cost of the assets transferred. Consequently, even the repayment of the loan by the transferee company in the normal course could trigger an additional taxable gain which could not have been intended. This will especially be the case where the market value of the asset transferred in terms of section 45 increased over time (i.e. in respect of an asset carrying an inherent gain). This is because there will in such instance be a difference between the face value of the loan (representing the market value of the assets) and the base cost of the loan (which will now in terms of section 45(3A) be equal to the base cost of the assets), thus creating a capital gain for CGT purposes.

14 The above will furthermore result in double taxation for the companies in the group. Consider the following example: Subsidiary 1 and Subsidiary 2 forms part of the same group of companies. Subsidiary 1 disposes of an asset (i.e. an inherent gain asset) on loan account to Subsidiary 2 and elects that section 45 intra-group relief applies (so that no immediate capital gain is triggered). In terms of the existing section 45, Subsidiary 2 will assume the base cost of the asset from Subsidiary 1 so that when Subsidiary 2 eventually disposes of the asset outside the group, a capital gain will be triggered in its hands (which is the normal result in terms of the current section 45 provisions). However, in terms of the proposed amendments to section 45, Subsidiary 1 will have a base for the loan account equal to the base cost of the assets transferred (meaning that the base cost of the loan will be lower than the face value thereof). Consequently, when Subsidiary 2 repays the loan to Subsidiary 1, Subsidiary 1 will realize a capital gain on which it must pay tax. Consequently, the group is taxed twice in respect of a single economic gain or benefit. We submit that this could not have been the intention of the legislature.

15 In certain circumstances, the above double taxation issue could be mitigated, for example where the asset is disposed of at base cost within the group. However, commercial considerations will not always allow for such a sale. The sale of an asset from one group company to another could for example detrimentally affect the position of minorities holding an interest in the disposing group company.

16 As mentioned above, the new proposed amendments to section 45 could have far reaching implications and negatively affect a number of legitimate business transactions which has no avoidance element whatsoever, including black economic empowerment ('BEE') transactions, securitisations, cash settled intra-group transactions, leveraged transactions etc.

17 By way of an example, BEE deals, where funding is hard to obtain, are typically structured using the roll-over relief provisions of section 45 as follows: Holdco, holding all the shares in Subco, establishes a new company (Newco) at nominal value of which it holds 80% interest and the BEE participants holds 20% interest. The business of Subco is then sold to Newco using section 45 relief.

18 The purpose of the above type of transaction is entirely commercially motivated and there is not tax avoidance element. Commercial advantages of structuring a BEE deal in this manner includes providing BEE investors with a platform of entering into the transaction at little or no cost and thereby solving difficulties for them in obtaining funding, affording BEE participants the opportunity to participate in a Newco and be protected from historical liabilities etc. The above structure is also commonly used where there are minimal or no alternatives available for funding

sustainable empowerment, particularly in the instance of broad based economic empowerment.

19 Another example of transactions which could be negatively influenced by the proposed amendments is securitisation transactions where a group would transfer a certain class of assets (for example properties) into a ring-fenced vehicle in terms of section 45 which vehicle is then used as collateral to acquire cheaper rates of funding based on credit risk. The transaction is concluded for purely commercial results, i.e. to obtain cheaper funding. Furthermore, there is no 'cash-out' which the proposed changes are targeting as the group retains ownership of the underlying assets used to obtain the cheaper funding.

20 Consequently, it is submitted that there is no reason why roll-over relief in terms of section 45 should be denied in the current instance (where the assets are transferred for cash) or why the transaction should trigger an additional tax charge on the repayment of the loan (where the assets are transferred on loan account), yet this is exactly the result of the new proposed legislation.

21 In the instance where a group company has cash to acquire an asset from another group company it may in our opinion correctly be asked why, in order to qualify for the tax relief, should it be forced to issue a debt instrument it does not require. To issue a debt instrument with the intention of immediately repaying it would be absurd and would in any event result in double tax in respect of a single economic benefit (as illustrated above).

Conclusion and request

22 The proposals made in respect of section 45 will clearly result in adverse and far reaching tax consequences for taxpayers.

23 In particular, the concern is that the proposals will lead to double taxation and also exclude legitimate business transactions from the ambit of section 45 thereby denying relief to such transactions. The proposed section 45(3A) is also undesirable in that it applies not only where there is a cashing-out or de-grouping but in all instances where a debt instrument is issued.

24 We submit that the definition of intra-group transaction as currently stands should be left unchanged, i.e. covering also cash transactions.

25 Whilst we accept the need for an anti-avoidance measure, we submit that the measure should satisfy the following requirements:

25.1 It should apply in instances of both cash and debt instruments and only in cases where an actual tax free cashing out would otherwise result;

26 It should only apply for the same six year period as the de-grouping charge;

27 Provision should be made for an adequate base cost for the loan (created with the intra-group transfer) so that no capital gain is triggered on repayment of the loan.

28 In view of the above, we kindly request that:

28.1 The proposed amendments to section 45 be reconsidered in view of the comments and submissions above as it would not be in line with the purposes and spirit of the intra-group relief provisions in section 45;

28.2 Also, given the extent of the implications of the new and proposed amendments to section 45, and whilst we appreciate the need for anti-avoidance provisions to be included as early as possible, we request that in order to have an adequate consultation period the effective date for the proposed changes be deferred.

We trust that the above comments will add value to the legislative process.

Kind regards

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