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South Afri Inst. Tax Payers  
[SATA. Notes on]

**Proposed suspension of section 45 of the Income Tax Act 58 of 1962: Clause 75(b) of the Draft Taxation Laws Amendment Bill**

**Introduction**

In terms of the Explanatory Memorandum to the Draft Taxation Laws Amendment Bill ("the Explanatory Memorandum") read with the National Treasury Media Statement dated 2 June 2011 ("the Media Statement"), the suspension of section 45 for a period of 18 months was driven *inter alia* by the use of the intra-group relief provisions to facilitate leveraged buy-outs, many of which are perceived to involve excessive levels of debt. These levels of debt appear to be a concern from both a commercial perspective, leaving the companies vulnerable to economic downturns as well as in terms of the potential to erode the South African tax base where the resultant interest payments are made to exempt parties.

Whilst the above concerns may be warranted, we submit that the total suspension of the section will jeopardise legitimate transactions which do not display the above characteristics. One such transaction (the details of which are set out below) forms the specific subject matter of this letter.

**Purpose of this letter and summary of request**

The purpose of this letter is to highlight the salient features of the transaction in support of the fact, for the reasons set out below, that:

- the utilization of section 45 in this transaction was not done with the view of abusing or misusing the provisions of section 45; and
- this transaction does not display the characteristics as set out in the Explanatory Memorandum read with the Media Statement.

Therefore, the parties will proceed to close and implement the transaction on 30 June 2011 (as originally planned) on the basis that the provisions of section 45 will apply to the transaction, i.e. on the basis of applying the tax legislation as it currently reads.

Accordingly, for the reasons set out below, we request assurance that:

- the provisions of section 45 of the Act, as it currently reads, will apply to this transaction;

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- if section 45 of the Act is amended, it will only exclude the application thereof to transactions that display the characteristics as set out in the Explanatory Memorandum read with the Media Statement and accordingly as this transaction does not display such characteristics, the parties to the transaction will qualify for the tax roll-over relief provided for in section 45 of the Act; and
  - any amendment to section 45 of the Act will not be promulgated (once approved by Parliament) with retroactive effect.

#### **Background**

You may be aware from the various press releases in this regard that Mr X ("MrX") in conjunction with the S group of companies ("the Group") (referred to herein as "the Purchasers") have entered into agreements to acquire the shares in Company A South Africa (Pty) Ltd ("the Transaction"). The process in relation to the Transaction essentially started 21 months ago with the issue of the Information Memorandum dated 18 September 2009 ("the IM") issued by Company A's Holding company in the United States of America ("Company M" or "the Seller") to prospective developmental licensees. This document was key not only in starting the ball rolling on the transaction but also in terms of influencing the ultimate structure of the Transaction as it stipulated categorically that whereas MrX and the Group wished only to acquire the business operations, Company M was only prepared to sell the share capital of Company A South Africa (Pty) Ltd ("TargetCo") on a cash only basis. In addition to the provisions of the IM, initial communications from the Seller indicated that no warranties at all would be provided by the Seller in relation to TargetCo. The acquisition of the shares in TargetCo by the Purchasers on a stand-alone basis would therefore have left the Purchasers exposed to the historical potential risks associated with the business for an indefinite period.

#### **The Transaction Mechanism**

In order to limit its exposure in respect of the historical activities of TargetCo and to satisfy the security requirements of the banks for funding the acquisition, the transaction was structured on the basis that the acquisition of the shares and settlement of the loan claim owing by TargetCo would be followed by an immediate restructuring of the operations of TargetCo.

In terms of the proposed restructure of the operations of TargetCo post acquisition, the restructure mechanism will ensure, *inter alia*:

- The successful transfer of the business of TargetCo into a newly established company to ensure that any historical risks associated with TargetCo are not carried forward with the business of TargetCo acquired by the Purchasers;

Should the Transaction proceed as planned, the Purchasers are faced with having to fund an unanticipated tax liability (i.e. income tax and capital gains tax arising from the sale of the business in the absence of the roll-over relief of section 45 applying to the sale of business of TargetCo to OpCo). Both such an unanticipated tax liability and the concomitant delay in closing the Transaction will (a) fundamentally negatively impact the return on investment projected and the capital expenditure and cost requirements projected by the Group and MrX and by implication therefore also negatively impact Black Economic Empowerment and (b) negatively affect and delay the expansion of the Company M South Africa operations (which the Group and MrX are obliged to effect in terms of the provisions of the Master Franchise Agreement) which in turn has negative effects on both employment and economic growth within South Africa. In this regard it is important to note that as part of the Agreement, MrX and the Group have committed to building and developing more than 100 additional stores over the next 5 years, with each store creating at least 50 additional new jobs at store level. Both the delay and the potentially unanticipated tax burden will jeopardize this employment creation opportunity.

If the transaction is restructured it will result in further delays in the implementation and as a consequence, result in the following, amongst other things:

- Loss of profits which could have been earned by the Purchasers;
- Significant costs and delay in redrafting agreements;
- The prospect of having to apply anew to the Competition Commission for approval and to the SARB for exchange control approval, which will entail additional cost and delay in closing the Transaction;
- As s the transaction documents contemplate that the Purchasers is obliged to carry all capital expenditure from 1 January 2011 onwards without receiving the benefit of the cash flows and profits generated by the business , very significant adverse impact on the purchase price which will be detrimental to the Purchasers, key Suppliers and Landlords;
- Uncertainty to the employees of the Company M South Africa operations, who have already received communications as to the imminent change of ownership, which has now had to be suspended.

**Request**

We believe that in light of the fact that the Transaction was not seeking to abuse or misuse the provisions of section 45 the total suspension of the section is unfairly prejudicial to the Purchasers. This prejudice is exacerbated by immediate retroactive effective date of the amendment to section 45.

Therefore, the parties will proceed to close and implement the transaction on 30 June 2011 (as originally planned) on the basis that the provisions of section 45 will apply to the transaction, i.e. on the basis of applying the tax legislation, as it currently reads.

We, therefore, request that:

- 1) The effective date of the amendment of section 45 of the Act should be some reasonable future date to enable the Transaction to be concluded on the basis it was originally structured;
- 2) The provisions of section 45 should merely be amended to exclude the specific transactions which are of concern i.e. transactions where any associated debt will be in excess of a specific percentage or any associated debt gives rise to interest payable to a non-resident or exempt entity; and
- 3) This transaction does not display the above characteristics, and as such the parties to the transaction will qualify for the tax roll-over relief provided for in section 45 of the Act when the Transaction is closed and implemented on 30 June 2011.

Yours sincerely

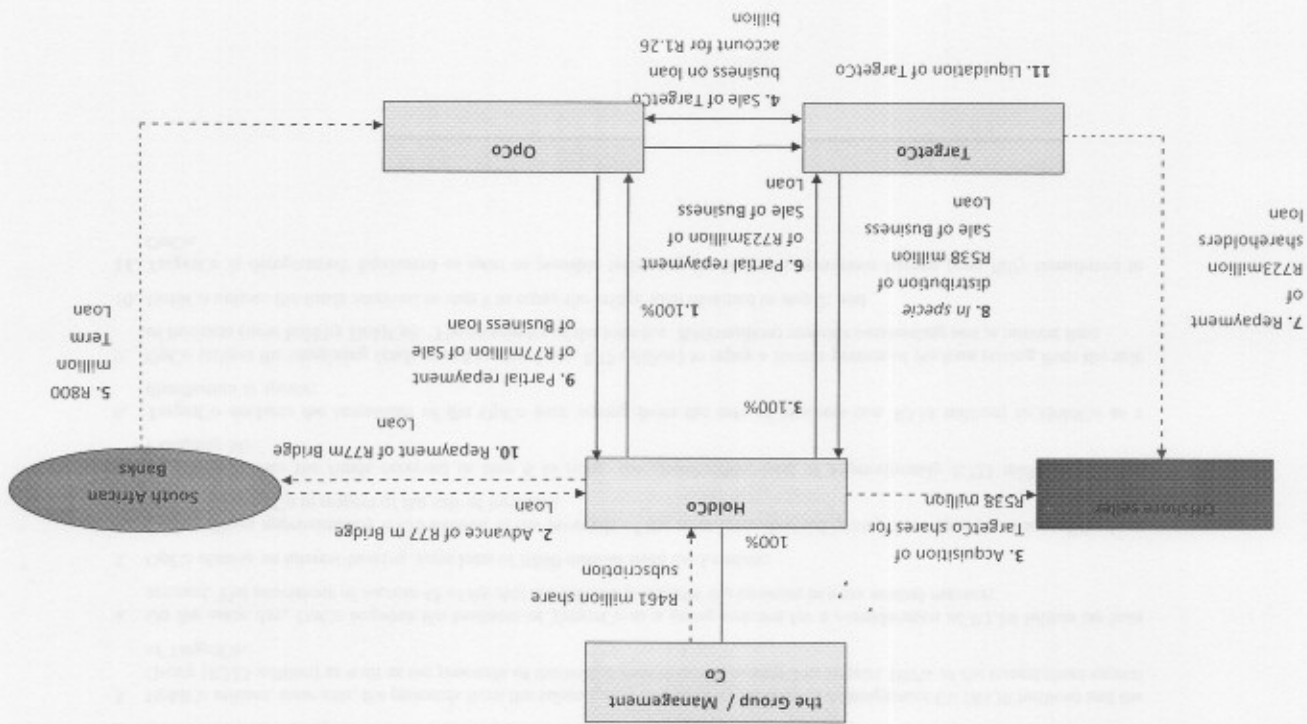
MrX

Chairman of the Group (Pty) Ltd

Developmental Licensee in respect of the Company M South Africa business

ANNEXURE A

Diagrammatic presentation of transaction structure



#### Transaction Steps

1. HoldCo incorporates a wholly owned subsidiary, OpCo;
2. HoldCo obtains a bridge loan of R77 million from the Lenders (i.e. South African banks);
3. HoldCo utilises, *inter alia*, the proceeds from the subscription of shares by Restaurant Management Co (R138 million) and the Group (R323 million) as well as the proceeds of the bridge loan obtained in step 2 to acquire 100% of the issued share capital of TargetCo.
4. On the same day, OpCo acquires the business of TargetCo as a going concern for a consideration of R1.26 billion on loan account. The provisions of section 45 of the Act are utilised to transfer the business in a tax neutral manner;
5. OpCo obtains an interest-bearing term loan of R800 million from the Lenders;
6. OpCo utilises approximately R723 million of the proceeds of the term loan obtained in step 5 to repay a portion of the loan owing to TargetCo in respect of the sale of business;
7. TargetCo utilises the funds received in step 6 to repay the shareholders loan of approximately R723 million owing to Company M;
8. TargetCo declares the remainder of the OpCo loan arising from the sale of business (i.e. R538 million) to HoldCo as a distribution *in specie*;
9. OpCo utilises the remaining funds raised in step 5 (i.e. R77 million) to repay a further portion of the loan arising from the sale of business (now held by HoldCo). The remainder of the loan (i.e. R460million) remains outstanding and is interest free;
10. HoldCo utilises the funds received in step 9 to repay the bridge loan obtained in step 2; and
11. TargetCo is deregistered/ liquidated as soon as possible following the business operations having been fully transferred to OpCo.