THE TAX TREATMENT OF DEBT AND EQUITY IN LEVERAGE FINANCE TRANSACTIONS

By

Joseph Rydell Tettey

Student number 0200906n

Supervisor: Roy Blumenthal

Presented to the School of Accountancy

University of the Witwatersrand, Johannesburg

This research report is submitted to the faculty of Commerce, Law and Management in partial fulfilment of the requirements for the Degree of

Master of Commerce (specialising in Taxation)

Date: 31 March 2016

Contact detailed:

e-mail address	josephrydelltettey@gmail.com
	joseph.tettey@rmb.co.za
Cell number	083 632 5656

Abstract

This research focuses on large corporate transactions and acknowledges that they play a significant role in the allocation of resources in society. For this reason (1) the composition of firms' capital structure and (2) how they choose to fund their investments are important.

The South African income tax system has a bias towards debt and this bias (1) distorts the financing and investment decisions of firms; and (2) creates international tax arbitrage opportunities. These circumstances are not exclusive to South Africa. In order to address these distortions and loopholes the National Treasury and the SARS Commissioner have introduced complicated interest deduction limitations.

This research critically analyses (1) the new adjusted tax rules concerning interest deduction limitations in finance transactions and (2) whether these new rules encourage investment. To assist with this critical analysis we use corporate finance theory to examine debt push-down transactions/structures because these structures are seen as highly tax-efficient for investors (both foreign and local).

This research demonstrates that there are many different ways to finance a transaction but ultimately the choice of finance lies along the continuum between the issue of debt or equity. From an economic perspective this research confirms that there is no material reason for the disparate treatment between debt and equity. However from a legal perspective debt and equity instruments are materially distinct and thus tax considerations are influential in selecting the form of finance used in a transaction.

This research not only concludes that leverage transactions utilising excessive debt pose a risk to tax revenues, tax sovereignty and tax fairness but also that the artificial statutory treatment of interest deductions on leverage transactions and working capital facilities means that (1) firms' ability to finance their operations is reduced, (2) the value of firms is reduced and (3) the incentive for investors to invest in South Africa is also reduced.

Keywords: *Income Tax Act; Tax-Efficient Structures; Leverage Finance; Tax Shields; Investors; Economic Distortions; Corporate Finance Theory; Tax Arbitrage; Tax Avoidance Schemes; Hybrid Instruments; Financing and Investment Decisions; Capital Neutrality; Interest Limitation Rules; Debt Push-Down Structure; Deductibility of Interest Expenditure; Capital Gains Tax; Corporate 'rollover relief' Rules; Debt Crisis; the Great Recession; General Anti-Avoidance Rules; Simulated Transaction; Tax Sovereignty; Tax Fairness.*

Acknowledgement

I would like to extend a special thanks to Katie Savage for her encouragement and support.

I also am grateful for all the encouragement I received from my colleagues at FirstRand Bank Limited, especially those in Rand Merchant Bank.

Finally, I acknowledge my supervisor, my family, all my friends and fellow students.

Dedication

Miller and Modigliani's seminal works recognised and highlighted to the world that the differential tax treatment of debt and equity meant that corporate financial policy did matter. Their belief that theory should be "grounded" in reality, allowed them and financial economists to recognise that neo classical theory, which was "ungrounded" in reality, had led them astray. This recognition allowed space for the development of economic theory that was grounded in the realities of (1) imperfect and asymmetric information and (2) the possibilities of bankruptcy. This development allowed financial economists to better understand the real determinants of investment behaviour. This work is dedicated to better understanding investment behaviour.

Declaration on plagiarism

I, Joseph Tettey, student number 0200906n, registered for a Master of Commerce (Taxation) in the year 2016, do hereby declare the following:

I confirm that the work I will submit for all assessment for the above course is my own unaided work. I have followed the required conventions in referencing the thoughts and ideas of others. I am aware of the correct method for referencing material.

I am aware that plagiarism (the use of someone else's work without their permission and/or without acknowledging the original source) is wrong. I understand that the University of the Witwatersrand may take disciplinary action against me if there is a belief that this is not my own unaided work or that I have failed to correctly acknowledge the source of the ideas or words in my writing.

Signature: _____ Date: 31 March 2016

(Assumed to be signed if submitted electronically)

Contents

THE TAX TREATMENT OF DEBT AND EQUITY IN LEVERAGE FINANCE TRANSACTIONS i
Section 1: Introduction 1
Background to the Study 3
Problem Statement 6
Research Questions 6
Research Methodology 7
Section 2: Corporate Finance Theory 8
Introduction 8
The bias towards debt 8
Rationale for the debt bias 9
Distortions associated with the debt bias 10
Distortion of the financing decision 10
Hybrid mismatch arrangements 12
Neutrality 14
Domestic tax neutrality 15
Neutrality towards financing decisions 16
Neutrality towards investment decisions 16
Neutrality towards the choice of a legal form 17
International tax neutrality 18
Capital Export Neutrality 18
Capital Import Neutrality 19
Conclusion 19
Section 3: South African Corporate Taxation 20
Introduction 20
Deductibility of interest expenditure 20
Historical Government Intervention and Reforms 22
Common Law 33
'In the production of income' 33
'not of a capital nature' 36

The area of contention 37
Tax efficient arrangements 38
Debt Push Down structures 39
Corporate Rules 41
Introduction 41
Key Definitions 41
Tax relief explained 42
Section 41 -47 of the ITA 44
Hybrid arrangements and the Interest Limitation Rules 58
Conclusion 70
Section 4: Analysis 71
Introduction 71
Legal Analysis 74
Tax avoidance 74
Tax benefit 75
Tainted elements 75
Lack of commercial substance 76
Conclusion on the GAAR 78
Simulated transaction analysis 78
Commercial Analysis 81
Opportunities to shift and decrease reported profit 81
Tax arbitrage 82
Conclusion 83
Section 5 Conclusion 86
Bibliography 89

Section 1: Introduction

Structuring transactions is an important part of commerce. Well-structured transactions, where the fundamental economics of the transaction are the deciding factors, allow firms to grow, optimise their profit and loss and balance sheet objectives and ultimately contribute to the efficiency of the economy.

Irrespective of the economic fundamentals of an acquisition finance transaction, these fundamentals do not immediately translate to profitable businesses and this is why the Income Tax Act No 58 of 1962 (the ITA) may allow certain deductions or the postponement of tax consequences until a true economic profit is made.

There are number of other considerations when parties structure these types of leverage finance transactions. Ultimately these considerations differ according to the type of investor. Traditionally, leverage finance distinguishes between operational and financial investors.

Operational investors typically are concerned with the creation of value by improving the actual business operations, whereas financial investors look to create value by innovative financial solutions. This distinction between investors must be seen as opposite ends of a continuum upon which all investors fall.

In any acquisition transaction, the first consideration undertaken by investors or deal-makers is the choice between equity financing and debt financing; this choice will in most cases have tax implications and consequences for the value of the firm and profitability of the transaction. Modigliani and Miller (1963) hypothesized that the tax benefits of debt increase firm value and decrease the cost of using debt capital[1]. The tax treatment of debt financing creates a tax shield because interest on debt is a tax-deductible expense that, as a corollary, reduces the firm's taxable income. This treatment of debt capital increases the value of the firm and incentivises investors to

[1] F. Modigliani, M. Miller 'Corporate income taxes and the cost of capital: a correction' (1963) 53 *American Economic Review* 433–443.

optimise the use of debt and equity in the capital structure of firms involved in a transaction.

There are many theories regarding the effect of capital structure on the value, size and profitability of a firm of which investors or deal-makers need to be cognizant.

The trade-off theory provides that profitable firms will use more debt financing so as to take advantage of the tax shield it offers. Trade-off theory holds that where a firm utilises equity financing solely, only shareholders and the tax authorities have claims on the firm. Thus the shareholders own the value of the firm and taxes are merely a cost. The value of a firm utilising debt financing has an additional claimant to those noted above, these being shareholders, debt holders and the tax authorities. Thus the value of such a firm is the value of equity plus the value of the debt. In this scenario the value of the firm is enhanced with the structure paying the least amount of tax to the tax authorities.

In South Africa, using debt financing instead of equity results in an advantageous tax position, since the interest is deductible in the case of debt and not in the case of equity. If the tax implication of a transaction was the only consideration for investors, the broad effect would be that company investments or deals would be financed with large amounts of debt relative to equity; resulting in what is referred to as thin capitalisation.

Owing to the different treatment of debt and equity, it is tempting to disguise equity instruments as debt instruments, especially in cross-border transactions. Where a South African company is to be acquired by a foreign firm located in a country with a relatively lower corporate tax rate, the deducted interest expense will be worth more in the South African company since the implicated tax deduction will be higher. It is thus tempting for foreign investors to fund the South African company using large amounts of debt. This structure allows untaxed profits of the South African company to be distributed to the foreign parent company in the form of interest payments instead of

dividends. The result would be that the tax burden of the group becomes lower and that the South African company would appear to be a more favourable investment. The obvious risk from this type of structure is that the tax authority's tax base is eroded.

This research reviews certain leverage transactions, where investors take on additional financial risk and increase the expected return on investment. This outcome is achievable through funding such transactions with excessive amounts of debt: the key to creating value in these types of investments is through understanding the tax consequences each party attracts and structuring the investment accordingly. This highlights that tax planning is a key issue in leverage finance and that these considerations inform the structure of a transaction.

Each party to a leverage transaction is motivated to maximise his position in respect of each other. One consideration in this game is the minimisation of the amount of tax a party is liable to pay to the Commissioner for the South African Revenue Service (the Commissioner). One method to achieve this goal is by structuring the transaction using a special purpose investment vehicle that allows the parties to take advantage of the intra-group tax neutral provisions in the corporate rules.

The above method is complicated when it comes to cross-border transactions in that a conflict of interest rises between (1) the Commissioner's interest in taxing corporate taxpayers' profits and (2) the investors' goal to minimise costs and maximise value in a group company setting. Profits may be transferred from one group company to another by means of setting pricing on goods and services below or above market value.

Background to the Study

Mergers can be described from a legal and an economic perspective. This distinction is relevant to considerations vis-à-vis deal structuring, regulatory issues and strategic planning. An important, but not determinative, consideration in almost all merger or

acquisition transactions is the tax benefits accruing to the parties. The tax consideration in such transactions fluctuates depending on the form of transaction and the nature of firms involved therein.

There are various formulations for structuring transactions to achieve the parties' objectives, but in order to ensure a tax-efficient structure, sound knowledge of corporate finance, economics, company law, contract law and taxation is needed. Irrespective of the economic fundamentals of an acquisition or merger, the transactions do not necessarily and instantaneously translate to profitable businesses and it is for this reason that the ITA allows for tax rollover relief in respect of mergers and acquisitions. This regime allows for the postponement of the tax consequences until the resultant firms achieve a true economic profit.

Determining how to fund a leverage finance transaction is absolutely vital. There are two ways to do this: the first is through the use of equity, retained profits or informal capital contributions; and the second is through the use of debt. The standard Modigliani-Miller theorem states that in an efficient market a company should be indifferent between regarding two sources of financing, under the assumption that there are no taxes, no asymmetric information and no bankruptcy and agency costs. In reality we do not live in a world with efficient markets; in our world we are faced with the realty of asymmetric information, the existence of bankruptcy and agency cost as well as taxes.

Our tax system makes a distinction between the tax treatments of equity and debt. Interest on debt is deductible as a business expense, whilst returns on equity such a dividends are not. This discrimination between equity and debt creates a bias towards debt finance both locally and internationally. Thus in a leverage transaction, whether local or cross-border, participants are incentivised to use high levels of debt in order to receive a large interest deduction, which in turn reduces a company's taxable income.

A fundamental distinction must be made between foreign and local investors. A foreign

investor, who through a structured deal holds shares in a subsidiary company, is subject to corporate income tax on the company's profits, whereas a foreign investor, who provides a loan to the subsidiary, is exempt from corporate tax since the interest is in principle deductible at the level of the source country. In terms of the allocation of taxing rights, the return on equity is therefore effectively taxed in the source country and the return on debt is effectively taxed in the residence country.

This debt equity distinction may also be enhanced due to the imposition of withholding taxes. In addition to the corporate income taxation, foreign investors who own shares in a subsidiary are also subject to a withholding tax on distributed profits[2] (provided that the withholding tax is not exempted by a prevailing tax treaty) and therefore face a double tax burden.

A foreign investor who provides a loan to a subsidiary, however, may only face a withholding tax on interest[3], but many countries—on a unilateral or bilateral basis—have largely abolished such a withholding tax.

Each party to a structured transaction is motivated to maximise his position in respect of each other. One of the considerations in this game is the minimisation of the amount of tax he is liable to pay to the Commissioner. The desire to minimise one's tax liability is a legitimate one. Every taxpayer has a legitimate right to arrange his affairs in such as manner so as to pay the least amount of tax. The obligation to pay taxes is one that is derived from statute and not nature. To this end the legislature has enacted anti-avoidance provisions limiting the practice of 'tax avoidance' for the benefit of the whole.

[2] S 64E of the ITA levies a dividends tax at the rate of 15 percent of the amount of any dividend paid by any company other than a headquarter company. Dividends tax is only a withholding tax where cash dividends are paid. It is also levied on foreign dividends, which constitute cash dividends, if the shares in respect of which those dividends are paid are listed on the JSE Limited. The dividends tax is a final tax.

[3] The withholding tax on interest is levied at the rate of 15 percent in terms of s 50B of the ITA on any interest that is paid by any person to or for the benefit of any foreign person to the extent that the amount is sourced in South Africa. S 9(2)(b) of the ITA determines when interest will be deemed to be sourced in South Africa.

Problem Statement

The purpose of this research is to analyse critically the tax rules concerning finance transactions where large amounts of debt are involved and whether these rules encourage such investments. To assist with this critical analysis we will examine debt push-down transactions because this type of structure is seen as a highly tax-efficient method for investors (both foreign and local).

The key component of the debt push-down structure is the intra-group rollover provisions contemplated in terms of Part IIA of the ITA. Any analysis of the corporate 'rollover relief' provision necessitates an analysis of the general tax consequences each party attracts under each structure as well as the General Anti-Avoidance Rules.

Research Questions

Corporate transactions have a positive and negative role in our society. They play a significant role in the allocation of resources in society. How firms choose to fund their investments is important. The disparate treatment of debt and equity in our income tax system results in distortions in the allocation of resources.

The questions this research will address are:

1. Whether there is a debt bias in our income tax system;
2. Does the difference in tax treatment between debt financing and equity generate economic distortions and is it responsible for tax avoidance schemes?
3. How can the concept of tax neutrality towards a firm's (a) financing decisions and (b) investment decisions assist in eliminating the distortions generated in our current tax system?
4. What reforms have been implemented to reduce the effectives of these distortions on economic decisions of firms? We will use the debt push-down structure to demonstrate these distortions and incentives; and
5. The last question is: what harm does the difference in tax treatment between debt financing and equity inflict on society.

The purpose of this research is not to study debt push-down structures from a corporate finance perspective; however notwithstanding this, corporate finance theory will be used to analyse the debt push-down structures from an economic perspective.

Research Methodology

Traditional legal research methods will be used to investigate the tax rules governing situations that flow from the debt push-down structures. This means the legal rules will be analysed using a pre-described hierarchy. This is based on South African legislation, commentary on the legislation, usage of court cases as well as available legal doctrines. In addition, corporate finance theory is used as a framework in discussing the situations. This means that the information gathered and investigated mainly pertains to literature in the form of articles, books and publicly published information.

Section 2: Corporate Finance Theory

Introduction

Modigliani and Miller's approach to capital theory, devised in the 1950s, has fundamentally influenced the development of modern theory of corporate finance[4]. Their approach to capital gives rise to the capital structure irrelevancy theory: in terms of which, in a world with perfect capital markets, no taxes, no transaction costs and no costs of financial distress, the capital structure of a company is irrelevant to the company's value.

In our world, the assumptions in Modigliani and Miller's theory are not a reality. The Government taxes companies and thus debt financing is treated in a different manner to equity financing. The difference in tax treatment between debt financing and equity generates many distortions and is responsible for many tax avoidance schemes. These distortions will be discussed in the following section. The subsequent section will further this analysis into whether differential tax treatment of debt and equity is justified.

The bias towards debt

Allowing interest to be tax deductible provides a subsidy to financing via debt. This distortion in allocation efficiency might be sizeable and give life to investments that would not be profitable in the absence of taxation. Thus the composition of the funding of a transaction is absolutely vital. There are two ways to do it: the first is through the use of equity, retained profits or informal capital contributions; and the second is through the use of debt. However there are many non-tax reasons why debt and equity financing may be distorted. Raising debt and dividend policy produce signalling effects.

For instance, where a firm raises debt for a particular investment, this could be a

[4] F. Modigliani; M. Miller 'The cost of capital, corporation finance and the theory of investment' (1958) 48 *American Economic Review*, 261-97

signal to the market that the firm is confident about its ability to repay that debt (Ross, 1977). At the same, it may signal that the firm lacks requisite internal resources for the investment and is reliant on the debt market to fund its investment. This can lead to an adverse selection problem where there is too little borrowing in general but also an asymmetry with too little borrowing from good firms and too much from bad firms.

Stiglitz and Weiss (1981) provide such a model of credit rationing based on adverse selection[5]. This adverse selection problem led to the pecking order theory of Myers and Majluf (1984).[6] This theory maintains that firms adhere to a hierarchy of financing sources, first preferring internal financing, then debt, and lastly equity. Thus, the form of debt a firm chooses can act as a signal of its need for external finance.

To conclude this section, we note that a firm has an incentive to take on more debt capital since the resulting interest expense is generally tax-deductible. The deductibility of interest in this manner creates a tax shield that can be used to reduce the firm's tax burden: this will result in a higher value of the firm, however, the use of debt financing gives rise to additional costs since the firm will be burdened with interest payments.

Rationale for the debt bias

Some of the aspects reviewed above may offer theoretical economic rationales for using the tax system to differentiate between debt and equity. De Mooij (2011)[7] notes that the tenuous distinction between debt and equity instruments alters the relevance of these theories. The traditional justification for the differential treatment of debt and equity is that the interest charged on debt is regarded as a cost of doing business, and as such, should be exempted from income tax. In contrast, a dividend or distribution of profits is regarded as the remuneration of capital.

[5] J. Stiglitz; A. Weiss 'Credit Rationing in Markets with Imperfect Information' (1981) 71 *The American Economic Review* 393 – 410.
[6] S. C. Myers, N. Majluf 'Corporate Financing and Investment Decisions when firms have information that investors do not have' (1984) 13 Journal of Financial Economics 187-221.
[7] R. De Mooij 'Tax biases to debt finance: assessing the problem, financing solutions' (2011), IMF Staff Discussion Note11/11.

Distortions associated with the debt bias

The debt bias has a distorting effect on the financing decisions in transactions and creates room for international tax arbitrage opportunities. These distortions will be further elaborated below.

Distortion of the financing decision

The bias towards debt has a distorting effect on the financing decisions of leverage finance transactions since it creates an incentive for firms and deal-makers to finance with debt rather than with equity. The favourable tax treatment of debt leads to excessive leverage and increases bankruptcy risks.

In domestic markets, debt bias encourages discrimination against young and risky businesses. It is more difficult for these companies to obtain debt financing and as a consequence the favourable tax treatment of debt puts those firms at a disadvantage when compared with more established firms.

In a cross-border setting, this debt bias creates international tax arbitrage opportunities for multinationals. Each country's tax policy designs its income tax systems in order to give rise what it considers the most appropriate level of revenue by determining the broadness of its tax base and its tax rate. As a result, tax regimes around the world differ with respect to their tax bases and tax rates. Due to this difference in tax regimes, mismatches can occur when cross-border transactions take place, allowing multinational corporations to exploit differences between national tax systems in order to minimize their tax burdens.

Debt shifting is one of these tax arbitrage opportunities in which the differences between tax regimes are exploited. The interest deductibility, combined with the differences in statutory tax rates of national tax systems, creates these debt-shifting opportunities within multinationals.

Debt shifting can be achieved by setting up a financial parent company in a low-tax

country or a country with a preferential tax regime, preferably a tax haven, to fund the activities of the subsidiaries located in high-tax countries. As a result, interest payments can be deducted at a high tax rate, whereas the interest income is taxed at an extremely low rate, or no tax rate at all, at the level of the recipient.

This allocation of debt claims to low-tax countries and debt to high-tax countries is a very simple way for multinationals to lower the total tax burden at group level. This particularly applies to the option to use intra-company debt and creates opportunities for international corporations to exploit this tax arbitrage opportunity.

In addition to the fact that the deductibility of interest has a generally eroding effect on the tax base of source countries, the above-mentioned international tax arbitrage activities aggravate erosion of the tax base of high-tax countries involved.

Moreover, this tax arbitrage opportunity has created fairness issues for all parties involved. Governments are harmed, since the international tax arbitrage opportunities undermine the integrity of their income tax system.

When companies do not pay their fair share because of their use of the international tax arbitrage opportunities, governments seek to recover the equivalent of the lost corporate tax revenue from the less-mobile individual taxpayers who consequently have to pay higher taxes on their consumption and labour income. Thus individual taxpayers are also harmed.

Business can also be harmed by international tax arbitrage opportunities. Some firms may assess reputational risks differently from other firms and thus fail to take advantage of the international tax arbitrage opportunities to lower their tax burdens. As a result, these firms are placed in a competitive disadvantage.

International tax arbitrage opportunities may also undermine competition between firms that (1) only operate on domestic level and (2) firms that operate cross-border.

The latter firms have access to sophisticated tax expertise and may profit from these tax arbitrage opportunities and therefore gain unintended competitive advantages compared to other business, such as the small and medium-sized businesses that only operate on a domestic level and therefore cannot use tax arbitrage opportunities. Fair competition is thus harmed by the distortion of international tax arbitrage opportunities.

Hybrid mismatch arrangements

Another international tax arbitrage opportunity created by the debt bias is the use of hybrid mismatch arrangements, such as hybrid financial instruments and hybrid entities.

Most countries exempt foreign source dividend income at corporate level, as the dividend income—as a part of the total source income—is generally taxed abroad. In addition, most countries tax foreign sourced interest income at the corporate level, which is typically not taxed abroad since it is treated as a deductible expense. Companies can thus choose where to be taxed.

If it wishes to be taxed abroad, a company can finance its subsidiary through equity. If it would prefer to be taxed at home, a company can finance its subsidiary through debt. This, in combination with the existence of hybrid instruments, creates tax arbitrage opportunities for multinationals.

Hybrid instruments are financial instruments that have characteristics of both equity and debt. Due to the differences in definitions of debt and equity across different national tax systems, these hybrid instruments can be qualified as debt in one country and as equity in another country for tax purposes. This mismatch in characterization can lead to double non-taxation. Payments made under the instruments are then deductible for tax purposes in the country of the payer.

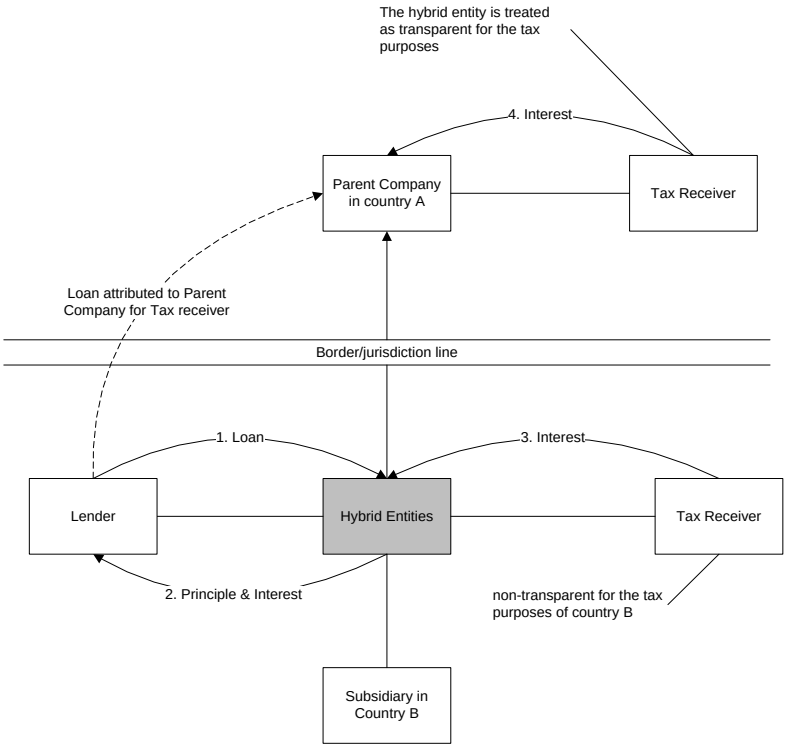
The corresponding receipts, however, are treated as exempt dividends in the country

of the recipient, since most countries exempt foreign source dividend income at a corporate level, as it should already have been taxed abroad. As a result, a deduction is created in one country without a corresponding income inclusion in the relevant other country.

The OECD calls these types of arrangements deduction/no inclusion schemes. Such schemes lead to a reduction of the overall tax burden at group level. Similar results can be achieved through the use of hybrid entities. Hybrid entities are entities that are treated as transparent for tax purposes in one country and as non-transparent in another country.

This is, for instance, the case if the subsidiary residing in Country B receives a loan from its parent company in country A and the subsidiary is treated as transparent in country A and non-transparent in country B. As a result, the interest payment is deductible in country B; whereas the payment is not taxed in country A since this country disregards the payments for tax purposes. However, it should be kept in mind that in the inverse situation, double taxation could occur.

The use of hybrid instruments can also result in double deduction schemes, in which the interest payment can be deducted for tax purposes in two different countries. This occurs, for example, if a hybrid entity is interposed between a parent company residing in country A and a subsidiary residing in country B. The hybrid entity is treated as transparent for the tax purposes of country A and non-transparent for the tax purposes of country B. The hybrid entity acquires a loan from a third party. As a result, the interest expenses cannot only be deducted in country B, but are also allocated to the parent company since the hybrid entity is disregarded for the tax purposes of country A. See diagram below:



Neutrality

In the previous sections it has been demonstrated that corporate income taxation has an impact on local and cross-border leverage finance transactions. The debt-equity distinction is one of the main distortions in current corporate tax systems, which are responsible for many distortions, such as tax avoidance, financing and investment decisions.

Against this background, this section discusses how a corporate tax system should be constructed in order to reduce or eliminate these economic distortions inherent in leverage finance transactions.

To eliminate these economic distortions, taxation should not—or at least as little as possible—influence the economic decisions of firms. This concept of tax neutrality, which underlies the concept of economic efficiency, will serve as a benchmark to evaluate the current South African tax system and proposals for reform.

To achieve tax neutrality on an international level, it is important that a tax system is tax neutral on a domestic level. It would be inconsistent if a tax system was neutral towards inbound and outbound flows of corporate financial flows of capital, but was still highly non-neutral towards different types of finance[8]. This domestic non-neutrality will worsen internationally when tax systems interact, because there is currently no harmonization.

The next section will discuss domestic tax neutrality and the following section will discuss international tax neutrality.

Domestic tax neutrality

The main goal of a tax system is to efficiently raise revenue that is needed for government spending. A tax system is generally considered efficient if it does not distort the decisions that individuals and firms would otherwise make for purely economic reasons.[9] In this respect, tax neutrality plays a big role in achieving economic efficiency. A tax-neutral system is consistent and does not influence private market decisions (except where intended to do so). Economic motives should determine the behaviour of taxpayers instead of tax-driven ones. According to economic theories, total tax neutrality is not feasible.[10]

Any tax will distort economic choices and thus taxes cannot be neutral by definition. For this reason it is normally argued that taxes should distort economic choices as little as possible. There are many dimensions to neutrality. A tax system may be neutral with respect to all kind of factors from: Neutrality towards the legal form that is used, towards (1) different sources of income, (2) employers and employees and (3) different countries (level playing field).

[8] OECD, Taxing profits in a global economy: domestic and international issues, Paris: OECD Publications 1991, 179.
[9] D. E. Kwak '*America's refusal to 'race to the bottom': worldwide vs. Territorial taxation*', Tax Notes International, 2012 - 395
[10] C.A.T. Peters '*International tax neutrality and non-discrimination: Plea for a more explicit dialogue between the state and the market*' in M. Lang, P. Pistone, J. Schuch, C. Staringer, A. Storck & M. Zagler, Tax treaties: building bridges between law and economics, Amsterdam: IBFD Publications 2010, 607.

When examining whether an income tax system is neutral with respect to the financing of business activities, an income tax system should be neutral towards a firm's financing decisions, investment decisions and towards the company's choice for a legal form for its foreign business activities. These neutralities will be outlined below.

Neutrality towards financing decisions

A corporate income tax system should be neutral towards the choice between equity and debt finance.

As discussed in this research, South Africa's corporate tax system embodies a tax incentive for debt finance instead of equity finance. Interest on debt is generally treated as a deductible expense for tax purposes, whereas the return on equity is not. This differential tax treatment distorts the corporate financing decisions of firms, since it creates an incentive within firms to finance with debt rather than equity. There is, however, no rationale behind this different tax treatment, since both interest and the return on equity are regarded as remunerations of the capital provided to fund the business activities of a firm. Therefore South Africa's income tax system is not neutral in regard to the choice made by a firm to finance with debt or equity. Fiscal motives, instead of economic motives, are decisive in that respect. The non-neutrality results in many other distortions, both in domestic and international settings.

Neutrality towards investment decisions

As discussed earlier, the tax-induced bias towards debt distorts the investment decisions of firms as long as firms are not fully financed with debt. When an investment is financed with debt, the normal return on that investment (the interest rate) is not taxed, since interest expenses are generally deductible. Therefore, only the economic rent is taxed.

Taxation on economic rents has no impact on the volume of investment and is thus not distortive. However, when an investment is (partially) financed with equity, the normal return on that investment is also taxed, since the normal return on that equity investment is not deductible. This increases the cost of capital and consequently firms

must then realize a higher pre-tax rate of return on their investment to compensate for the imposition of tax and in order to generate the after-tax return required by investors. As a result, the scale of investment decreases. The imposition of tax on the normal rate of return may also reduce domestic investment.[11]

If the business activity that 'generates the rent' is internationally mobile, the capital will flow out of that country until the pre-tax rate of return has risen sufficiently to compensate for investors' imposition of tax. It is therefore important that a corporate income tax system is neutral in regard to a firm's investment decisions.

Neutrality towards the choice of a legal form

Income tax systems might distort the choice of a legal form that a firm might select to carry out its foreign business activities.[12]

If a firm wants to conduct business activities in another country (the source country), it basically has two options. It can incorporate a legally independent subsidiary in that country or it can create a foreign branch.

The difference between a branch and a subsidiary is that a branch is not considered to be a distinct legal entity from the head office, whereas a subsidiary is an independent company. A branch can be considered more of an extension of the company (head office). If the branch constitutes a permanent establishment in the source country, profits will be taxed under the source country's corporate income tax. The corporate income tax system of the source country might treat permanent establishments differently from subsidiaries for tax purposes. This differential tax treatment could make it preferable to either carry out activities through a permanent establishment or a subsidiary.

As a result of this tax non-neutrality towards the choice of a legal form, companies

[11] R. Griffith, J. Hines, P.B. Sorensen '*International capital taxation*', in: Dimensions of tax design: The Mirrlees Review, Oxford: Institute for Fiscal Studies 2008, 16

[12] OECD, Fundamental reform of corporate income tax, OECD publishing 2007, 72

could base their decisions purely on tax-driven reasons instead of economic reasons. It is therefore important to assess whether the corporate income tax system is neutral towards the choice between a permanent establishment and a subsidiary.

International tax neutrality

In terms of international taxation, resources should be allocated to the location where they would generate the highest return. Variances within the tax regimes across jurisdictions/locations invariably influence each other and result in distortions between markets.

In an international context, the theory of 'capital neutrality' is the starting point for the efficiency debate raised in the previous paragraph. The idea of capital neutrality is that the maximisation of production and of global resources is best achieved by the removal of barriers to the free flow of capital. Capital import neutrality (CIN) and capital export neutrality (CEN) are two traditional option used to achieve a tax-neutral flow of capital.

The following paragraphs will evaluate whether CIN or CEN should prevail and subsequently how the benchmark of international tax neutrality should be understood for the purpose of this report.

Capital Export Neutrality

CEN[13] operates under the principle that investors in a particular market must be in a neutral position (face the same tax burden) as compared to other local investors, regardless of whether they invest abroad or in their domestic economy.[14]

A pure residence-based taxation, which is also known as the taxation of worldwide income, is consistent with CEN, because resident investors pay the same amount of

[13] R. Griffith, J. Hines, P.B. Sorensen, International capital taxation, in: Dimensions of tax design: The Mirrlees Review, Oxford: Institute for Fiscal Studies 2008, 17.
[14] OECD, Taxing profits in a global economy: domestic and international issues, Paris: OECD Publications 1991, 18.

income tax on their income irrespective of the location of the activity that gives rise to the income.[15]

Proponents of this theory of neutrality require that investors be taxed on their worldwide income in the state of residence, and are offered a full tax credit against the domestic tax liability for all foreign taxes paid (credit method).

Capital Import Neutrality

According to this notion, foreign and domestic suppliers of capital in a certain country are taxed at the same effective tax rate, irrespective of the investor's place of residence.[16] Thus the location of the owner of capital ought not to influence the tax burden of such an owner when capital is invested abroad and it achieves a level playing field with other foreign competitors.

Proponents of this theory of neutrality promote source-based taxation, meaning that capital is only taxed in the country in which the capital is invested and, as a relief, such investors are provided with an exemption from foreign capital (exemption system).

Conclusion

Both CIN and CEN are based the operation of distinct markets among which a certain level of equality exists. With the integration of markets, the concept of distinct national markets is gradually dissipating and those markets that remain distinct are disparate levels of equality such that neither theory provides a satisfactory framework from which to develop legal mechanisms to ensure tax neutrality. As a result of these realities, countries adopt elements of both theories, making it difficult to discern from actual legal rules which of the concepts of tax neutrality is adhered to by a particular government.

[15] Ibid 163

[16] R. Griffith, J. Hines, P.B. Sorensen, International capital taxation, in: Dimensions of tax design: The Mirrlees Review, Oxford: Institute for Fiscal Studies 2008, 17.

Section 3: South African Corporate Taxation

Introduction

This section discusses the South African income tax system in order to examine the types of distortions it gives rise to in leverage finance transactions as result of the different tax treatment of debt and equity. The section begins by describing the characteristics of a leverage transaction (Debt Push-Down Structure), before proceeding to describe how the ITA deals with debt and equity. This section also includes a discussion of the tax treatment of hybrid debt and equity instruments, before evaluating the income tax regime against the benchmarks of economic efficiency and equity. Finally, the last part of the section will address the main conclusions that can be drawn from this section.

Deductibility of interest expenditure

This subsection addresses the basic principles about leverage finance and addresses the concepts of debt and equity and the tax treatment of these concepts.

Leveraged financed transactions characteristically involve the purchase of a target company or asset, using a blend of equity and debt, structured in such a way that the target company's cash flows or assets are used as security for the borrowed funds. Since debt has a lower cost of capital than equity, the returns on the equity increase as the amount borrowed increases. This is why, in leverage finance transactions, the acquiring company tries to obtain maximum debt financing.

South Africa has a 'classical approach' to the treatment of debt and equity for income tax purposes. This means that debt finance confers a tax benefit on firms when interest payments can be deducted from taxable income. This benefit of debt has been a cornerstone of leverage finance transactions since at least Modigliani and Miller[17]. South African courts have examined and developed the deductibility of expenditure (Interest) for the purpose of determining the taxable income on which

[17] Note 1 above

normal tax is levied. But before we examine the court cases we will first review the provisions in the Act dealing with the deductibility of expenditure (interest).

There are a many sections or subsections in the Act dealing directly or indirectly with interest. A number of those sections are anti-avoidance measures or special rules that override the normal provisions of the Act. Later in this research, we will discuss the anti-avoidance measures noted in s8E, 8F and 31 as they pertain to hybrid mismatch arrangements. We will also discuss the Interest Limitation Rules found in ss23J and 23K. But first we will discuss the provisions of the Act that allow interest as a deduction in terms of the 'general deduction formula'.

In determining the taxable income of taxpayer, the deductibility of expenditure incurred is determined in terms of s11 (*a*) of the Act, which provides that:

> For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived—
> (a) expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature;…

Complementary to the above-quoted section, and forming an integral part of the general deduction formula, are the provisions of s23.[18] The provisions of s23 prohibit deductions of certain kinds. The relevant subsection of s23 for purposes of this research is s23 (*g*), which prohibits the deduction of:

> any moneys claimed as a deduction from income derived from trade to the extent to which such moneys were not laid out or expended for the purposes of trade.

Thus from the above we note that the test for the deductibility of any expense is that it must (i) be actually incurred, (ii) be incurred in the production of income, (iii) not be an expenditure of a capital nature, and (iv) be laid out for the purpose of trade.

[18] *KBI v Van Der Walt* 1986 (4) SA 303 (T) the court held that s 11 (a) and s 23 (g) must be read together when considering whether an amount is capable of deduction.

In the next section we will consider each element in the test noted above, but is it important at this stage to note that in determining whether income is produced, the courts have held that the 'income' referred to is taxable income as indicated in the preamble to s11 and accordingly excludes tax-exempt income such as dividends.[19] This determination has been of significant historical importance in structuring leveraged finance transactions.

We must also note that s24J allows an interest deduction when income is derived from the carrying on of a trade and the interest was incurred in the production of income. The feature distinguishing this provision from the above ones is that it does not require that interest must not be of a capital nature in order for the interest to be deductible. For this section, the amount of interest that can be deducted is calculated by using the yield to maturity rate. This is the rate of compound interest in each accrual period at which the present value of all amounts payable or receivable in relation to the instrument during the 'term' of such instrument equals the issue price or transfer of the instrument.

S24J allows interest as a deductible expense if it was incurred 'in the production of income' and the 'trade' tests are satisfied.

Historical Government Intervention and Reforms

The Debt Crisis

Prior to 1989, the only way in which any expense, including interest, could be disallowed was if it failed to meet the basic tests for deductibility found in s11 (a) as read together with s23 (*g*) of the ITA[20], and especially if the expense was laid out for some other purpose other than the purpose of trade.[21]

[19] *CIR v Nemojim (Pty) Ltd* 1983 (4) SA 935 (A) at 946H-947C

[20] The basic tests for deductibility of any expense are that it must (i) be actually incurred, (ii) be incurred in the production of income, (iii) not be an expenditure of a capital nature, and (iv) be laid out for the purpose of trade.

[21] Of course, it is always possible that there could be a re-categorization by the application of the general anti-avoidance rule, then in s. 103(1) of the ITA1962, now in sections 80A to 80L, but the circumstances would have to

During the sanctions period leading up to 1989, South Africa suffered huge net capital outflows that led to a moratorium on debt and the collapse of the Rand. This meant that those large corporates with forward exchange contract[22] exposures suffered losses wiping out their profits and ultimately reducing tax revenue.

The dilemma the Government faced, as a result of the losses noted above, was that from a tax perspective the Commissioner was unable to collect taxes, but he was still required to allow interest deductions on working capital loans. This was not balanced out and presented a serious problem for the Government because the Commissioner taxed the corporate lenders on interest income from the working capital loans at a tax rate of 50 percent and thus only recovered half of the deduction he allowed.

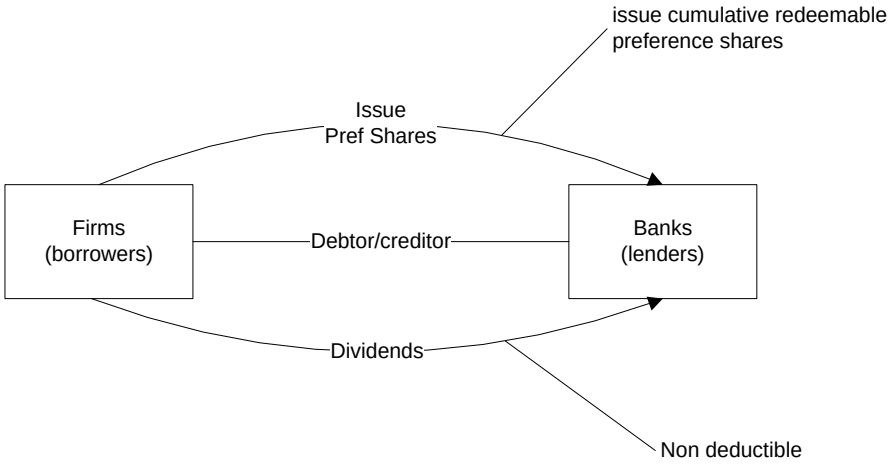
This situation was aggravated when large corporates started using debt instruments. These debt instruments required the Commissioner to allow the interest deduction by the borrower, however on the slip side, the Commissioner could not tax the lender on dividend income because it was exempt income.

By 1989 it had become a widespread practice that, instead of firms borrowing funds from the banks, they would issue cumulative redeemable preference shares, with the 'borrowing' cost being in the form of a non-deductible dividend. Since company-to-company dividends were exempt from tax in the recipient's hands, the banks did not object.

---

be quite extreme before this rule could be invoked where a reasonable amount of interest is paid on a genuine loan.

[22] A forward exchange contract is a special type of foreign currency transaction. Forward contracts are agreements between two parties to exchange two designated currencies at a specific time in the future. These contracts always take place on a date after the date that the spot contract settles, and are used to protect the buyer from fluctuations in currency prices.



On this basis, the preference share could have a coupon of, say, 50 percent of the going interest rate, which gave the same after-tax cost to the borrower as where it paid interest and would have been in a tax-paying position, but now the cash flow relief was immediate.

It became common practice for firms to issue preference shares *in lieu* of short-term notes, and roll them over every three months. This meant that preference shares were being issued and redeemed every three months.

The Commissioner quickly realized that there was a tax leakage, and introduced s8E in 1989. S8E provided that, if an issuer of a redeemable preference share had to redeem the share within a period of three years from date of issue, or the holder of the share could compel the company to redeem, or the holder had a put option in respect of that share against another party that could be exercised within three years, the dividend received was deemed to be interest, which immediately stopped the banks accepting these instruments, as they would then still be taxable, but on the lower coupon. We will discuss further below see section dealing with hybrid arrangements and the Interest Limitation Rules.

As far as interest is concerned, historically, this was treated just like any other income or expense, so that it was taxable when accrued or received and deductible when

incurred. However, this resulted in mismatches and deferrals, in the case of a recipient, or acceleration, in the case of a payer. Some features of an instrument that would economically normally be recognized as part of the cost of issuing it, or the return from holding it, would not have been treated as deductible or taxable in certain circumstances, for example, discounts or premiums on issue or redemption.

In 1995, s24J was inserted into the ITA with a view, first, to broadening the definition of interest so as to capture all such aspects of a debt instrument and, second, to ensuring that there was an appropriate timing of the interest income and interest deductions.

Broadly, what s24J regulates is the deduction of interest, specifically the timing of the incurrence and accrual of interest in respect of debt instruments. The section defines Interest as, *inter alia*, the gross amount of interest or related finance charges, discount or premium payable in respect of any financial arrangement.

Interest was previously defined in our case law as the payment made for the use of money, akin to rent. The spirit of this definition continues to inform the interpretation of the statutory definition.

S24J has the same requirements for deductibility that interest be incurred ‘in the production of income’ and ‘for the purposes of carrying on a trade’ as outlined in the general deduction formula. It provides that where any person is the issuer in relation of an instrument, during any year of assessment such person shall be deemed to have incurred an amount of interest during such year of assessment (as calculated in terms of s24J), which must be deducted from the income of that person derived from carrying on any trade, if that amount is incurred in the production of the income.

In order to determine whether such interest is deductible, the requirements of s24J must be met, i.e. the purpose for which the debt was incurred must be established to determine whether or not the related interest expense incurred thereon has been

incurred ‘in the production of income’.

Furthermore the provision also states that an amount of interest (as calculated in terms of s24J) is deemed to have accrued to a person (the holder) and must be included in the gross income of that person during that year of assessment whether or not that amount constitutes a receipt or accrual of a capital nature.

When viewed critically, it is clear that interest viewed in isolation cannot be stated to give rise to income, because it is the funds advanced that give rise to the interest charges. It is established that such interest charges must bear a sufficiently close connection to the production of income in order that they may be deducted.

The Great Recession

By the end of 2008, South Africa was reeling from the effects of the Great Recession. Global growth was subdued along with slowed prospects for revenue growth. With downward pressure on the fiscus, the Government needed to take steps against structural weaknesses within the tax system, and aggressive tax schemes that undermined principles of equity and the revenue base.

In an effort to protect the fiscus, the Government decided to take action against aggressively structured transactions where interest was deducted by the borrower, but received by the lender as tax-exempt dividend income.

Before the Great Recession foreign jurisdictions had already begun taking measures against excessive debt, including reducing debt ceilings and enforcing limitations against excessive interest claims.

On 2 June 2011 the Government released the Draft Taxation Laws Amendment Bill, which expressed its concerns with the negative incentives that s45 of the Income Act produced, in that firms contemplating an acquisition would use the section to move target assets to group companies with assessed losses which could then be applied

against operating target company income, thereby reducing the returns to the fiscus.[23]

The Government also noted that the corporate rules were only intended to facilitate the transfer of assets in specified circumstances and were never intended as an enabler for interest deductions when those deductions would not otherwise be available.[24]

In many settings, the above use of s45 and other corporate rules does not jeopardise the fiscus. Interest deductions for the borrower are often matched by taxable interest income for the creditor. However, the fiscus is at risk if the interest is paid to parties that are not subject to tax on the interest or that have on-going losses to absorb the interest income.

The Government was concerned about the high frequency of the use of s45 and other reorganisation rollovers as a tool to achieve a mismatch of interest deductions *vis-à-vis* the exempt receipt of that interest. The nature of the transactions causing concern involved large amounts of debt with many aggressive transactions utilising debt with share-like features (including soft shareholder loans). In the most aggressive schemes, the interest paid is artificial, being re-routed back to the same economic group via tax-free preference share dividends.

The Government's initial proposal was to suspended, for a period of approximately 18 months, s45 in order to provide the fiscus with some breathing space to re-evaluate the tax system so as to prevent the ongoing use of excessive debt payable to exempt (or loss-making) parties.

---

[23] Background Note: 2011 Draft Taxation Laws Amendment Bills: Revised proposals on s45 intra-group, hybrid shares and related matters' National Treasury and SARS, 3 August 2011, available at http://www.treasury.gov.za/public%20comments/Background%20note%20section%2045.pdf

[24] http://www.treasury.gov.za/public%20comments/section45/Reorganisation%20Rollover%20Acquisition%20Debt.pdf

The Introduction of S23K: stem the losses

The introduction of s23K[25] stems from the concern that the excessive debt eliminated substantial amounts of operating income for the targets of acquisition finance transactions.

S23K was an interim measure to stem the losses to the fiscus while the Government formulated a more permanent solution. In terms of s23K, deductions of interest associated with debt used by an acquiring company directly or indirectly for the purpose of procuring, enabling, facilitating or funding the acquisition of any asset under certain re-organisation transactions would be disallowed unless a specific directive was obtained from SARS. This was the case regardless of whether such interest expenditure would otherwise been deductible under the general principles of deductibility or any other specific provision.

This was an approach to strike a more refined balance between the need to protect the fiscus versus the need to facilitate commerce. Interest deductions in respect of debt used to facilitate ss44, 45 and 47 reorganisations were to be controlled (as well as interest deductions for debt that refinances or other substitutes for the initial debt). More specifically, interest associated with this debt would no longer be automatically deductible. The interest deduction may be allowed if the Commissioner is satisfied that such deduction does not significantly erode the tax base by allowing the reduction of the aggregate taxable income of all parties who incur, receive or accrue interest in respect of and for all periods during which any amounts are outstanding in terms of such debt.[26]

Section 24O

> ***Section 24O Incurral of interest in respect of certain debts deemed to be in the production of income.—***

[25] Introduced in terms of the Taxation Laws Amendment Act 24 of 2011

[26] http://www.treasury.gov.za/public%20comments/section45/Reorganisation%20Rollover%20Acquisition%20Debt.pdf

(1) For the purposes of this section—

'acquisition transaction' *means any transaction in terms of which a company acquires an equity share—*

(a) in another company—

(i) that is an operating company; and

(ii) as a result of which, at the end of the day of that transaction—

(aa) that company is a controlling group company in relation to that other company; and

(bb) that company and that other company form part of the same group of companies as defined in section 41 (1); or

(b) in another company—

(i) that is a controlling group company in relation to an operating company that forms part of the same group of companies, as defined in section 41 (1), as that controlling group company; and

(ii) as a result of which, at the end of the day of that transaction,

(aa) that company is a controlling group company in relation to that other controlling group company; and

(bb) that company and that other company form part of the same group of companies as defined in section 41 (1);

'operating company' *means a company of which—*

(a) at least 80 percent of the receipts and accruals constitute income in the hands of that company; and

(b) the income contemplated in paragraph (a) is derived—

(i) from a business carried on continuously by that company; and

(ii) in the course or furtherance of providing goods or rendering of services for consideration by that company.

(2) Subject to subsections (3) and (4), where during any year of assessment a debt is issued, assumed or used by a company—

(a) for the purpose of financing the acquisition by that company of an equity share in terms of an acquisition transaction; or

(b) in substitution for a debt issued, assumed or used as contemplated in paragraph (a),

any interest incurred by that company in respect of that debt must, to the extent to which that equity share constitutes a qualifying interest in an operating company, be deemed to have been—

(i) so incurred in the production of the income of that company; and
(ii) laid out or expended by that company for the purposes of trade.

(3) An equity share in a company constitutes a qualifying interest in an operating company, on the date of acquisition, if that equity share is an equity share in—

(a) an operating company; or

(b) any other company, to the extent that the value of that equity share is derived from an equity share or equity shares held by that company in an operating company or operating companies—

(i) in relation to which that company is a controlling group company; and

(ii) that form part, with that company, of a group of companies, as defined in section 41 (1): Provided that if at least 90 percent of the value of that equity share is so derived, that equity share must be treated as an equity share in an operating company.

(4) A determination of the extent to which an equity share acquired in terms of an acquisition transaction constitutes a qualifying interest in an operating company—

(a) must apply, for purposes of subsection (2), until any of the following events occurs in relation to a company taken into account in making that determination:

(i) a controlling group company ceases to be a controlling group company in relation to any operating company;

(iii) an operating company ceases to be an operating company; or

(iii) any company ceases to form part of the group of companies contemplated in paragraph (a) (ii) or (b) (ii) of the definition of 'acquisition transaction' in subsection (1); and

(b) must, if any of the events contemplated in paragraph (a) occurs, be determined as if that equity share had been acquired on the date of that event and must apply, for purposes of subsection (2), from that date.[27]

S24O was introduced[28] to address the disparity in the tax rules that allowed taxpayers to gain tax relief when acquiring control of businesses through asset acquisitions, but not through share acquisitions. According to some legal professionals[29], s24O was introduced as an alternative to '*debt push-down structures'* and is applicable in respect of any acquisition transaction entered into on or after 1 January 2013.

The introduction of s24O removes the requirement for taxpayers to apply the general principles applicable to the deductibility of interest where an acquisition transaction is being entered into. The section also introduced the definition of an 'acquisition transaction' into the ITA.

The objective of s24O is to provide a deduction for interest incurred where a company

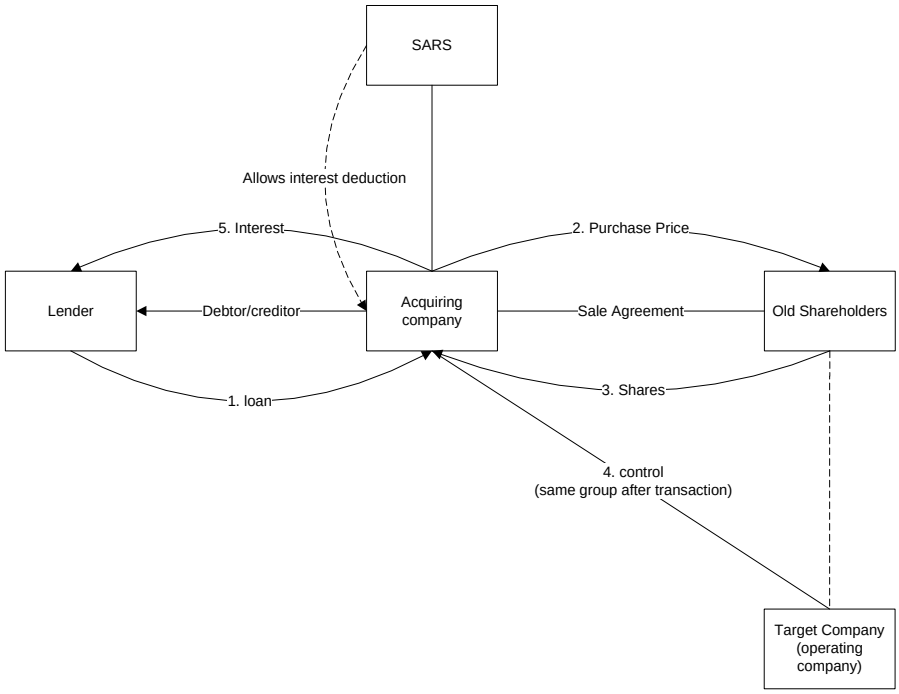
[27] S. 24O inserted by s. 57 (1) of Act No. 22 of 2012, amended by s. 72 (1) of Act No. 31 of 2013 and substituted by s. 46 (1) of Act No. 25 of 2015 with effect from 1 January, 2016 and applicable in respect of years of assessment ending on or after that date.

[28] Introduced by the Taxation Laws Amendment Act 22 of 2012

[29] http://www.taxtalk.co.za/acquisition-of-shares-using-interest-bearing-funding-refinements-to-section-24o/

acquires a controlling share interest. It is specifically aimed at the situation where debt is used to acquire a controlling equity share interest in an operating company.

Thus an acquiring company (subject to certain interest deduction limitation provisions in the ITA) would be entitled to deduct the interest incurred on a loan utilised to purchase the shares of a target company, where the target company was an operating company[30], provided that, at the close of the day of the acquisition transaction, the two companies formed a group of companies, with the acquiring company being the controlling group company in respect of the target company.



In the circumstance noted above, any interest incurred by the acquiring company in respect of such loan funding would be deemed to be (1) incurred in the production of the company's income (notwithstanding that only dividend income would likely be forthcoming), (ii) laid out or expended for the purposes of trade, and (iii) incurred in respect of income received by or accruing to the income of the acquiring company.

[30] Operating Company is defined in s24O(1) being a company that carries on business continuously and in the course or furtherance of that business provides goods or services for consideration.

The deduction does not take account of the general rules prescribed in the so-called general deduction formula comprising s11 (*a*), the positive test which allows expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature; and s23 (*g*), which stipulates what may not be deducted, namely, the negative test.

Despite this new arrangement, s23K still provided that the acquiring company might not claim a deduction for the interest incurred by it on the loan, unless the Commissioner issued a directive that the interest would be deductible by the acquiring company. This was an inappropriate arrangement that created uncertainty and unnecessary delays for those who wished to enter into debt push-down transactions (s45 transactions) or s24O acquisitions. Accordingly the s23K directive system was terminated and a new s24N was introduced into the ITA.

Section 24N

On 1 April 2014, s24N[31] was enacted as a final solution to the concerns raised by the Government. This section is a specific anti-avoidance provision largely replacing s23K. S24N limited the deduction of interest incurred in respect of debt financing, utilised to fund group re-organisations and acquisition transactions. The effect of the limitation was to provide partial relief to taxpayers by allowing the deduction of interest expenditure to a degree in prescribed circumstances.

The amount of interest deductible for debt used to finance any transaction carried out under the auspices of s45 or s24O is limited to 40 percent of the acquiring company's adjusted taxable income, being the taxable income of the acquiring company determined in the normal manner, reduced by interest received or accrued, controlled foreign company net income and recovered or recouped amounts in terms of capital allowances and 75 percent of the acquirer's rental income[32].

[31] Introduced in terms of the Taxation Laws Amendment Act, 31 of 2013
[32] S23 N(1)

The 40 percent limitation itself is measured against the higher of the acquiring company's adjustable taxable income in the year in which the re-organisation or acquisition transaction occurred and the year in which the interest expenditure is incurred. The limitation applies for the year in which the relevant transaction occurred and for 5 (five) years afterwards.

Common Law

As noted in the previous section, the South African courts have examined and developed the test for the deductibility of expenditure (interest) for the purpose of determining the taxable income on which normal tax is levied. The meanings of the elements, noted earlier, are not set out in the ITA and it is necessary to have regard to the decision of the courts in order to gain the clarity on what each requirement entails.

When determining whether interest will be deductible, it is vital to determine first whether the interest is directly or indirectly incurred in the production of (taxable) income. This is the first element we will discuss in light of the court decisions. The court decisions do not specifically refer to interest deductibility but provide guidance on what the expense is used for.

'In the production of income'

The most authoritative case in this area is *Port Elizabeth Electric Tramway Co Ltd v Commissioner for Inland Revenue, 1936 CPD 241*. In this case Watermeyer AJP developed the test for determining whether expenditure is incurred in the production of income.

According to Watermeyer AJP, when determining whether expenditure is incurred in the production of income two questions arise. The first is whether the act to which expenditure is attached is performed in the production of income, and secondly whether the expenditure is linked to it sufficiently closely.

The essence of this test is the purpose of the act, which if found to be to produce

income, then leads on to the second step, which is to determine whether such expenditure is closely linked to that act.

Our courts have held that there are three types of expenditure. The first type is expenses that are necessary for the performance of the business operations; the second is expenses attached to the performance of the business operation by chance, and the last is expenses that are *bona fide* incurred for the more efficient performance of such business operations. All these types of expenditure are deductible provided they are closely connected with the performance of the business operations.[33]

In a finance acquisition transaction, where there is a purchase of an income-producing business together with the assets of a seller, the purchaser utilises funds advanced, by a financier, to pay the seller for the business and assets. In this transaction, the interest charged in the financing of the acquisition will be sufficiently closely connected to the production of income for the taxpayer (the purchaser). The result of this finding is that the incurred interest will be deductible, irrespective of whether the assets are fixed or current, so long as the interest incurred is not of a capital nature.

Prior to the insertion of the definition of '*interest'* into s24J, a finance transaction of shares in a firm would not give rise to an allowable deduction in respect of the relevant interest expenditure to the extent that the shares produce only tax-exempt income.

The judgements given in CIR v Shapiro[34] and CIR v Drakensberg Gardens[35], prior to the amendments to the ITA, demonstrate the above principle well, and the salient points of these judgements will be briefly discussed.

In CIR v Shapiro the purpose test was considered; in this case the taxpayer used funds loaned by a financier to purchase shares in a private company. As part of the transaction, the taxpayer was appointed managing director of the firm, with a salary,

[33] *Commissioner of Taxes v Rendle* 1965 (1) SA (SR, AD) at 62B – D
[34] 1928 NPD 436
[35] 1960 (2) SA 475 (A)

housing allowance and commission payable as a result of the transaction.

The taxpayer claimed that the interest on the loan should be allowed as a deduction against his salary and commission he received from the company.

The Commissioner disallowed the deduction of the taxpayer's interest paid on his loan, as a deduction in the calculation of his taxable income. On appeal to the provincial division, the taxpayer contended that the interest was incurred in respect of the loan in connection with the salary earned in his capacity as the managing director of the company.

The court dismissed this argument on the basis that the purchase of the shares merely facilitated the appointment of the taxpayer as managing director. The court held that the income, which was produced in connection with the purchase of the shares, was deemed to be tax-exempt income and it could not be said that the interest had been incurred in the production of income. Furthermore the court held that the taxpayer's salary and commission were not produced by his shareholding in the company, but by his duties as the managing director.

It is clear from the above case that the interest on the loan and the taxpayer's salary were not sufficiently close. The case has shown that self-interest will not suffice; only a business benefit will be sufficient to satisfy the requirement 'in the production of income'.

In *CIR v Drakensberg Gardens* the court held that the taxpayer, a hotel company, was entitled to claim a deduction for interest incurred on loans used to acquire shares in a property-owning company which leased premises to the taxpayer. The court found that the taxpayer's purpose in taking the loan was to purchase the shares in the company and thereby ensure security of tenure and all rights for the hotel, and it was sufficiently closely connected to meet the requirement that the expense be incurred in the production of income.

'not of a capital nature'

There is no one test for determining whether or not expenditure is of a capital nature. In *New State Areas Ltd v CIR*[36] the Appellate Division noted that the problem arising when deductions are claimed is whether the expenditure in question should properly be regarded as part of the cost of performing the income-earning operations, or as part of the cost of establishing or improving or adding to the income-earning plant or machinery.

The Appellate Division then had regard to the decision in *CIR v George Forest Timber Co Ltd*[37] wherein Innes CJ noted that money spent in creating or acquiring an income-producing concern must be capital expenditure. It is invested to yield future profit; and while the outlay does not recur, the income does. There is a great difference between money spent in creating or acquiring a source of profit, and money spent in working it. The one is capital expenditure, the other is not. According to Innes CJ the reason is plain; in the one case it is spent to enable the concern to yield profits in the future, in the other it is spent in working the concern for the present production of profit.

The Appellate Division in *CIR v Genn & Co (Pty) Ltd*[38] held that in deciding how the expenditure should properly be regarded, the court clearly has to assess the closeness of the connection between the expenditure and the income-earning operations, having regard both to the purpose of the expenditure and to what it actually effects.

The test for determining the capital nature of expenditure thus requires an assessment of the purpose of the expenditure, and what it actually effects must be looked at to determine whether it can be said to be more closely connected with performing the income-earning operations. Should it be said to be more closely connected with performing the income-earning operations then the expenditure is revenue in nature

[36] 1946 AD 610 (14 SATC 155)
[37] 1924 AD 516 (1 SATC 20)
[38] 1955 (3) SA 293 (A) (20 SATC 113)

and therefore deductible, or should the expenditure be said to be establishing, improving or adding to the income-earning structure, then the expenditure is capital in nature and not deductible in terms of s11 (a).

Watermeyer CJ in *New State Areas Ltd v CIR* highlighted that the true nature of each transaction must be enquired into in order to determine whether the expenditure attached to it is capital or revenue expenditure. Its true nature is a matter of fact and the purpose of the expenditure is an important factor. If it is incurred for the purpose of acquiring a capital asset for the business, then it is capital expenditure even if it is paid in annual instalments; if, on the other hand it is in truth no more than part of the cost incidental to the performance of the income-producing operations, as distinguished from the equipment of the income-producing machine, then it is a revenue expenditure even if it is paid in a lump sum.

In *Rand Mines (Mining & Services) Ltd v CIR*[39], the court held that an abiding problem has been to identify and then synthesise into a reasonably accurate and universally applicable yardstick the factors which are indicative of each of the two classes of expenditure. No such yardstick has yet been fashioned and the attempt has come to be regarded as futile and has been abandoned. Instead, the courts have identified useful indicia to which regard may be had, emphasising that they are no more than that and that in each case close attention must be given to its particular facts. In an English case, *Commissioner of Taxes v Nchanga Consolidated Copper Mines Ltd,* Viscount Radcliffe warned against the notion that any of the indicia identified by the courts, taken singly, will always lead to the right conclusion.

The area of contention

From the above analysis, the deductibility of an interest expense is an area of contention, more so where interest is incurred in close proximity to the declaration of a dividend by the borrowing company. This area of conflict also extends to the

[39] [1997] 1 All SA 279 (A) (59 SATC 85)

deductibility of an interest expense in close proximity to the advancement of an interest-free loan by the borrowing company. This is evidenced by a number of South African court cases.

In the *Giuseppe Brollo Properties (Pty) Ltd* case[40], the court held that where a taxpayer issues a debt instrument, with the purpose of using the funds obtained to secure or acquire the means of earning income, the interest paid on that debt instrument is *prima facie* expenditure incurred in the production of income. If however the purpose of the funds obtained by the taxpayer is to pay, for instance, dividends, then the interest on such a debt instrument is not deductible.

In addition to the above cases, it is a well-established principle in case law that where a taxpayer is presented with a choice between two single transactions the taxpayer may choose the alternative that is the most tax-efficient. This principle was recently reinforced in Commissioner for the South African Revenue Service v NWK Ltd[41] ('the NWK Case'), where it was stated that 'it is trite that a taxpayer may organize his financial affairs in such a way as to pay the least tax permissible. There is, in principle, nothing wrong with arrangements that are tax–effective'.

Tax-efficient arrangements

It is clear from the above cases that in finance transactions, our courts look to establish the primary purpose for which the money was borrowed. It is also clear that a taxpayer has the liberty to choose between utilising existing cash resources to fund a distribution or raise additional funding.

For this reason tax practitioners structure transactions so that they can obtain a deduction for interest expenditure when acquiring shares of a target company. The most common technique for obtaining the above benefit is through a debt push-down structure.

[40] CIR v G Brollo Properties (Pty) Ltd [1994] (56 SATC 47)
[41] 2011 (2) SA 67 (SCA)

There is no standard definition of debt push down since the concept can be achieved in various ways. The concept is also used in financial accounting, although it is often referred to as push-down accounting, where the purpose is to have an impact on how a group of companies is presented in financial statements rather than to have tax implications. From a tax perspective, a debt push down is the concept of attributing debt to a subsidiary from a parent company and, as a result, achieve transfer of income between the two. This kind of tax planning generally results in the subsidiary being thinly capitalised.

Debt Push-Down structures

For purposes of this research we will consider two types of push-down transactions, those that typically involve acquisitions and those that typically involve mergers. The first type of push-down transaction (acquisitions) requires the acquiring company to follow the following steps:

Step 1: the acquiring company establishes a new company as an acquisition vehicle for the transaction. This new company must be financed either through share capital or alternative financing such as a shareholder loan or other external loans. The funds received by the new company must be sufficient for the acquisition of the target.

Step 2: The nature of a leverage transaction requires, as a pre-condition, that the target company's cash flows or assets must be sufficient to repay the new company's debt and interest payments. The target company is typically an operating business. If the new company had to proceed and purchase the assets of the target company, Capital Gains Tax would be triggered.

At this point the Corporate Rules become applicable. The acquiring company enters into a sale agreement with the target's shareholder and purchases control (the entire share capital) of the target company on loan account, such that the target company and the new company form part of the same group and enter into a tax-neutral intra-

group transaction.[42] Interest expenses incurred by the new company will be tax-deductible.

The second type of push-down transaction (mergers) requires all the assets of a target company to be absorbed by the new company and as a result, the absorbed company ceases to exist. A merger of the acquisition company with the target company can generally be done in a tax-neutral way, provided it complies with s44 of the ITA.

The acquisition company may claim unused tax-loss carry-forwards of the target company and offset such losses with future profits. In addition, in the course of such absorption a merger gain or loss may arise if the tax value of target company shares on the books of the acquisition company does not match the net asset value of the target company as reported in its own books.

The absorption of the target company after being acquired typically results in a merger loss for the acquisition company. This is based on the fact that the price paid for the target company is usually higher than its net asset value.

In most cases, such merger loss is referred to as 'unreal', as it is compensated by the goodwill of the target company and other hidden reserves not shown in its balance sheet. Although from a commercial law perspective such unreal merger loss at the level of the acquisition vehicle qualifies as goodwill that can be amortized, however the tax authorities will not accept such amortization for income tax purposes; hence, the tax balance sheet is amended accordingly.

Regarding the deductibility of interest expenses, these are generally regarded as tax-deductible. Also, any borrowing costs should then be qualified as justified business expenses to the extent that the merged company is not thinly capitalized.

[42] See http://www.treasury.gov.za/public%20comments/section45/Reorganisation%20Rollover%20Acquisition%20Debt.pdf

This research is concerned with the tax aspects of leveraged transactions that utilise the Corporate Rules.

Corporate Rules

Introduction

The Capital Gains Tax and corporate 'rollover relief' provisions were introduced and came into effect on 1 October 2001[43]. The purpose of the corporate 'rollover relief' provisions was to allow for the transfer of assets with limited tax consequences, as well as to be of application in transactions between companies and between founding shareholders and their companies.

The corporate 'rollover relief' provisions were introduced because the previous tax provisions regarding corporate restructures were inadequate to mitigate the adverse Capital Gains Tax consequences triggered in a reorganisation of companies in a group setting. Without the corporate 'rollover relief' provisions, the transfer of assets between companies would represent a separate Capital Gains Tax event and accordingly, a reorganisation in the context of a multi-tier group of companies would lead to an assortment of Capital Gains Tax events, each event attracting Capital Gains Tax in respect of a single disposal.

The next sub-section critically analyses the current tax legislation on intra-group transactions and the economic outcomes these corporate 'rollover relief' provisions create.

Key Definitions

The Corporate Rules offer tax relief to group companies in transactions where qualifying assets are disposed and acquired.

The Act defines a 'group of companies' in s1 as meaning two or more companies in which one company, the controlling group company, directly or indirectly holds shares

[43] Second Revenue Laws Amendment Act of 2001

in at least one other company, the controlled group company, 'to the extent that –

(a) *at least 70 percent of the equity shares in each controlled group company are directly held by the controlling group company, one or more other controlled group companies or any combination thereof; and*
(b) *the controlling group company directly holds at least 70 percent of the equity shares in at least one controlled group company*.'

However, s41 of the Act narrows the above definition for purposes of corporate rules, by firstly excluding certain companies from the definition of 'group of companies' and secondly by excluding certain capital transactions from the equity share capital definition.

Certain intra-group provisions make reference to the defined term 'connected person'. In terms of s1 of the Act, 'a connected person' in relation to a company implies that:

(a) Any other company would form part of the same group of companies as the company. The percentage interest in the equity shares of a company is however reduced from 70 percent to 50 percent for purposes of this definition; or
(b) Any person other than a company which directly or indirectly holds 20 percent of the equity shares individually or jointly with any of the connected parties of the company; or
(c) Any other company that holds at least 20 percent of the equity share capital of the company, provided that no shareholder holds the majority voting rights of the company; or
(d) Any other company and its connected persons, if such company is managed or controlled by a connected person of the company.

Tax relief explained

Tax relief is provided to group companies in a transaction where a group or their shareholders have retained a substantial interest in the assets transferred. This tax relief permits the tax-free transfer of the assets to a group company where the asset

can be most efficiently used for business purposes. Other than intra-group transactions as reflected in s45, no consideration is received for the disposal of the asset other than equity shares.

The explanatory memorandum on the Second Revenue Laws Amendment Bill, 2001, noted that such tax relief is often abused to avoid tax and that a balance must be achieved between the breadth of the concession provided and the potential for tax avoidance.

The Second Revenue Laws Amendment Act of 2001 introduced both the corporate rules and the Capital Gains Tax into the South African tax landscape. The corporate rules were designed to provide relief to group companies taking part in any of the following transactions: (1) Company formations; (2) Share-for-Share Transactions; (3) Intra-group Transactions; (4) Unbundling transactions; and (5) transactions in respect of liquidations, winding up and de-registrations.

All these envisaged transactions provided various forms of rollover relief, mainly:

(a) The deferral of Capital Gains Tax consequences on the disposal of assets;
(b) The deferral of income tax consequences on the disposal of trading stock or an allowance asset;
(c) Donations tax on disposal of an asset, provided under s56 (1) (*q*);
(d) They also included relief from transactions taxes such as Securities Transfer Tax, Uncertificated Securities Tax, Stamp Duties and secondary company tax.

The Corporate Rules also include various anti-avoidance measures designed to combat the exploitation of loopholes in the provisions. The effect of the rollover relief was that it deferred any potential Capital Gains Tax liability, with such potential Capital Gains Tax liability arising in the transferee's hands.

Section 41-47 of the ITA

Background

Internationally, tax regimes provide for varying degrees of relief in respect of transactions between companies in the same group or between founding shareholders and their company. The underlying philosophy is that where the group or the shareholders have retained a substantial interest in the assets that have been transferred, it is appropriate to permit the tax-free transfer of those assets to the entity where they can be most efficiently used for business purposes.

The corporate rules in their current form cover asset-for-share transactions, amalgamation transactions, intra-group asset transfers, unbundling transactions and liquidation distributions.

This section will focus on the transactions contemplated in ss41-47 of the ITA. S41 provides for definitions of terms used in ss42-47. For the purposes of Part III of the Act, s41 narrows down the definition of a group to ensure that relief is only provided to SA-resident companies that are subject to tax on accrued income (Olivier, 2010:41).

Sections 41-47 of the Act contain the corporate rules with respect to the following three classes of transactions; asset transfers (in return for consideration); asset distributions; and capital restructuring.

The first class of transactions gives rise to three permutations, the first, which is described as an Asset-for-Share transaction, provided for in s42, contemplates the exchange of assets for equity in a company. The second permutation, described as an Amalgamation Transaction, contemplates the disposal of assets by one company to another (s44). The last permutation, which is described as an Intra-group Transaction, contemplates the rationalisation of a group (of companies) through the transfer of assets between two companies in the same group (s45).

The second class of transactions gives rise to two variations, the first, which is described as an unbundling transaction, which involves the unbundling of company's assets by means of a distribution in specie (s46). This variation involves the distribution of capital assets by liquidating the company in term of liquidation distribution to the holding company (s47).

The last class of transaction has one permutation, which involves the substitutive share-for-share transaction (s43).

It is important to note that in terms of s41, the corporate rules enjoy precedence over other tax rules as provided for in the ITA except in regard to the following sections: ss24B (2); 24B (3)[44]; 80A; 80L[45] and 103[46] of the ITA.

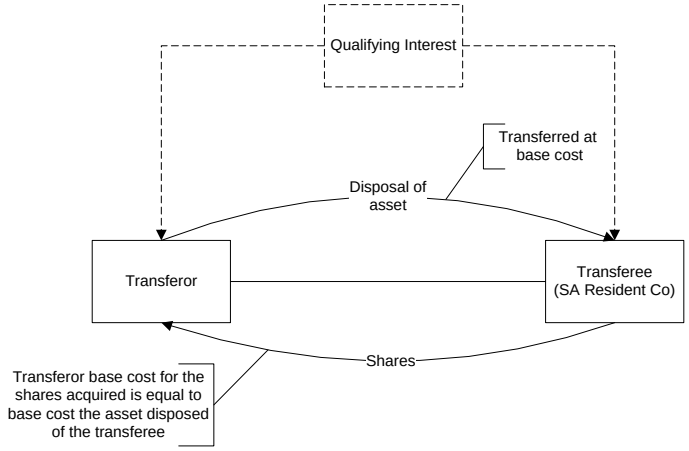
The following paragraphs will review the three classes of transactions contemplated in terms of ss42-47.

Asset-for-Share transaction

S42 of the ITA provides for the tax-deferred treatment of transactions where there is the disposal of an asset[47] by a company or even a natural person (the transferor) to a South African-resident company in exchange for equity shares in such a South African-resident company (the transferee). The transferor is required, at the end of the day on which the asset is disposed of, to hold a Qualifying Interest, as defined in s42 (1) (b) and (c)[48]. The transferee is meanwhile required to treat the capital asset acquired as a capital asset and trading stock as trading stock[49].

In the next section we discuss deferred treatment in more detail.

[44] Both subsections 24B (2) and (3) deal with transaction where assets are acquired in exchange for shares issued.
[45] These section contain the general anti-avoidance provisions
[46] This section deals with anti-avoidance provision in terms of assessed losses
[47] other than a restraint of trade or personal goodwill
[48] A qualifying interest for unlisted requires the transferor to hold at least 20 percent of the shares and voting rights in the transferee, alternative the transferor can hold such shares in a company forming part of the same group as the transferee. A qualifying interest for a listed company involves the transferor holding shares in the transferee.
[49] The exception to this rule is where the transferor and transferee are not part of the same group of companies s42(1) (b) (iii).



Rollover relief

In these transactions there are no Capital Gains Tax implications for the transferor because capital assets are deemed to be transferred at base cost.[50] The base cost of the asset accordingly 'rolls over' to the transferee and the deferred capital gain on the asset is accordingly only triggered when the transferee disposes of the asset, unless any relief finds application at such time.

In addition, the transferor's base cost in the shares acquired in the transferee is equal to the base cost of the asset disposed of to the transferee.[51]

For the transferee, its base cost for the capital asset (or even trading stock)[52] acquired would be that of the transferor.[53] The transferee can be seen to substitute the transferor in terms of the asset transferred. This principle also applies to allowances claimable under s24C in respect of contracts where a business is transferred as a going concern[54]. In the case of capital assets in terms of which allowances have been claimed, no recoupments would be recognised in the transferor's hands and the

[50] the 'asset-for-share' provisions are not applicable when the disposal of an asset would give rise to a loss; see Paragraph (a)(i)(aa) and (bb) of the definition of 'asset-for-share transaction' in s42(1)
[51] See s42 (2) (a) (ii) (bb)
[52] S42 (2) (b) (ii) (bb)
[53] S42 (2) (b) (ii) (aa)
[54] S42(3) (c)

transferee would be entitled to claim any future allowances thereon, if still applicable[55].

The provision of s42 relief only apply to the extent that assets are transferred in exchange for shares: rules of apportionment apply where additional consideration, in a form other than shares, is provided by the transferee to the transferor.[56]

S42 (8) provides that a proportionate part of any qualifying debt that was assumed by the transferee as part of an asset-for-share transaction will constitute an amount received by or accrued to the transferor in respect of the disposal of any of the shares in the transferee acquired in terms of the asset-for-share transaction, should such shares be disposed of by the transferor.

Essentially, s42 (8) provides that the transferor will have additional proceeds upon the disposal of the shares equal to a proportional amount of the debt that was assumed by the transferee.

There is no time limitation to the application of s42 (8). It will continue to find application in regard to a disposal of shares acquired in terms of an asset-for-share transaction, irrespective of the time period that elapses between the asset-for-share transaction and the future disposal of the shares.

Generally, s42 automatically applies on an asset-by-asset basis unless otherwise agreed to by the transferor and transferee.[57] The application of this section means for these transactions that they have no immediate income tax, Capital Gains Tax, Value Added Tax or security transfer tax implications.

Anti-Avoidance provisions

S42 contains an anti-avoidance provision that is triggered in the following four circumstances:

The first is where a transferor ceases to hold a qualifying interest in the transferee

[55] S42 (3) (a) and (b)
[56] S42 (4)
[57] S42 (8A)(a)

company within 18 (eighteen) months after the conclusion of the asset-for-shares transaction. However, the anti-avoidance provisions are not triggered where the transferor ceases to hold a qualifying interest pursuant to a transaction contemplated in terms of ss43-47 of the ITA or in terms of an involuntary disposal. A deemed disposal and reacquisition of a transferor's remaining interest in the transferee company is triggered, thereby giving rise to a CGT liability to the transferor.[58]

The second circumstance is where the transferor disposes of shares in the transferee within 18 months after the conclusion of an asset-for-shares transaction (other than a transaction pursuant to the corporate rules), the shares disposed of could be treated as the disposal of trading stock.[59]

The third circumstance is where the transferee company disposes of a capital asset within 18 months from the conclusion of an asset-for shares transaction; ring-fencing rules would apply to a portion of any resultant capital gain or loss.[60]

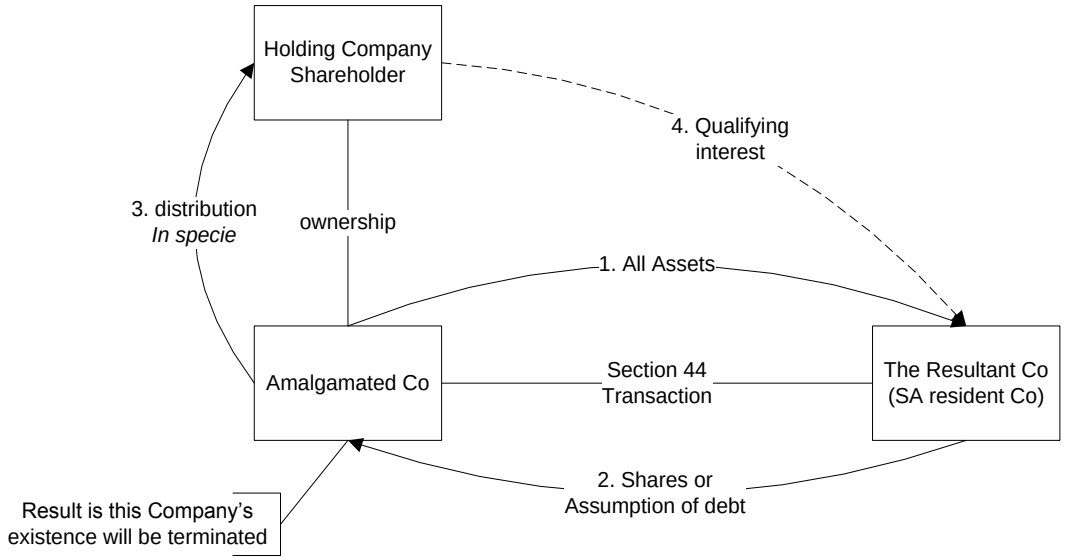
The ring-fencing rules[61] would also apply to a portion of any recoupment of allowances arising on the disposal of a capital asset within the aforementioned 18 month period and to any profit realised on the disposal of trading stock within the 18 month period, unless the trading stocking stock is of the same kind or equivalent quality as the trading stock it regularly and continuously sells.[62]

Amalgamation transactions

These types of transactions are executed in terms of s44 and they involve an amalgamation, conversion or merger of a company (the amalgamated company) in terms of which the amalgamated company disposes of all its assets (except those required to settle its trade debts) to a South African-resident company (the resultant company) in exchange for shares in the resultant company or the assumption of debt by the resultant company and in terms of which the amalgamated company's

[58] S42 (6)
[59] S42(5)
[60] S42 (7)(a)
[61] S42 (7)(b) (ii)
[62] S42 (7) (b) (i) read together with paragraph (b) of the s42 definition of 'trading stock'

existence is terminated.[63]



The shareholder of the amalgamated company is required to hold a qualifying interest in the resultant company when shares in the resultant company are distributed by the amalgamated company on its liquidation, deregistration or winding up.[64]

S44 applies automatically in the context of the disposal of assets by the amalgamated company to the resultant companies unless the holding company of the amalgamated company and the resultant company form part of the same group of companies and the three companies agree for it not to apply.[65]

Rollover relief

Where the amalgamated company transfers asset to the resultant company for shares in the resultant company, the following three rollover relief implications apply. We also note these applicable anti-avoidance provisions.

An asset transferred as a capital asset and treated by the resultant company as a

[63] The termination of the amalgamated company involves its liquidation, deregistration or wind-up coupled with the distribution in specie of the resultant company to the shareholder(s) of the amalgamated company.
[64] S44(6)
[65] S44 (1) (b)

capital asset is transferred at its base cost.[66]

Trading stock acquired by the resultant company as trading stock is transferred as its base value.[67]

In the case of capital assets in terms of which allowances have been claimed and would be claimable, no recoupments would be recognised in the transferor's hands and the resultant company would be entitled to claim any future allowances, if still applicable.[68]

The rollover relief also applies to allowances claimed and claimable under s24C in respect of contracts where a business is transferred as a going concern.[69]

The above reliefs are all based on the fact that the resultant company effectively steps into the shoes of the transferor company.

The tax implications for these types of transactions are similar to asset-for-shares transactions save that in the latter transaction, the transferee in a group of companies scenario has to elect whether to treat a capital asset transferred to it as a capital asset or as trading stock.

Anti-Avoidance provisions

As in s42, s44 also has anti-avoidance provisions that are triggered on the disposal of assets acquired by a resultant company from the amalgamated company within 18 months of the conclusion of the amalgamation transaction. These will now be discussed in sequence.

Ring-fencing rules would apply to a portion of any capital gain or loss arising as a result of the disposal of capital asset by a resultant company.[70]

The disposal by the resultant company of trading stock would result in any profits or

[66] S44 (2) (a)
[67] S44 (2) (b)
[68] S44 (3) (a) (ii) and (iii)
[69] S44 (3) (b)
[70] S44 (5) (a) and(ii)

losses in terms of such disposal being ring-fenced.[71]

Rollover relief

Where the amalgamated company disposes of and transfers the shares in the resultant company to its holding company, the rollover relief in s44 will only apply if the amalgamated company takes steps within 18 months after the amalgamation transaction to liquidate, wind up or deregister, or has not done anything to prevent its liquidation, winding up or deregistration from taking place.[72]

Rollover relief also applies where the amalgamated company's holding company disposes of its interest in the amalgamated company (as part of its liquidation, wind up or deregistration), and in turn holds equity shares in the resultant company either as capital assets or trading stock and holds a qualifying interest in the resultant company.[73]

The holding company is deemed to have disposed of its shares in the amalgamated company at its base cost (or at the tax cost) thereof and to have acquired the shares in the resultant company at the same base cost (or tax cost), depending on whether the shares in the amalgamated company were disposed of and the shares in the result company were acquired as capital assets or as trading stock, as the case may be.[74]

The shares in the amalgamated company are thus effectively substituted by those of the resultant company. Furthermore, the acquisition by the holding company of the shares of the resultant company in terms of a distribution in specie from the company is deemed not to be dividend.[75]

Anti-Avoidance provisions

Where the holding company ceases to hold a qualifying interest in the resultant

[71] S44 (5) (b) (i) and (ii)
[72] S44 (13)
[73] S44 (6)
[74] S44(6) (b) (i) and (iii) and s44 (6) (c)
[75] S44 (8) and 44 (9) read together

company within 18 months after the conclusion of an amalgamated transaction (other than transactions in terms of the corporate rules or in terms of a involuntary disposal), a deemed disposal and re-acquisition of the holding company's remaining interest in the resultant company is triggered.[76]

Intra-group transactions

S45 of the ITA deals with intra-group transactions. This class of transaction involves the transfer of an asset by one company (the transferor company) to a South African-resident company (the transferee company) where both companies at the end of the day on which the transaction is concluded, form part of the same group of companies. This transfer can be in exchange for cash or in exchange for a note issued by the transferee company, but not in exchange for shares issued by the transferee company. If the transferor receives a note issued by the transferee, the tax cost equals the fair market value of the note at the time of issue.[77]

The fair market value tax cost of the note can give rise to tax avoidance in the case of appreciated assets because a fair market-value tax cost exists for the note, even though the transferor receives rollover treatment for the appreciated assets.[78]

This treatment differs from s42 rollovers, which also allows for deferral of the transferred assets. However, unlike s45, any consideration issued (i.e. preference shares) in exchange under s42 has a rollover base cost (as opposed to a fair market value base cost).[79]

In 2007, the tax-free increase in tax cost was identified as problematic, but an interim solution was proposed. This second best solution requires re-examination given the on-going problems associated with s45. The exclusion of any shares as consideration in an s45 transaction is also problematic, especially since preference shares may

[76] S44 (11)
[77] http://www.treasury.gov.za/public%20comments/section45/August%202011%20Intra-group%20notes.pdf
[78] http://www.treasury.gov.za/public%20comments/section45/August%202011%20Intra-group%20notes.pdf
[79] http://www.treasury.gov.za/public%20comments/section45/August%202011%20Intra-group%20notes.pdf

pose less of a risk to the fiscus.[80]

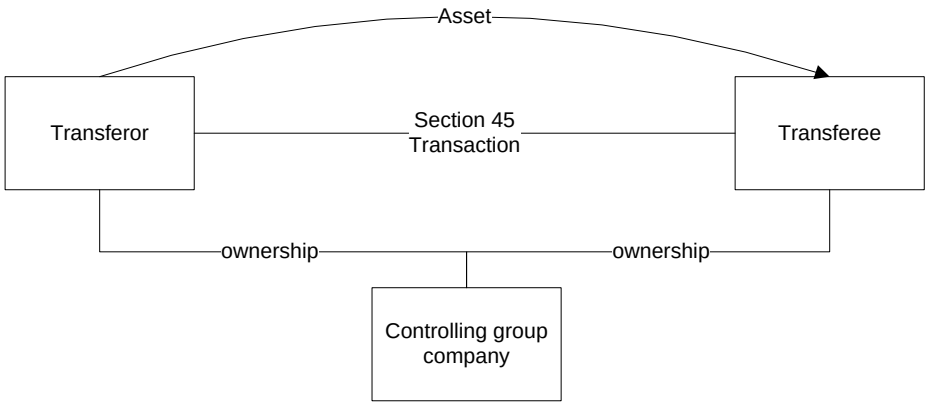
The use of preference shares as consideration for s45-transferred assets was permitted from 3 August 2011. This use of preference shares does not overlap with s42, which excludes preference shares. Preference shares are a useful tool in s45, especially if the s45 transfer is part of a shift to owners outside the group (up to 30 percent). Preference shares are often preferred in this instance because the newly formed entity with outside shareholders often lacks the income to absorb the interest expenses associated with debt.

The tax cost for notes and preference share consideration within the context of s45 raises two sets of issues. Rollover tax cost is the most appropriate result (like s42) if this consideration is transferred to parties outside the group because an elevated tax cost can act as an indirect form of exemption. On the other hand, repayment of a note or preference shares within the group should not give rise to taxable gain or income because the repayment represents a mere internal group shift.[81]

It is accordingly proposed that notes and preference shares issued as consideration under s45 have a split impact. These notes and preference shares will have a nil tax cost. However, any gain or income from the repayment of notes or preference shares will be exempt if the notes or preference shares are repaid while both parties to the notes or preference shares remain together within the same group of companies.[82]

The intra-group transaction provisions apply automatically unless the transferor and transferee companies jointly elect for the provisions of s45 not to apply.

[80] http://www.treasury.gov.za/public%20comments/section45/August%202011%20Intra-group%20notes.pdf
[81] http://www.treasury.gov.za/public%20comments/section45/August%202011%20Intra-group%20notes.pdf
[82] http://www.treasury.gov.za/public%20comments/section45/August%202011%20Intra-group%20notes.pdf



Rollover relief

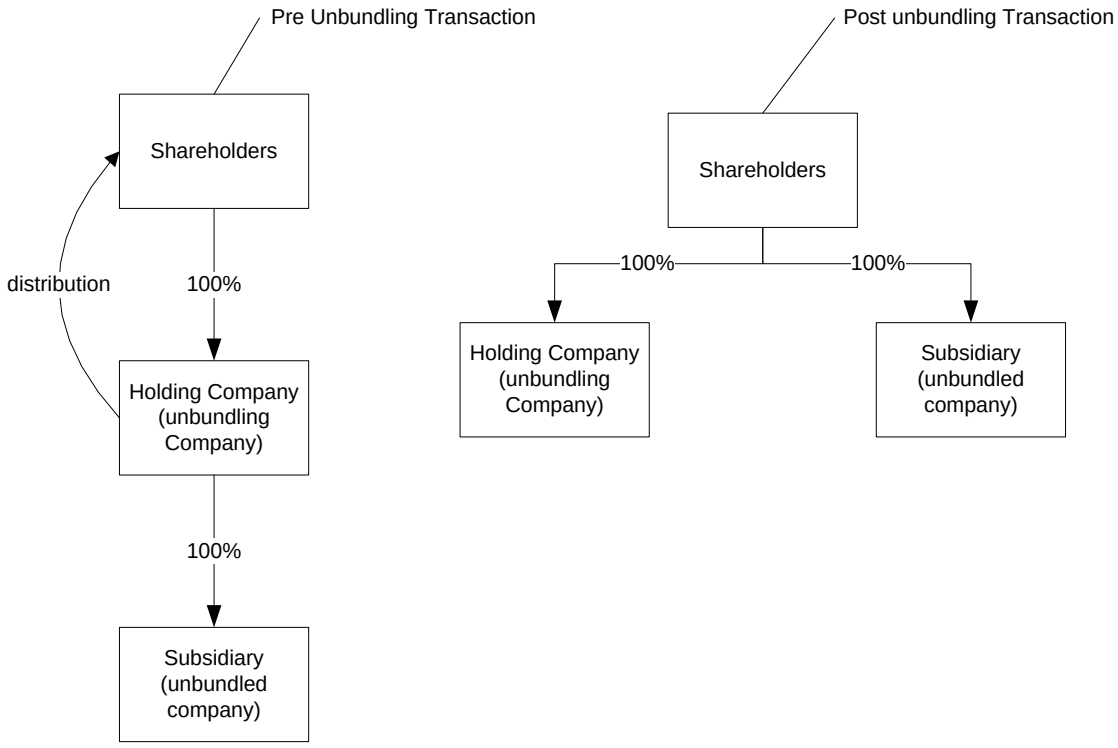
The above transaction, but for s45, would give rise to adverse tax consequences such as Capital Gains Tax and the recoupment of capital allowances. The intra-group transaction applies automatically unless the transferor and the transferee jointly elect that it will not apply.[83]

S45 is often used for corporate acquisition transaction, and in 2011 the National Treasury proposed to suspend the use of s45 in terms of a draft Tax Laws Amendment Bill. The National Treasury had concerns about the use of this provision in transactions where acquiring companies were incentivised to have acquisition debt/financing 'pushed-down' into a target company to facilitate the deduction of excessive acquisition-related interest costs, thereby reducing the returns to the fiscus. These concerns will be discussed in greater detail in the analysis of s45.

Unbundling Transactions

S46 provides for unbundling transactions, where all the equity in one subsidiary company (the 'unbundled company') is distributed by its holding company (the 'unbundling company') to the holding company's shareholders.

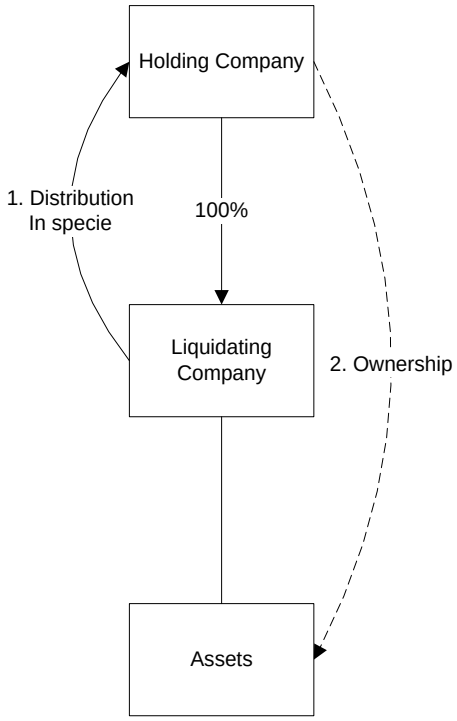
[83] S45 (6) (g)



The unbundling company is required to distribute all its equity shares in the unbundled company so that the effective shareholding of the shareholders in the subsidiary shares is altered by virtue of the unbundling transaction.

Transactions relating to Liquidation

Where the commercial usefulness of a company has come to an end, whether voluntarily or otherwise, and it must be liquidated and de-registered, such a process may involve the transfer of the company's assets to its shareholders. Such a distribution in specie may be subject to dividend tax as well as Capital Gains Tax. S47 provides relief for such instances where the assets of a liquidating company are distributed to its shareholders in anticipation of its liquidation, winding up or deregistration.



The provisions of s47 only give relief in the instances where the assets are distributed to another company. Hence the shareholder receiving the dividend must be a company. Furthermore the corporate shareholder must form part of the same group of the liquidating company.

Anti-Avoidance provisions

As with the other corporate rules, s47 has an anti-avoidance provision. This provision is aimed at stopping a liquidating company from being able to transfer assets with a 'built-in' gain to the holding company with excess losses, so that the holding company can sell the asset and set off its excess losses against the gain.[84]

Conclusion

All the transactions dealt with in ss41-47 of the ITA involve dispositions and should attract normal tax liability, or at the very least Capital Gains Tax, but these transactions do not result in gains that truly affect a person's ability to contribute to revenue. Some

[84] M Stiglingh, A Koekemoer, L Van Schalkwyk, J Wilcocks, & R. De Swardt,. *Silke: South African income tax. Durban*: (2014) 544

authors believe that the scheme of Part III of the ITA provides appropriate relief in these circumstances. However the anti-avoidance rules add considerable complexity to the corporate rules.

The authors of Silke (2014) provide a highly descriptive and technical account of the provisions of the ITA, in particular sections 41-47. We must note that the literature does not articulate the perverse and harmful incentives that the corporate rules give rise to in corporate finance transactions.

These transactions have been challenged by the Commissioner on concerns around excessive interest tax deductions, leading to base erosion, which the commissioner views as a threat to tax revenues, tax sovereignty and tax fairness (‘*social welfare*’).

Hybrid arrangements and the Interest Limitation Rules

In this section, tax rules relating to hybrid debt and hybrid equity instruments are examined and the related interest limitation rules, which prevent excessive interest deductions, are discussed.

As discussed in previous sections, when a firm issues debt and pays interest on it, that firm can normally deduct the interest paid from its taxable income, whilst the firm's debt holder receiving the interest will pay tax on such income.

By comparison to the above, when a firm declares a cash dividend to its shareholders out of its profits, the firm derives no taxation benefit or deduction. The shareholder receiving the cash dividend does not include the dividend in taxable income but, where the shareholder is not a corporate entity, he or she pays 15 percent dividends tax on such receipt.

An instrument in terms of which a firm owes money is a hybrid debt instrument if:

1. That firm is entitled or obliged to convert or exchange the instrument for shares, unless the market value of the shares is equal to the amount owed, at the time of conversion or exchange; or
2. The obligation to pay an amount in respect of the instrument is conditional on the firm being technically solvent (the market value of the assets not being less than the market value of the liabilities); or
3. The firm owes the amount to a *connected person* in relation to the firm (including a 20 percent shareholder) and is not obliged to redeem the instrument within 30 years from the date of issue or from the end of the current fiscal year of assessment, unless the instrument is payable on demand.

Deeming under the first category can be avoided by ensuring that any provisions in a shareholders' agreement which demand a subscription for shares instead of advancing shareholder loans provide that shareholders will take up a number of shares the collective value of which equals the required capital injection.

Deeming under the second category can be avoided by leaving out or revising the wording of subordination clauses and deeming under the third category can be

avoided by ensuring that shareholder loans are effectively repayable on shareholder demand.

There are certain exceptions to the deeming provisions, including linked units in a company held by long-term insurers, pension funds, provident funds and REITs.

A hybrid debt instrument is where debt is treated, for purposes of the ITA, as being equity. It is important to note that our tax rules do not re-categorise the instruments themselves, but, rather, re-categorize the payments and receipts under the instruments.

S8FA of the ITA is concerned with amounts paid in relation to an instrument and looks at the type of interest paid on any instrument ('*any form of interest-bearing arrangement or debt*') and classifies that interest as 'hybrid interest' in certain instances.[85]

If interest paid by a firm is classified as hybrid interest, then it is deemed to be a dividend *in specie* and it is not deductible in the hands of the firm. The recipient of the interest will be deemed to have received a dividend in specie and the firm will be liable for dividends tax.

There are exceptions to the deeming provisions that run along the same lines as those for hybrid debt instruments themselves.

Interest in relation to any debt owed by a firm in terms of any instrument is 'hybrid interest' if:

1. The amount of the interest is not determined with reference to a specified rate of interest; or
2. The amount of the interest is not determined with reference to the time value of

[85] However, subject to certain exemptions, dividends are liable to a withholding tax at the rate of 15 percent, referred to as dividends tax, which is a final tax payable by residents and non-residents alike

money; or

3. The amount is payable over and above the normal amount of interest payable on the instrument by reason of an increase in the profits of the firm …only the additional amount is hybrid interest.

This analysis cannot be undertaken in isolation from certain other interest-limitation rules contained in the ITA. These rules are: (i) where the recipient of the interest is not subject to tax in South Africa, usually, but not exclusively, in the case of cross-border loan agreements; and (ii) to prevent tax leakage arising from highly-geared acquisition transactions. The foregoing must also be considered in conjunction with South Africa's thin capitalization and transfer pricing rules.

Hybrid Equity Instruments

The new rules

There were substantial amendments to s8E in 2007, eventuating in major rewrites and amendments of the section in 2011 and 2012[86], which were aimed at aligning the income tax implications arising in respect of financial instruments with the economic substance of such instruments. During this period of review s8EA was also introduced.

The above changes that became law on 10 January 2012 were controversial. These changes provided for the extension of the definition of 'hybrid equity instrument' under s8E as well as the introduction of anti-avoidance measures for third-party backed shares under the new s8EA.

Many lawyers argued that the extended definition of hybrid equity instruments would trigger unintended consequences for ordinary 'vanilla' funding arrangements. The Government responded to these concerns with the release of the Draft Taxation Laws Amendment Bill on 13 March 2012 aimed at addressing the so-called 'Technical Corrections' to sections 8E and 8EA (the 'Technical Corrections').

Sections 8E and 8EA are generally aimed at transactions that use shares (usually

[86] Taxation Laws Amendment Act 24 of 2011

preference shares) to 'disguise' otherwise taxable interest as tax-exempt dividend income.

The Explanatory Memorandum to the Taxation Laws Amendment Act 24 of 2011 states that debt and share instruments differ in their essential features and consequences. The mischief that sections 8E and 8EA target is the realisation of a tax advantage where the consequences of shares are enjoyed but the substantial features of debt are employed.

The amendments recognise that preference share funding is often legitimately used to fund share acquisitions because of the disallowance of interest expenditure as a tax deduction where the purpose of the expenditure is a share purchase.

Section 8E

8E. Dividends on certain shares deemed to be income in relation to recipients thereof.—

(1) For the purposes of this section—

***'date of issue'**, in relation to a share in a company, means the date on which—*

(a) the share is issued by the company;

(b) the company at any time after the share has been issued undertakes the obligation to redeem that share in whole or in part; or

(c) the holder of the share at any time after the share has been issued obtains the right to require that share to be redeemed in whole or in part, otherwise than as a result of the acquisition of that share by that holder;

***'financial instrument'** means any—*

(a) interest-bearing arrangement; or

(b) financial arrangement based on or determined with reference to a specified rate of interest or the time value of money;

***'hybrid equity instrument'** means—*

(a) any share, other than an equity share, if—

(i) the issuer of that share is obliged to redeem that share in whole or in part; or

(ii) that share may at the option of the holder be redeemed in whole or in part,

within a period of three years from the date of issue of that share;

(b) any share, other than a share contemplated in paragraph (a), if—

(i)
(aa) the issuer of that share is obliged to redeem that share in whole or in part within a period of three years from the date of issue of that share;

(bb) that share may at the option of the holder be redeemed in whole or in part within a period of three years from the date of issue of that share; or

(cc)at any time on the date of issue of that share, the existence of the company issuing that share—

(A) is to be terminated within a period of three years; or

(B) is likely to be terminated within a period of three years upon a reasonable consideration of all the facts at that time; and

(ii)
(aa) that share does not rank pari passu *as regards its participation in dividends or foreign dividends with all other ordinary shares in the capital of the relevant company or, where the ordinary shares in such company are divided into two or more classes, with the shares of at least one of such classes; or*

(bb) any dividend or foreign dividend payable on such share is to be calculated directly or indirectly with reference to any specified rate of interest or the time value of money; or

(c) any preference share if that share is—

(i) secured by a financial instrument; or

(ii) subject to an arrangement in terms of which a financial instrument may not be disposed of,

unless that share was issued for a qualifying purpose;

***'preference share'** means a preference share as defined in section 8EA (1);*

***'qualifying purpose'** means a qualifying purpose as defined in section 8EA (1).*

(2) Any dividend or foreign dividend received by or accrued to a person during any year of assessment in respect of a share must be deemed in relation to that person to be an amount of income accrued to that person if that share constitutes a hybrid equity instrument at any time during that year of assessment.

S8E (2) deems the dividend declared by a firm on a share qualifying as a 'hybrid equity instrument' to be taxable interest income.

There are essentially three categories of hybrid equity instruments.

The First category of hybrid equity instruments is a share, not being an equity share,[87] if, within three years from the date of issue, either:

(i) the issuer is obliged to redeem the share; or

(ii) the holder has the option to have it redeemed.

It should be noted that the date of issue is not limited to the date that the share is actually issued, but, rather, the expression is extended to include:

(i) the date on which the company, at any time after issue, has undertaken the obligation to redeem; or

[87] An equity share is defined in s1 of the ITA to be 'any share in a company, excluding any share that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution'. Consequently, if a share has an unlimited right to participate either in dividends or in a return of capital, it is an equity share. Conversely, however, a share that has a limited right to participate both in dividends and returns of capital is not an equity share.

(ii) the holder has, at any time after issue, obtained the right to require the share to be redeemed.

The second category of hybrid equity instruments is an equity share if the issuer must redeem it within three years of the date of issue, as defined in the first category above, or if the holder has the right to have it redeemed within such three years, or, if, on the date of issue, the existence of the firm is to be terminated within three years or is likely to be terminated within three years. In addition to these requirements, to be a hybrid equity instrument, the share must either:

(i) not rank *pari passu* as regards participation in dividends with all other ordinary shares or, if there is more than one class, with at least one class of the shares; or

(ii) the dividend is calculated, directly or indirectly, by reference to any specified rate of interest or the time value of money.

The third category of hybrid equity instruments is a preference share[88] where the share is either secured by a financial instrument[89] or is subject to an arrangement in terms of which a financial instrument must not be disposed of. If these criteria are met, the preference share is still not a hybrid equity instrument if it was issued for a 'qualifying purpose'.

The definition of '*qualifying purpose*' is intended to cover the following circumstances:

(i) The acquisition of an equity share in an operating company, being a company that carries on business continuously and in the course or furtherance of which the business provides goods or services for consideration, any company that is a controlling company in relation to the operating company, or any listed company. Consequently, the dispensation is granted if the preference share funding is used to finance the acquisition of active investments and this is done, particularly with the need to assist the financing of acquisitions of minority

[88] In the first and second categories of hybrid equity instruments the share might or might not have been a preference share, but in this case it is limited to a preference share.

[89] Defined, for this purpose, as meaning any interest-bearing arrangement, or any financial arrangement based or determined by reference to a specified rate of interest or the time value of money.

stakes in companies in terms of South Africa' s black economic empowerment policies, to enable stakes to be financed by banks, in circumstances where the individuals did not have adequate resources of their own;

(ii) The refinancing of any debt used, directly or indirectly, to acquire an equity share in an operating company or debt in respect of the resulting interest; and

(iii) The refinancing of existing preference shares that are to be redeemed or the financing of the payment of the related dividends thereon.

The underlying philosophy is if the instrument is a hybrid equity instrument, the dividend received is treated as ordinary income. In this respect, the following two points should be noted: the dividend is not deemed to be interest, but simply taxable income; and the payer is treated as distributing a dividend.

Third-party-backed shares

8EA. Dividends on third-party-backed shares deemed to be income in relation to recipients thereof.—(1) For the purposes of this section—

'enforcement obligation' in relation to a share means any obligation, whether fixed or contingent, of any person other than the issuer of that share to—

(*a*) acquire the share from the holder of that share;

(*b*) make any payment in respect of that share in terms of a guarantee, indemnity or similar arrangement; or

(*c*) procure, facilitate or assist with any acquisition contemplated in paragraph (a) or the making of any payment contemplated in paragraph (b);

'enforcement right' in relation to a share means any right, whether fixed or contingent, of the holder of that share or of **any** person that is a connected person in relation to that holder to require any person other than the issuer of that share to—

(*a*) acquire that share from the holder;

(*b*) make any payment in respect of that share in terms of a guarantee, indemnity or similar arrangement; or

(*c*) procure, facilitate or assist with any acquisition contemplated in paragraph (a) or the making of any payment contemplated in paragraph (b);

'operating company' means—

(*a*) any company that carries on business continuously, and in the course or furtherance of that business—

(i) provides goods or services for consideration; or

(ii) carries on exploration for natural resources;

(*b*) any company that is a controlling group company in relation to a company contemplated in paragraph (a); or

(*c*) any company that is a listed company;

'preference share' means any share—

(*a*) other than an equity share; or

(*b*) that is an equity share, if an amount of any dividend or foreign dividend in respect of that share is based on or determined with reference to a specified rate of interest or the time value of money;

'qualifying purpose', in relation to the application of the funds derived from the issue of a preference share, means one or more of the following purposes:

(*a*) The direct or indirect acquisition of an equity share by any person in an operating company, other than a direct or indirect acquisition of an equity share from a company that, immediately before that acquisition, formed part of the same group of companies as the person acquiring that equity share;

(*b*) the partial or full settlement by any person of any—

(i) debt incurred for one or more of the following purposes:

(*aa*) The direct or indirect acquisition of an equity share by any person in an operating company, other than a direct or indirect acquisition of an equity share from a company that, immediately before that acquisition, formed part of the same group of companies as the person acquiring that equity share;

(*bb*) a direct or indirect acquisition or a redemption contemplated in paragraph (*c*);

(*cc*) the payment of any dividend or foreign dividend as contemplated in paragraph (d); or

(*dd*) the partial or full settlement, directly or indirectly, of any debt incurred as contemplated in item (aa), (bb) or (cc); or

(ii) interest accrued on any debt contemplated in subparagraph (i);

(*c*) the direct or indirect acquisition by any person or a redemption by any person of any other preference share if—

(i) that other preference share was issued for any purpose contemplated in this definition; and

(ii) the amount received by or accrued to the issuer of that preference share as consideration for the issue of that preference share does not exceed the amount outstanding in respect of that other preference share being acquired or redeemed, being the sum of—

(*aa*) that amount; and

(*bb*) any amount of dividends, foreign dividends or interest accrued in respect of that other preference share; or

(*d*) the payment by any person of any dividend or foreign dividend in respect of the other preference share contemplated in paragraph (c);

'third-party backed share' means any preference share in respect of which an enforcement right is exercisable by the holder of that preference share or an enforcement obligation is enforceable as a result of any amount of any specified dividend, foreign dividend, return of capital or foreign return of capital attributable to that share not being received by or accruing to any person entitled thereto;

(2) **Any** dividend or foreign dividend received by or accrued to a person during any year of assessment in respect of a share must be deemed in relation to that person to be an amount of income received by or accrued to that person if that share constitutes a third-party backed share at any time during that year of assessment.

(3) (*a*) Where the funds derived from the issue of a preference share were applied for a qualifying purpose, in determining whether—

(i) an enforcement right is exercisable in respect of that share, no regard must be had to any arrangement in terms of which the holder of that share has an enforcement right in respect of that share and that right is exercisable; or

(ii) an enforcement obligation is enforceable in respect of that share, no regard must be had to any arrangement in terms of which that obligation is enforceable,

against the persons contemplated in paragraph (b).

(*b*) For the purposes of the determination contemplated in paragraph (a) no regard must be had to the following persons:

(i) The operating company to which that qualifying purpose relates;

(ii) any issuer of a preference share if that preference share was issued for a qualifying purpose;

(iii) any other person that directly or indirectly holds at least 20 percent of the equity shares in—

(*aa*) the operating company contemplated in subparagraph (i); or

(*bb*) the issuer contemplated in subparagraph (ii);

(iv) any company that forms part of the same group of companies as—

(*aa*) the operating company contemplated in subparagraph (i);

(*bb*) the issuer contemplated in subparagraph (ii); or

(*cc*) the other person that directly or indirectly holds at least 20 percent of the equity shares in the operating company contemplated in subparagraph (i) or the issuer contemplated in subparagraph (ii);

(v) any natural person;

(vi) any organisation—

(*aa*) which is—

(A) a non-profit company as defined in section 1 of the Companies Act; or

(B) a trust or association of persons; and

(*bb*) if—

(A) all the activities of that organisation are carried on in a non-profit manner; and

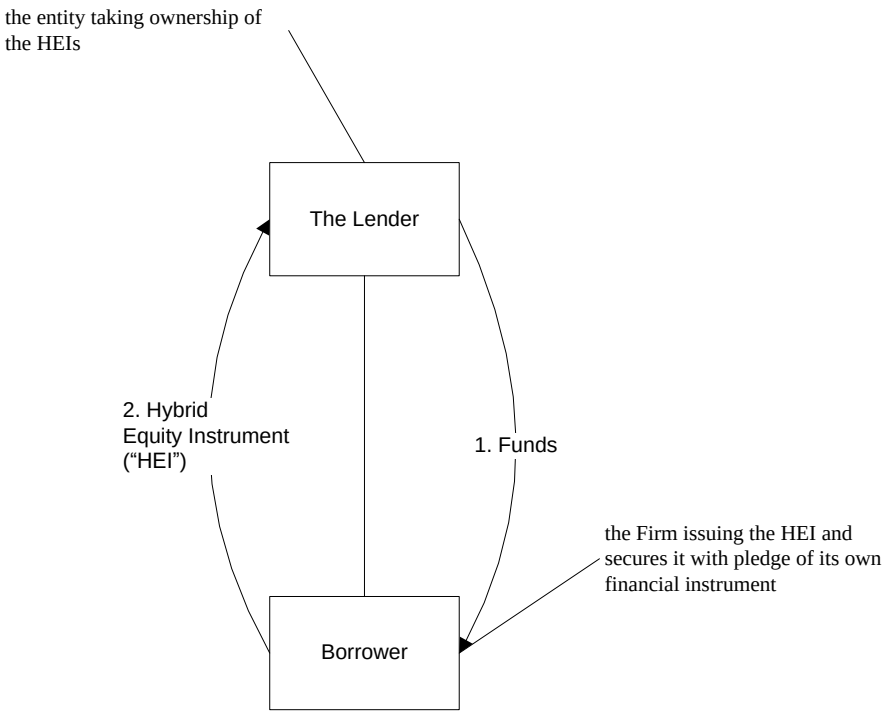
(B) none of the activities of that organisation are intended to directly or indirectly promote the economic self-interest of any fiduciary or employee of that organisation, otherwise than by way of reasonable remuneration payable to that fiduciary or employee; or

(vii) any person that holds equity shares in an issuer contemplated in subparagraph (ii) if—

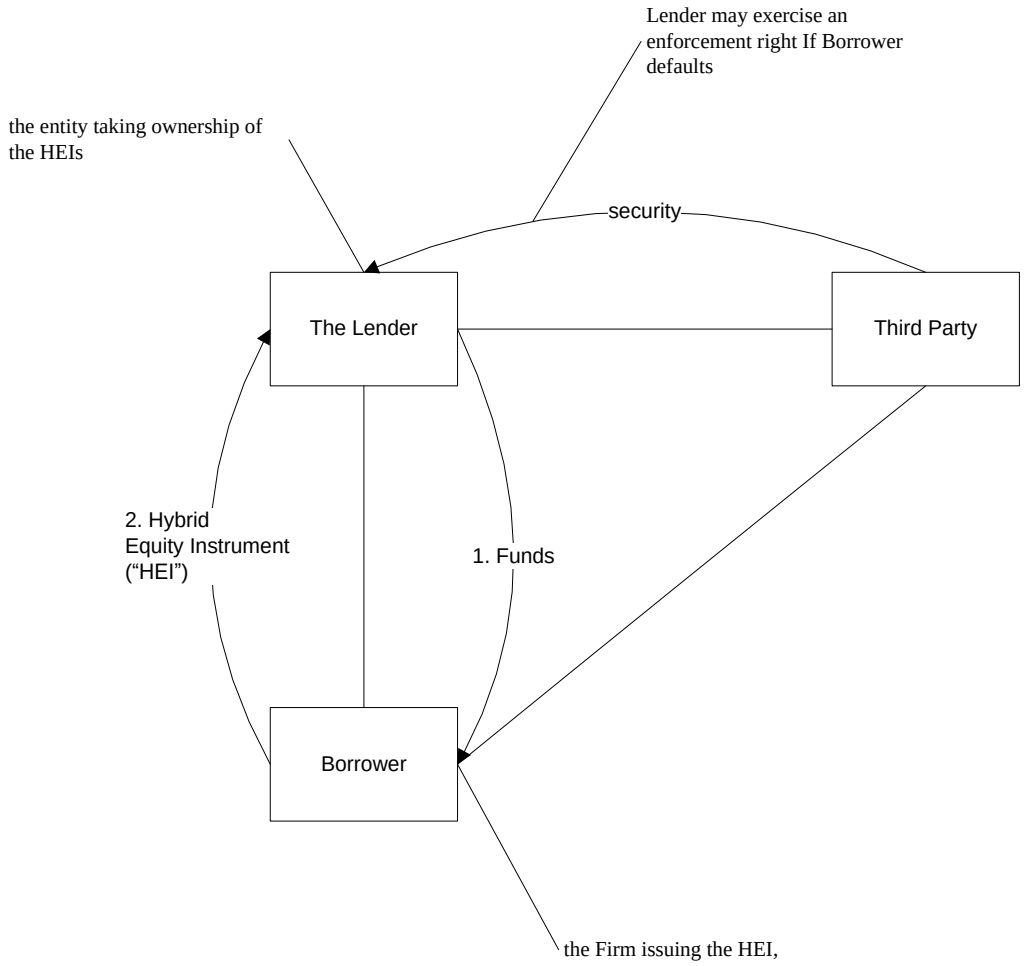
(*aa*) that issuer used the funds provided by that person solely for the acquisition by that issuer, other than from a company that immediately before that acquisition formed part of the same group of companies as the issuer, of equity shares in an operating company; and

(*bb*) the enforcement right exercisable or enforcement obligation enforceable against that person is limited to any rights in and claims against that issuer that are held by that person.

As stated in the previous section, s8EA relates to the situation where there are enforcement rights or enforcement obligations in relation to preference shares. S8E is limited to the terms of the instrument or where the issuer itself secures performance by means of a pledge of its own financial instrument.



S8EA deals with third-party-backed shares, where a third party, one way or another, ensures that the holder of the preference share is secured if the issuer does not perform.



Consequently, a third-party-backed share is defined to mean any preference share in which the holder may exercise an enforcement right or the issuer has an enforcement obligation that is enforceable if any dividend or return of capital is not received by the person so entitled. In such a case, again, the dividend is treated as non-exempt income and, once again, the issuer obtains no deduction.

In this case, however, a preference share is defined as meaning either:

(i) A share that is not an equity share; or

(ii) A share that is an equity share, as it participates beyond a specified amount, but the amount of the dividend is based on, or is determined by reference to, a specified rate of interest or the time value of money.

An enforcement right means, in relation to the share, any fixed or contingent right that

the holder/lender has to require any person other than the issuer to:

(i) Acquire the share from the holder,

(ii) Make any payment in respect of the share in terms of a guarantee, indemnity or similar arrangement, or

(iii) Procure, facilitate or assist with either the acquisition in (i) or the payment in (ii) above.

An enforcement obligation is essentially the corollary of the enforcement right. Yet again, if the security features in relation to the performance of the issuer's obligations under a share are similar to what one would expect in respect of debt, the recipient of the dividend is taxable as if it were receiving income on a debt instrument.

As with hybrid equity instruments, there are exceptions to the rule, such that the existence of the enforcement right or enforcement obligation must be disregarded, thereby ensuring that the share is not a third-party-backed share. The overriding requirement for the enforcement right or enforcement obligation to be disregarded is that the share must be applied for a qualifying purpose as discussed in the previous section, but the enforcement right or obligation is disregarded only if it is, in addition, exercisable against a limited number of parties, these being, briefly:

(i) The operating company itself;

(ii) The issuer of the preference share;

(iii) Any other person that directly or indirectly holds at least 20 percent of the equity shares in the operating company or in the issuer;

(iv) Any company that forms part of the same (tax) group of companies as the operating company, the issuer or the person that holds at least 20 percent of the equity shares;

(v) A natural person; or

(vi) Certain non-profit companies.

Conclusion

The Government recognises that there are many ways in which domestic tax bases can be eroded and the most significant types of base erosion in South Africa comes in the form of excessive deductible interest.[90]

In the cross-border context, excessive interest can arise if the interest yield is driven by tax considerations as opposed to arm's length commercial reasons, especially if the debtor and creditor are connected persons. Also of concern is 'lending' that would not arise in a commercial context. In these cases, transfer-pricing adjustments can be used to eliminate debt with excessive interest or excessive debt.[91]

While the need to obtain debt financing for acquisitions is well understood, excessive debt becomes problematic because excessive debt (or over-gearing) is often anchored on the expectation that the interest will be paid from future profits. If allowed to proceed to extremes, the interest on the debt often eliminates taxable profits for years to come. Acquisition debt of greatest concern is mezzanine and subordinated debt (i.e. debt containing an escalating number of equity features). Besides tax concerns, excessive debt gives rise to governance concerns with the excessive debt creating excessive risk.[92]

[90] The relationship between creditor and debtor often becomes blurred once both parties form part of the same economic unit. This situation often arises when a parent company lends money to a wholly owned subsidiary. In this situation, the terms of the instrument are somewhat irrelevant because both parties can change the terms at will to serve the overall interests of the group. As a result, the debt label for instruments in these circumstances is often driven by tax and other regulatory factors; whereas the payments often represent substantive capital contributions to be repaid only if the subsidiary at issue is profitable. See http://www.sars.gov.za/Media/MediaReleases/Documents/Media%20Release%2029%20April%202013%20-%20Proposed%20limitations%20against%20excessive%20interest%20tax%20deductions.pdf

[91] http://www.sars.gov.za/Media/MediaReleases/Documents/Media%20Release%2029%20April%202013%20-%20Proposed%20limitations%20against%20excessive%20interest%20tax%20deductions.pdf

[92] http://www.sars.gov.za/Media/MediaReleases/Documents/Media%20Release%2029%20April%202013%20-%20Proposed%20limitations%20against%20excessive%20interest%20tax%20deductions.pdf

Section 4: Analysis

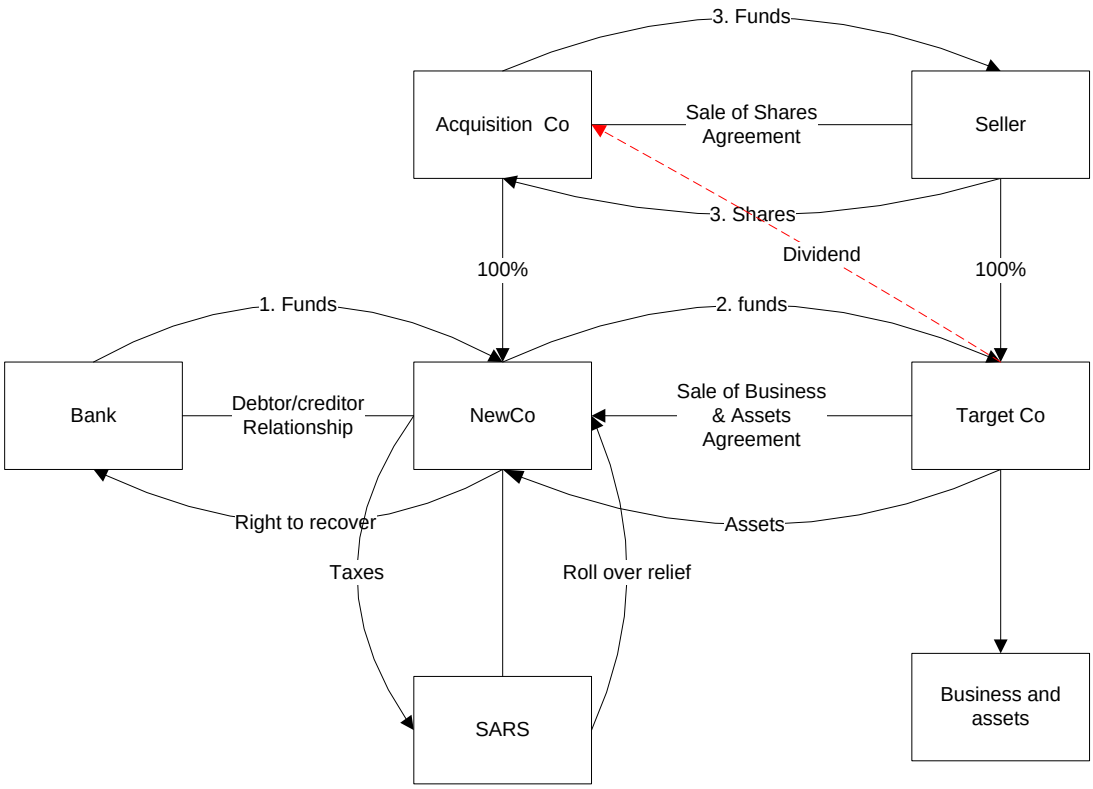
Introduction

Structuring transactions is an important part of commerce and tax savings are a key factor in designing or planning any transaction and can influence the ultimate structure of the transaction. This section will briefly outline a type of acquisition finance transaction.

As noted in the previous section, dividends constitute tax-exempt income and accordingly, where a taxpayer pays interest on borrowed funds to finance the acquisition of shares, such expenditure would, prior to the recent amendments to the ITA, not be deductible in the hands of the taxpayer as it cannot be said to have been incurred in the production of income.

However, in situations where the taxpayer has been able to show that the income produced as a result of the acquisition financed by the loan is not tax-exempt income, for example a salary or management fee, the courts have allowed the deduction of a portion of the relevant income expenditure.

As a result of this distinction between interest deductibility in shares and asset acquisitions, corporate finance transactions for the purchase of businesses and assets have typically used the intra-group relief provisions in the corporate rules to take advantage of the various benefits of financing described above, including the tax shield advantages thereof. To this end a number of such transactions have similar structures, which, although they may differ from transaction to transaction, are often conducted along similar lines as described below:



Step 1: A Purchaser, (the 'Acquisition Co.') makes an offer to the owners (the 'Sellers') of the Target Company ('Target Co'). On acceptance of the offer, a wholly owned subsidiary (NewCo) of Acquisition Co is created.

Step 2: Acquisition Co acquires the issued shares in the target Co from the Sellers for an agreed purchase consideration, payable by the creation of a loan account in the books of the Acquisition Co in favour of the Sellers.

Following the transaction, Acquisition Co and Target Co will form part of the same group, and Acquisition Co. will be indebted to the Sellers in respect of an amount equal to the agreed purchase consideration.

Step 3: NewCo borrows funds from a lender, so that NewCo is indebted to the Lender, and placed in funds.

Step 4: NewCo then acquires the business and operating assets of the Target Co, from Target Co in accordance with the intra-group provision of s45, for a purchase consideration equivalent to that payable by Acquisition Co to the Sellers.

Step 5: Target Co than makes a distribution (typically a dividend) to Acquisition Co of the proceeds received from NewCo.

Step 6: Having received a dividend from Target Co, Acquisition Co uses the proceeds, which are equal to the initial agreed purchase consideration, to settle its obligations to the Sellers.

Step 7: Target Co is then wound up.

There are many variations to this structure, but in each instance the net result is that the debt is 'pushed-down' from the Acquiring Company to the NewCo, as owner of the assets, and the debt burden is shifted onto the target business of the acquisition held in NewCo. The acquirer therefore purchases a profitable income-producing and tax-paying entity which, through a careful use of debt and astute structuring, remains an earnings-producing, cash-generative business, but lowers the tax payable and increases the net returns to (debt and equity) investors though the application of a tax shield effect. Thus the favourable treatment of debt in our income tax system provides an opportunity for investing companies in this group arrangement to pursue debt as a debt shifting strategy in order to minimise their total tax burden.

The Debt Push Down structure demonstrates that debt bias in our tax system distorts investment decisions.

From the above description of an acquisition (purchase of assets), it is obvious that the tax treatment of interest and dividends differs. For the acquiring company, the general rule is that the interest on the debt incurred and paid is deductible, while for the financing agent, such as a bank, the interest payment received from the

advancement is taxable. For the financing party, structuring their advancement in such a manner as to give rise to exempt income like a dividend seems like a more efficient structure. Traditionally when a financed company declares a dividend, that dividend is exempt for the shareholders, and the financed company loses the ability to receive a tax benefit because the dividends are not deductible as expenditure. Today, the dividend is subject to the dividends tax.

Legal Analysis

Tax avoidance

The 'debt pushed-down' structure needs to be considered in light of sections 80A to 80L, which deals with the general anti-avoidance rules ('GAAR').

The GAAR applies whenever all four of the following requirements are met:

1. There is an arrangement;
2. The arrangement results in a 'tax benefit' for one or more of the parties (i.e. it constitutes an 'avoidance arrangement');
3. The arrangement includes one or more 'tainted elements', and
4. The sole or main purpose of the arrangement is to obtain the 'tax benefit'.

The GAAR may be applied to an arrangement as a whole, or to any step in or part of an arrangement. If an arrangement does result in a 'tax benefit', its sole or main purpose is presumed to be tax avoidance unless and until the party obtaining the tax benefit proves that, 'reasonably considered in light of the relevant facts and circumstances' that obtaining the tax benefit was not the sole or main purpose of the arrangement.

S80A(1) requires that where a tax benefit exists, the party concerned will need to be able to factually demonstrate that obtaining the tax benefit was not the sole or main purpose. The Act also makes it clear that when applying this 'purpose test', the purpose of the steps in, or parts of an arrangement can be different from the purpose of the arrangement as a whole. Finally, in determining whether or not an arrangement

results in a ‘tax benefit’, SARS is specifically authorised to deem parties who are ‘connected persons’ in relation to each other as if they were one and the same person.

In considering the possible application of the GAAR, it is apparent that the ‘debt pushed-down’ structure constitutes an ‘arrangement’.

Tax benefit

A ‘tax benefit’ is defined in s1 as including any ‘avoidance, postponement, or reduction of any liability for tax’. It is worth noting that any hypothetical tax liability that may have arisen had the transaction been structured differently does not constitute an anticipated tax liability in this regard.

A tax benefit could arguably arise, as by virtue of the introduction of additional debt funding in the form of loan to NewCo, the taxable income of NewCo will be reduced resulting in a corresponding reduction of any liability for tax.

Based on the requirements of s80G (1), NewCo will bear the onus of proving that the loan from the Lender was not for the sole or main purpose of obtaining a tax benefit but to purchase the asset of Target Co.

Tainted elements

The ‘tainted elements’ under the GAAR apply to arrangements:

1. Entered into or carried out in a manner which would not normally be employed for bona fide business purposes, other than obtaining a ‘tax benefit’;
2. That have created rights or obligations that would not normally be created between persons dealing at arm’s length; or
3. That would result in the ‘misuse or abuse’ of any provision of the ITA.

It is clear that using the cash raised to enable NewCo to fund the purchase of the Business and assets of Target Co will be entered into and carried out in a manner normally employed for *bona fide* business purposes, other than obtaining a ‘tax

benefit'.

This principle is further supported by the *ITC* 1603 58 SATC 212 where Galgut J held that 'where a taxpayer requires capital to finance his operations, it is entirely up to him to choose the source from which he derives such capital. The fact that he chooses to borrow money … will not preclude him from deducting the interest payable on the loan, provided that the borrowed money is used in the production of income'.

The debt push-down arrangement does not create rights or obligations that would not normally be created between persons dealing at arm's length. Consequently it appears that the 'tainted element' will not apply.

Lack of commercial substance

In general, a 'lack of commercial substance' exists whenever an arrangement, in whole or in part, would result in a significant 'tax benefit' for a party, but would not have a significant impact on both its business risks and net cash flows (apart from the 'tax benefits' obtained from the scheme). Again, SARS is explicitly authorised to treat parties who are 'connected persons' in relation to each other as one and the same person for purposes of applying this test.

In our view, debt capital would have a significant effect on both the cash flows and business risks of NewCo and Acquisition Co. This is because Acquisition Co will have increased both its credit exposure and liquidity risk, as post the share purchase and settlement of the amount outstanding under the Sale of Shares Agreement, while NewCo will have increased both its credit exposure and liquidity risk, as post the purchase of Target's business and assets and declaration of dividends. Consequently, it appears that the 'tainted element' will not apply.

This principle is further supported by the ITC 1603 58 SATC 212 where Galgut J held that 'where a taxpayer requires capital to finance his operations, it is entirely up to him to choose the source from which he derives such capital. The fact that he chooses to

borrow money where he has cash available will not preclude him from deducting the interest payable on the loan, provided that the borrowed money is used in the production of income'.

The ITA also sets out four non-exclusive indicia of arrangements that lack commercial substance, namely:

1. Instances where the legal substance or effect of the avoidance arrangement as a whole is inconsistent with, or differs significantly from, the legal form of the individual steps;
2. Round-trip financing;
3. Accommodating or tax-indifferent parties, and
4. Offsetting or self-cancelling elements.

Round-trip financing

S80D provides that for there to be 'round-trip financing', funds must be transferred between or among the parties, which results in a tax benefit and also significantly reduces, eliminates or offsets any business risk incurred by any party to the 'arrangement'. One of the characteristics of 'round-trip financing' is where funds are made to pass between the parties, seemingly for commercial consideration, but at the end of the arrangement all parties are in the same financial position as they were previously, apart from them receiving a tax benefit along with no significant increase in business risk. The Debt Push Down structure does not contravene this provision as funds are used by NewCo to pay the purchase price of the business and assets of Target Co, and Target Co declares a dividend to Acquisition Co, which in turn settles its obligation in terms of the Share Purchase Agreement with Target Co's former shareholders.

Accommodating or tax-indifferent party

S80E (3) provides an exclusion to what constitutes an 'accommodating or tax

indifferent party'. From our understanding of the steps and parties involved in a typical Debt Push Down structure, none of the parties would be regarded as 'accommodating or tax-indifferent parties'.

Offsetting or cancelling

Although not defined for the purposes of s80C (2) (b) (iii), the presence of elements that have the effect of 'offsetting or cancelling' each other seems to come from the fiscal nullity doctrine which is dealt with in WT Ramsay Ltd v ICR[93]. This criterion is aimed at eliminating overly complex and intentionally misleading elements of a transaction which when looked at as a whole, seem to cancel each other out. It appears that the steps in the 'Debt Push Down' Structure do not have the effect of 'offsetting or cancelling' each other.

The debt push down structure does not show a 'lack of commercial substance' as none of the above indicators apply to it.

Conclusion on the GAAR

The debt push down structure does not and should not fall foul of the GAAR in sections 80A to 80L. It is fundamental that taxpayers are able to discharge their onus of proof that every transaction and operation, including every step therein, or part thereof, is not entered into or carried out solely or mainly to obtain a 'tax benefit'.

Whether or not a transaction is entered into solely or mainly to obtain a 'tax benefit' is a question of fact. As already concluded, the debt push down structure is not implemented solely or mainly to derive a 'tax benefit'.

Simulated transaction analysis

Until the judgement in the NWK Case was delivered in December 2010, the simulated transaction (or substance over form) analysis was not an investigation into the commercial substance of a transaction, but rather a consideration of whether the form

[93] WT Ramsay Ltd v Inland Revenue Commissioners [1981] UKHL 1 (12 March 1981)

of a transaction represented the true intentions of the parties and, therefore, the legal substance of the transaction.[94] In particular, in order to treat a transaction as simulated, it was necessary that it was dishonest or a sham, and that it did not reflect the true intentions of the parties.

The challenge in the NWK case and many other cases is that the 'substance over form' doctrine has proved insufficient in combating many tax-avoidance schemes because contract arrangements comprise valid agreements and are not easily susceptible to challenge. Thus, in Lewis JA's dictum, which held that (1) the test for simulated transactions should go further and require an examination of the commercial sense of the transaction; and (2) if the purpose of the transaction is only to achieve an object that allows the evasion of tax or of a peremptory law, then it will be regarded as simulated, even if the parties in fact mean that a contract shall have effect in accordance with its tenor, and are genuine in their intention, that transaction would be regarded as simulated if its only purpose was to evade tax.

Lewis JA added the requirement of a 'commercial purpose' to the test of simulation, because in the Friedman Motors case the court found that the parties intended their transactions to have legal effect because the transactions, in themselves, made good business sense. Robert Sharrock, writing in the Annual Survey of South African Law 2011, points out that the Friedman Motors case merely illustrated that whether a transaction make good business sense is an important consideration in deciding whether the parties had a contractual intention. Parties are at liberty to make an agreement with no identifiable commercial purpose whatsoever and, if they intend to uphold and implement the agreement then, whatever else may be said about it, the agreement is not simulated.

Robert Sharrock also notes in the Annual Survey of South African Law 2011 that the reason why a simulated agreement is not binding is that the parties do not intend to

[94] *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd* 1941 AD 369 at 395-7 and *Erf 3183/1 Ladysmith (Pty) Ltd v CIR 1996 (3)* SA 942 (A), 58 SATC 229

uphold or perform it and, as such, they lack contractual intention.

According to Robert Sharrock it is incorrect and confusing to classify as 'simulated' an agreement that the parties intended to have legal effect according to its tenor. Furthermore it also makes no sense to require an agreement to have a commercial purpose or rationale to avoid being classified as simulated. This effectively makes it necessary for every agreement to have a commercial purpose or rationale, which is clearly unrealistic, since a large number of agreements are not made for commercial reason and many, made in a commercial context, do not make good commercial sense.

Robert Sharrock concludes in the 2011 Annual Survey that

> *'it is regrettable that Lewis JA saw fit to depart from established precedent on what constitutes simulation because the test of simulation which she formulated is bound to create uncertainty and confusion. If there is perhaps a need to restrict the widespread practice of tax avoidance, it should not be addressed by applying a distorted conception of simulation, one which undermines settled contract law'.*

In the more recent case of *Roshcon (Pty) Ltd v Anchor Auto Body Builders CC & Others*[95], one of the five judges, namely Wallis JA, commented specifically on what he regarded 'may be a misconception regarding the proper approach to simulated transactions'. Wallis JA reaffirmed that the test is whether the parties truly intended to conclude the contract in accordance with its terms, if a transactions serves no commercial purpose, this is simply one of the facts that will be taken into account in applying this test.

In considering the judgement of NWK, Wallis JA rejected the proposition that the SCA had taken the law in a 'new direction'. Wallis JA held that the essence of a simulated transaction is that it involves a disguise. Whether a transaction is a simulated transaction is a question of its genuineness. Where the courts find a transaction is not a genuine transaction, they will give effect to the underlying transaction that it conceals. In determining whether a transaction is genuine, one must take into consideration all the facts and circumstances surrounding the transaction.

[95] (49/13) [2014] ZASCA 40.

In income tax cases such as NWK, explained Wallis JA, parties may seek to take advantage of income tax legislation in order to obtain a reduction in their overall liability for income tax. The various mechanisms for doing this involve taking straightforward commercial transactions and adding complex additional elements solely for the purpose of claiming increased or additional deductions from taxable income, or allowances provided for in the legislation. 'The feature of those that have been treated as simulated transactions by the courts is that the additional elements add nothing of value to the underlying transaction and are very often self-cancelling.' This was the case in NWK where a range of unrealistic and self-cancelling features had been included 'solely to disguise' the true nature of the loan. The requirement of disguise was thus met in the NWK case and therefore the simulation principle applied in these circumstances. The Roshcon judgement confirms that the essence of a simulated transaction is not that it has the effect of avoiding tax or that it lacks a 'commercial purpose' but rather that the essence of a simulated transaction is that it is not genuine.

There is nothing about the Debt Push Down structure that endeavours to conceal some other real character, or that there is some other real commercial intention to it that differs from the stated objective. On this basis, it is unlikely, that the debt push down arrangement, or any steps included therein, constitutes a simulated transaction.

Commercial Analysis

Opportunities to shift and decrease reported profit

It is clear from the above discussions that s11 (*a*) read together with s23 (*g*) of the ITA, does encourage commerce and risk-taking but it also creates a distortion and bias in the financing decision of companies. The deductibility of interest expenses exacerbates opportunities to shift and decrease reported profit via debt-shifting or the use of hybrid instruments. The deductibility of interest expenses may also lead to extreme levels of leverage in companies, increasing systemic risk.

In this last-mentioned instance a firm with large debt capital can use the deductibility of interest expenses to take a tax advantage over a firm with less or more equity capital. Where the investor is a resident of South Africa and the recipient of such financial assistance is also a resident of South Africa, there is no loss to the fiscus as the interest deducted in the hands of the recipient would be taxable in the hands of the investor. However, this does not hold true where it involves a foreign investor, in this situation interest payment would normally be deductible under s11 (*a*) of the Act and the income would be taxed in the foreign country resulting in a loss to the South African fiscus. S31 (3) was enacted to counter cunning, to the extent that the financing is not done at arm's length.

Tax policy is an expression of a country's sovereignty; every country is free to design its corporate tax system in a way that it considers most appropriate to raise revenue. As a result, corporate income tax systems of countries differ. These differences in corporate taxation have a generally distortive effect on the international flow of capital, resulting in welfare losses.

Tax arbitrage

Most tax arbitrage takes place with respect to the cross-border financing of business activities. International corporations often structure their cross-border finance activities in such a manner as to minimize their tax burdens. These sophisticated structures deprive the fiscus of tax revenues. This fact became most acute during the financial crisis when government was in desperate need of more corporate tax revenue.

These activities have been on top of political agendas across the world since the financial crisis. On an international level, the EU and the Organization for Economic Co-operation and Development (hereafter: OECD) issued several papers addressing these issues. The most important paper in this respect has been the Report on the issue of tax avoidance in the form of base erosion and profit shifting (hereafter: BEPS), issued on 12 February 2013.

The BEPS report identifies the differential tax treatment of debt and equity finance as one of the key issues of current corporate tax systems that causes the tax arbitrage opportunities that relate to the cross-border financing of business activities by multinationals.

Most corporate income tax systems make a fundamental distinction between the tax treatment of debt and equity finance. Interest on debt is generally regarded as a deductible expense, whereas the return on equity in the form of dividend is not deductible for tax purposes. This differential tax treatment of the two sources of finance both within and across countries leads to a tax-induced bias towards debt and creates room for arbitrage opportunities which achieve no or low taxation.

Examples of such tax arbitrage opportunities are base erosion through excessive deductibility of interest payments, debt shifting and the use of hybrid mismatch arrangements.

The latest OECD report identifies the actions needed to address the issue of BEPS, including base erosion, which is caused by the deductibility of interest expenses. According to the BEPS action plan, recommendations regarding best practices in interest deduction limitations should be developed in order to counter the base erosion that is created through the use of interest expenses.

Conclusion

The Government has repeatedly tried to prevent base erosion, which is caused by excessive debt financing, by introducing new interest deduction limitations. The National Treasury issued a four-part proposal to address these problems, as discussed below.

In order to curb excessive interest deductions as outlined above, the Government, through its agency, implemented legislative interventions to combat excessive deductible interest.

The introduction of s24N and the general limitation on interest deduction were enacted in order to combat base erosion and excessive deductible interest. This legislative intervention means that acquisition debt is subject to limitations designed to target potential base erosion caused by excessive and hybrid debt (and to prevent the interest deduction from becoming a facilitator of unwarranted risk to the economy in the form of excessive debt). These limitations ensure that debt used for the acquisition of the assets of target companies via an indirect s45 acquisition or a direct s24O acquisition do not eliminate excessive amounts of taxable income of the acquiring or target company for an indefinite period of time.

These provisions are not without their failings. Read together they fail to deal adequately with tax arbitrage because they fail to take into account the tax treatment of interest received in the hands of the lender.

The sections limit the borrower's ability to deduct the interest expense while the lender's obligation to pay tax on interest earned allows the Commissioner effectively to tax the same income stream twice in scenarios where there is no risk of tax arbitrage and thus no risk to the fiscus.

The application of s24N and the general limitation on interest deduction to a typical debt push down structure, where both the lender and borrower are South African resident taxpayers, would result in the NewCo's adjustable taxable income being rendered loss-making and yet still owing to the Commissioner.

The traditional justification for the differential treatment of debt and equity is that the interest charged on debt is regarded as a cost of doing business, and as such, should thus be exempted from income tax. There is no principle in Corporate Finance Theory that justifies the Commissioner's treatment of interest charged on debt as (1) partially a legitimate cost of doing business and exempted from income tax and (2) any interest charge in excess of the general limitation on interest deduction as being an illegitimate

or excess cost of doing business and not worth exemption.

This artificial treatment of interest charged means that firms' ability to finance their operations because of the reduction in the tax shield, reduces the worth of these firms and reduces the incentive for deal-makers and financiers to invest in South Africa. Thus the social welfare risk that these types of leverage transactions pose to tax revenues, tax sovereignty and tax fairness are not sufficiently addressed because they reduce the attractiveness of South Africa as an investment destination and diminish local investment.

Section 5 Conclusion

The disparate treatment of debt and equity in South Africa's income tax system results in economic efficiency and equity distortions. The tax-induced bias towards debt distorts the financing decisions and investment decisions of companies; it also creates potential for international tax arbitrage opportunities. This condition is not unique to South Africa. In order to address these distortions the National Treasury and the Commissioner have introduced complicated interest deduction limitations.

The first question this research had to address is whether there is a debt bias in South Africa's income tax system. This research has confirmed that South Africa's income tax system applies a 'classical approach' to the treatment of debt and equity for income tax purposes. This means that debt finance confers a tax benefit on firms when interest payments can be deducted from taxable income (a debt bias).

The second question this research had to address was whether the difference in tax treatment between debt financing and equity generated economic distortions and whether these were responsible for tax-avoidance schemes. This research has confirmed that as a result of this distinction between interest deductibility in shares and asset acquisitions, corporate finance transactions have been designed to take advantage of the various benefits of financing described above, including their tax shield advantages. This economic distortion has lead a number of transactions designed to avoid tax; these transactions may differ from transaction to transaction and are often conducted along similar lines to a debt push down transaction.

This research also demonstrated the manner in which South Africa's tax rules deal with debt push down transactions. The purpose of this research was not to study debt push down structures from a corporate finance perspective, however notwithstanding this, corporate finance theory was an important medium to analyse the debt push down structures from an economic perspective. In order to achieve this perspective Section 2 was included to give the reader a context within which to analysis the legal rules espoused by South Africa's statutory and common law.

Section 3 introduced the legal rules around the treatment of debt and equity, as well as introducing the debt push down structures and the legal rules that enabled and encouraged these types of transactions. In addition Chapter 4 used our understanding of corporate finance theory and as a framework to discuss and analyse the legal issues noted in Section 3, as applied to debt push down structures.

This research demonstrates that there are many different ways to finance a transaction but ultimately the choice of finance lies along the continuum between the issue of debt or equity.

Debt and equity have the same economic effect: in some circumstances debt can also be treated similarly to equity. In other circumstances debt instruments can even take on certain features commonly found in equity instruments. These types of hybrid instruments are difficult to classify as either debt or equity. As result of the differences in the manner jurisdictions treat these instruments, an opportunity for tax arbitrage arises.

From an economic perspective we accept that there is no material reason for the disparate treatment between debt and equity. From a legal perspective these debt and equity instruments are materially distinct and thus tax considerations may be decisive in selecting the form of finance used in a transaction, whether it be debt or equity.

Section 4 used our understanding of corporate finance theory to analyse typical debt push down structures and demonstrated that the essence of a debt push down transaction is to distribute debt within a group of companies in such a way that the taxable profits of the subsidiary are transferred to the holding or parent company, in the form of tax deductible interest expense. These structures also demonstrated the distortions to economic decisions of firms.

The third question this research had to address was what reforms have been

implemented to reduce the effectiveness of these distortions to economic decisions of firms. As noted above, in Section 3 it was established that the treatment of debt, coupled with the corporate rules which postpone or delay tax consequences, can be abused, giving rise to the erosion of the domestic tax. The most significant abuse of base erosion in South Africa comes in the form of excessive deductible interest.

S24N and the general limitation on interest deduction were introduced in order to combat base erosion and excessive deductible interest. The artificial treatment of interest charged in these provisions results in the reduction in the tax shield available to firms as well as the reduction in incentives to invest in South Africa.

The last question this research had to address was what harm is inflicted on society by the difference in tax treatment between debt financing and equity. This research confirms that leverage transactions utilising excessive debt pose a social welfare risk to tax revenues, tax sovereignty and tax fairness.

Bibliography

CIR v Drakensberg Gardens (1960) (2) SA 475 (A)

CIR v G Brollo Properties (Pty) Ltd (1994) (56 SATC 47)

CIR v Genn & Co (Pty) Ltd (1955) (3) SA 293 (A) (20 SATC 113)

CIR v George Forest Timber Co. Ltd (1924) AD 516 (1 SATC 20)

CIR v Nemojim (Pty) Ltd (1983) (4) SA 935 (A) at 946H-947C

CIR v Shapiro (1928) NPD 436

Commissioner for South African Revenue Service v NWK Ltd (2011) (2) SA 67 (SCA)

Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd (1941) AD 369 at 395-7

Commissioner of Taxes v Rendle (1965) (1) SA (SR, AD)

De Koker, A. & Williams, R. (2012) *Silke on South African Income Tax.* Online ed. www.lexisnexis.co.za: lexisnexis. [by subscription] [2015, November 13]

De Koker, A.P. & Williams, R.C. (2011) *Silke on South African Income Tax* Chapter 19. Durban, South Africa: LexisNexis.

De Koker, A.P. & Williams, R.C. (2012) *Silke On South African Income Tax* Chapter 13. South Africa: LexisNexis.

De Mooij, R. (2011) '*Tax biases to debt finance: assessing the problem, financing solutions*', IMF Staff Discussion Note 11/11.

Erf 3183/1 Ladysmith (Pty) Ltd v CIR (1996) (3) SA 942 (A), 58 SATC 229

Griffith, R., Hines, J. and Sorensen, P.B. (2008) '*International capital taxation*', in: Dimensions of tax design: The Mirrlees Review, Oxford: Institute for Fiscal Studies, 16.

IMF (2009) '*Debt Bias and other Distortions – Crisis-Related Issues in Tax Policy*' IMF Policy Paper June 12, 2009, IMF Fiscal Affairs Department.

Income Tax Act 31 of 1941

Income Tax Act 58 of 1962

'Income Tax-Deductibility of Interest-Test for simulated transactions – Former Section 103(1) of the Income Tax Act' (2010) *The Taxpayer*, Nov-Dec 2010, Vol. 59, No. 11 & 12.

Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa (The Katz Commission) (1994) Pretoria, Government Printers.

ITC 1603 58 SATC 212

KBI v Van der Walt (1986) (4) SA 303 (T)

Kwak, D.E. (2012) 'America's refusal to "race to the bottom": worldwide vs. Territorial taxation', *Tax Notes International*, 2012: 395

LexisNexis (2010) South Africa. Income Tax Act, No. 58 of 1962. In: Professional tax handbook. Durban: LexisNexis.

Modigliani, F. and Miller, M. (1958) 'The cost of capital, corporation finance and the theory of investment' *American Economic Review*, 48: 261-97.

Modigliani, F. and Miller, M. (1963) 'Corporate income taxes and the cost of capital: a correction' *American Economic Review* 53: 433-443.

Myers, S.C. and Majluf, N. (1984) 'Corporate Financing and Investment Decisions when firms have information that investors do not have' *Journal of Financial Economics* 13: 187-221.

New State Areas Ltd v CIR (1946) AD 610 (14 SATC 155)

OECD (1991) *Taxing profits in a global economy: domestic and international issues, Paris: OECD Publications, 179.*

OECD (2007) Fundamental reform of corporate income tax, OECD publishing, 72.

Peters, C.A.T. (2010) '*International tax neutrality and non-discrimination: Plea for a more explicit dialogue between the state and the market*' in Lang, M. *et al.* Tax treaties: building bridges between law and economics, Amsterdam: IBFD Publications 2010, 607

Port Elizabeth Electric Tramway Co Ltd v Commissioner for Inland Revenue (1936) CPD, 241.

Rand Mines (Mining & Services) Ltd v CIR (1997) 1 All SA 279 (A) (59 SATC 85)

Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa (The Margo Commission) (1987) Pretoria, Government Printers

Revenue Laws Amendment Act 60 of 2008

Revenue Laws Amendment Act 74 of 2002

Roshcon (Pty) Ltd v Anchor Auto Body Builders CC & Others (2014) (49/13) ZASCA 40.

Second Revenue Laws Amendment Act 60 of 2001

South African Revenue Service (2002) Explanatory Memorandum on the Revenue Laws Amendment Bill, 2002*. [Online] Available from: http://www.sars.gov.za/home.asp?pid=2631.*

Stiglingh, M. *et al.* (2012) *Silke: South African Income Tax*

Stiglingh, M. *et al.* (2014) *Silke: South African Income Tax*

Stiglingh, M. *et al.* (2014) *Silke: South African Income Tax* Durban, 544.

Stiglitz, J. and Weiss, A. (1981) 'Credit Rationing in Markets with Imperfect Information' *The American Economic Review* 71: 393-410.

Taxation Laws Amendment Act 22 of 2012

Taxation Laws Amendment Act 24 of 2011

Taxation Laws Amendment Act 3 of 2008

Third Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa (The Katz Commission (3), Pretoria, South Africa, Government Printers, 1995.

W.T. Ramsay Ltd v Inland Revenue Commissioners (1981) UKHL 1 (12 March 1981)