company mergers and tax (part 1)

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In a series of articles we will consider the relationship between the merger and acquisition rules in the new Companies Act 71 of 2008 (“Companies Act”) read with the relevant provisions of the Income Tax Act 58 of 1962 (“ITA”) and of the new Tax Administration Bill.

In this first article we focus on the application of the various tax “rollover” rules to merger and acquisition transactions, in particular with regards to the newly introduced statutory merger. We also consider the general ambit of the new statutory merger and its impact on the administrative tax obligations that the parties involved have in terms of the ITA.

The corporate reform

The Companies Act 63 of 1973 (“the Old Companies Act”) provided three mechanisms by which a company could obtain control of another company, namely:

- a sale of the whole or the greater part of its assets or undertaking (section 228);
- a scheme of arrangement involving a court application (section 311); or
- a so-called “squeeze out” or takeover offer (section 440K).

The new Companies Act became operative on 1 May 2011. The three traditional mechanisms of obtaining control of a company have effectively been retained in sections 112, 114 and 124 of the Companies Act. In addition to these mechanisms, the Companies Act also introduced “amalgamation or merger”
“Amalgamation or merger” is a defined term in the Companies Act. The ambit of this definition (the “Corporate Definition”) will be discussed in more detail below. Transactions falling within the Corporate Definition are governed by sections 113 to 116 of the Companies Act (referred to hereafter as the “statutory merger provisions”). Most relevantly, section 116(6) and (7) provides that:

(6) An amalgamation or merger –
(a) takes effect in accordance with, and subject to any conditions set out in the amalgamation or merger agreement;
(b) does not affect any –
(i) existing liability of a party to the agreement, or of a director of any of the amalgamating or merging companies, to be prosecuted in terms of any applicable law …

(7) When an amalgamation or merger agreement has been implemented –
(a) the property of each amalgamating or merging company becomes the property of the newly amalgamated, or surviving merged, company or companies; and
(b) each newly amalgamated, or surviving merged company is liable for all of the obligations of every amalgamating or merging company, in accordance with the provisions of the amalgamation or merger agreement, or any other relevant agreement, but in any case subject to the requirement that each amalgamated or merged company must satisfy the solvency and liquidity test, and subject to subsection (8), if it is applicable.” (Own emphasis)

An amalgamation or merger agreement will therefore not affect existing liabilities of the target company or companies (“TargetCo”) and all property and obligations of the TargetCo will become those of the acquiring company or companies (“AcquireCo”). Arguably, the underlying legal cause of this
“transfer” can be either:

- **Scenario 1:** the typical contractual causes for the transfer of assets and liabilities (i.e. sale, cession, delegation etc.) in terms of the agreement between the parties. In this scenario the statutory merger provisions merely recognise, regulate and supplement the implementation of the contract between the parties and also enable parties to avoid third party consents; or

- **Scenario 2:** the automatic operation of law alone. In this scenario assets and liabilities pass ex lege and there would, for example, be no sale construction in terms whereof TargetCo disposes of assets in exchange for consideration (e.g. the assumption of liabilities) to AcquireCo.

It remains uncertain which is the correct of the two interpretations regarding the causa and we assume that both are possible for purposes of this series of articles. Whether scenario 1 or 2 applies could have far-reaching tax implications for both TargetCo and AcquireCo. For this reason we will continuously distinguish between the two scenarios.

**The Corporate Definition**

Section 1 of the Companies Act defines an “amalgamation or merger” as:

“a transaction, or series of transactions, pursuant to an agreement between two or more companies, resulting in—

(a) the formation of one or more new companies, which together hold all of the assets and liabilities that were held by any of the amalgamating or merging companies immediately before the implementation of the agreement, and the dissolution of each of the amalgamating or merging companies; or

(b) the survival of at least one of the amalgamating or merging companies, with or without the formation of one or
more new companies, and the vesting in the surviving company or companies, together with such new company or companies, of all of the assets and liabilities that were held by any of the amalgamating or merging companies immediately before the implementation of the agreement.”

Whilst the term “amalgamation or merger” suggests two different possibilities (i.e. an “amalgamation” or a “merger”) the Corporate Definition does not distinguish between them. On the plain wording of the Corporate Definition, a plausible interpretation is that any transaction “resulting in” the situations described by paragraphs (a) and (b) would be an “amalgamation or merger”. This could mean that transactions that differ from what would classically be regarded a “merger” or an “amalgamation” could be governed by the statutory merger provisions. For purposes of this article we have assumed that the statutory merger provisions could apply to such “non-classical” merger transactions (e.g. unbundling transactions) and we have analysed the tax consequences on this basis. However, there is an ongoing debate on this point and the issue remains contentious.

Against this background, transactions satisfying the following requirements will fall within paragraph (a) of the Corporate Definition:

- at least one new AcquireCo must be incorporated;
- every TargetCo must be dissolved; and
- together, all of the AcquireCo’s must hold all of the assets and liabilities that were previously held by the TargetCo’s.

Similarly, transactions satisfying the following requirements will fall within paragraph (b) of the Corporate Definition, regardless of whether or not a new AcquireCo has been incorporated:

- at least one of the TargetCo’s must survive; and
• together, all of the assets and liabilities of the TargetCo’s must vest in all of the AcquireCo’s.

The use of the word “vesting” in paragraph (b) is noteworthy. In the case of Jewish Colonial Trust Ltd Appellant v Estate Nathan Respondents 1940 AD 163 at 175 it was held that “when it is said that a right is vested in a person, what is usually meant is that such person is the owner of that right, that he has all rights of ownership in such right”. The use of the present continuous tense in the current context (i.e. the vesting of assets and liabilities in the AcquireCo’s) could therefore imply that the AcquireCo’s (which should always include one or more surviving TargetCo’s) must become the owners of the assets and liabilities held by the TargetCo’s. It is uncertain if a surviving TargetCo can become the owner of assets and liabilities already owned by it.

Transfer of rights and obligations

As previously mentioned, upon implementation of an amalgamation or merger, the “obligations” of a TargetCo become enforceable against the AcquireCo.

The ITA places various obligations on taxpayers, including the obligations to:

- submit an income tax return on an annual basis (section 66(1));
- make payment of income tax on such days and at such places as SARS may notify a taxpayer (section 89(1)); or
- retain adequate records for a period of five years to substantiate tax returns previously rendered (section 73A).

The ITA also places contingent obligations on taxpayers, i.e. obligations which only become unconditional upon the happening of an uncertain future event. For example, all taxpayers have contingent obligations to furnish SARS with certain information, documents or things which SARS may need from time
to time for the administration of the ITA. Once SARS actually requests such information, documents or things from the taxpayer, the taxpayer must provide SARS therewith (section 74A), or make the information, documents or things available to SARS for inspection or audit thereof (sections 74B).

Whether or not the references to “obligations” in section 116(7) include unliquidated and contingent liabilities such as those contemplated in sections 74A and 74B of the ITA is a contentious issue. Dachs and La Grange in “Income Tax implications of the new company law merger provisions” argue that, despite its contingency, a conditional obligation remains a legal duty which is merely suspended until the happening (or non-happening) of the uncertain future event. They base their view on the premises that (i) obligations are the correlatives of rights and (ii) conditional rights remain existing legal rights, despite their contingency (First National Bank of South Africa v Lynn NO and Others (1996) 1 All SA 229 (SCA)). Should this be the case, a statutory merger could result in the transfer to AcquireCo of existing administrative tax obligations and contingent obligations that a TargetCo may have towards SARS, with obvious implications for an AcquireCo.

- In scenario 1 the underlying contract will have to provide for the transfer of rights and obligations to AcquireCo in accordance with the common law rules relating to cession, assignment, novation and delegation. In terms of these rules, certain formalities must be met for the transfer of rights and obligations. For example, before contractual duties can be delegated, the consent of the creditor is required. The underlying contract (e.g. a lease) may exclude such delegation by means of an anti-assignment provision (i.e. a clause prohibiting or restricting the transfer of contractual duties, similar to the common law pactum de non cedendo). In the law of contracts our courts have shown
a willingness to give effect to these types of clauses (Trust Bank of Africa Ltd v Standard Bank of SA Ltd 1968 (3) SA 166(A)). However, where the obligations concerned relate to SARS the relationship between SARS and taxpayers is governed by the ITA and not by an underlying contract. Arguably then it is not possible to preclude the transfer of tax related obligations contractually. Oddly, the statutory merger provisions fail to deal with the allocation of obligations in the case of multiple AcquireCo’s. In such case the question may arise exactly by which of the AcquireCo’s is the liability or obligation owed?

- In scenario 2 all of the rights and obligations of TargetCo vest automatically in AcquireCo by operation of law. Our law accommodates the transfer of rights and obligations by the operation of law or statute as an independent method of transferring rights and obligations and there are examples of this occurring in our case law. As such, the rights and obligations of TargetCo will vest in AcquireCo by virtue of section 116(7) and there would be no need to rely upon any of the methods usually associated with the common law methods of transfer of rights and obligations.

Irrespective of which interpretation regarding the caus a is followed or the structure of the merger agreement, SARS may arguably look to the AcquireCo for performance of various obligations and/or contingent obligations relating to the TargetCo. (In the case of contingent obligations the issue is more contentious. In the case of actual obligations, whilst the position may be clearer, it still gives rise to practical complications). For example, AcquireCo may have to respond to queries from SARS in respect of the tax affairs of a TargetCo or it may even be faced with additional assessments in respect of such TargetCo.

The corporate rules
The corporate restructuring provisions contained in sections 41 to 47 of the ITA (which have become known as the “corporate rules”) provide for a deferral of tax where certain specified transactions are undertaken within groups of companies (with the exception of section 42). Unlike certain foreign jurisdictions, South Africa does not apply a group basis of taxation.

Broadly speaking and provided that the requirements of the applicable sections are met, transactions within the ambit of the corporate rules can be undertaken with no immediate capital gains tax or income tax implications for either party. Furthermore, other taxing statutes (including the Value-added Tax Act, the Transfer Duty Act and the Securities Transfer Tax Act) may provide for similar tax deferred treatment to such transactions. Below we discuss the respective rules and their requirements.

**Asset-for-share transactions**

Section 42 of the ITA applies where a company disposes of assets in exchange for equity shares in another resident company and holds a “qualifying interest” in that other resident company after the disposal. For purposes of this section a “qualifying interest’ means (i) an equity share in a listed company, (ii) an equity share in a collective investment scheme in securities, (iii) at least 20% of the equity shares and voting rights of a company, or (iv) an equity share in a company of the same group of companies. Following the Taxation Laws Amendment Act, 24 of 2011 ("2011 TLAA"), section 42 now also applies to certain disposals to foreign companies.

If a qualifying interest is acquired in exchange for assets, the requirements of section 42 could be met in certain instances. For example, if scenario 1 is the correct interpretation regarding the causa, the underlying agreement could be drafted in such a manner to ensure that shares are
received as a quid pro quo for the disposal of assets. (There may be some doubts about whether it is correct to describe such a transaction as an “exchange” but we will leave this aside for now). If scenario 2 applies, assets and shares will automatically transfer by operation of law and arguably not “in exchange for” one another and the requirements of section 42 would accordingly not be met.

Amalgamation transactions

An “amalgamation transaction” under section 44 of the ITA and an “amalgamation or merger” in terms of the Corporate Definition, are not per se aligned.

An amalgamation transaction under section 44 of the ITA essentially envisages that an amalgamated company (i.e. a TargetCo) disposes of all of its assets (other than assets it elects to use to settle any debts incurred by it in the ordinary course of its trade) to a resident resultant company (i.e. an AcquireCo) by means of an “amalgamation, conversion or merger” and as a result of which the amalgamated company’s existence will be terminated. Following the 2011 TLAA, section 44 now also applies in some instances in respect of disposals between foreign companies.

Position if scenario 1 correctly describes the causa:

- Upon a comparison between the plain wording of the Corporate Definition and the requirements of section 44, the following potential inconsistencies are noteworthy:
  - Paragraph (a) of the Corporate Definition refers to the “dissolution” of a company, while the definition of “amalgamation or merger” in section 44 refers to the “termination” of the “existence” of a company. Also, section 44(13) requires that steps be taken to “liquidate, wind-up or deregister” within 18 months after the disposal. “Dissolution” is a legal concept distinct from
“liquidation”, “winding-up” or “deregistration” and these terms should best not be used interchangeably.

- The dissolution of the TargetCo’s in terms of paragraph (a) of the Corporate Definition must seemingly occur immediately upon implementation of the transaction, whereas section 44 affords parties 18 months after the disposal to “take steps” to liquidate, wind-up or deregister.

- Section 44 relief (following amendments in the 2011 TLAA), only applies where assets are given in exchange for (i) no consideration, (ii) consideration in the form of equity shares, or (iii) consideration in the form of assumption of the liability for certain debts. The statutory merger provisions (in particular section 113(2)) are not prescriptive as to the consideration allowed, for example, the consideration could include cash, the assumption of non-qualifying debt or shares in an entity other than the merged entity. It appears that the section 44 relief may well be given despite the fact that non-qualifying debt have been transferred to the AcquireCo.

- In terms of the Corporate Definition, the AcquireCo’s must hold or be vested with “all of the assets and liabilities that were held” by the TargetCo’s. Section 44 contains various provisions regarding the effects of the transfer of assets of TargetCo’s and which liabilities of TargetCo’s may be assumed. For example:
  - assets which a TargetCo elected to use to settle any debts incurred by it in the ordinary course of its trade, may be retained;
  - debts incurred within a period of 18 months before the disposal of the assets may be assumed but without tax relief, unless the
debt constitutes the refinancing of a debt incurred more than 18 months before that disposal, or the debt is attributable to and arose in the normal course of the disposal, as a going concern, of a business undertaking the AcquireCo as part of the transaction.

- Following the enactment of the 2011 TLAA, debts incurred by a TargetCo for the purposes of “procuring, enabling, facilitating or funding the acquisition” by an AcquireCo of any of the assets of the TargetCo, may no longer be assumed by an AcquireCo on a tax rollover basis. The statutory merger provisions contain no similar restrictions as to which debts may be transferred and prescribes that all debts shall be assumed by the AcquireCo.

Position if scenario 2 correctly describes the causa:

- Before the release of the 2011 TLAA, section 44 and the statutory merger provisions were irreconcilable, mainly because section 44 required that the assets of the amalgamated company had to be disposed to the resultant company in exchange for equity shares or for the assumption of certain debts. Since the assets would pass ex lege and not “in exchange for” shares or debts, the relief provisions of section 44 would not apply, regardless of whether the transaction fell into paragraph (a) or paragraph (b) of the Corporate Definition.

- However, in terms of amendments in the 2011 TLAA, it is arguably no longer a prerequisite that the resultant company should acquire the assets of the amalgamated company for a consideration. Section 44(4), which used to read that the rollover relief would only apply to the extent that the assets are “so disposed of in exchange for” equity shares or the assumption of the qualifying
debts, is now turned around to provide that the rollover relief will not apply to the extent that assets are “so disposed of in exchange for consideration other than” equity shares or the assumption of the relevant debts. As such, if the amalgamated company disposed of its assets for no quid pro quo, as envisaged in scenario 2 regarding the causa, section 44(4) will no longer prevent the transaction from qualifying for the rollover relief irrespective of the liabilities which ex lege pass to the AcquireCo. Because there is no “consideration” at all, there can be no consideration falling foul of the anti-avoidance provisions of section 44. Whether or not this consequence was intended may be open to debate. Another interesting issue worth mentioning is that the definition of “amalgamation transaction” in section 44 requires that the amalgamated company must dispose of all of its assets. For purposes of the corporate rules, the word “dispose” shall bear its definition as per paragraph 1 of the Eighth Schedule”, which specifically includes an “operation of law”. As such, the use of the word “dispose” should also not prevent a statutory merger from qualifying for rollover relief.

Accordingly, if scenario 1 is followed, there are various inconsistencies between section 44 and the statutory merger provisions which may or may not prevent parties from qualifying for rollover relief. If scenario 2 is followed, it seems that section 44 and the statutory merger rules are now more closely aligned, but not perfectly so. Whether a particular transaction will qualify for section 44 relief, is therefore a factual question to be considered on a case by case basis.

Intra-group transactions

Intra-group transactions under section 45 of the ITA essentially entail a company disposing of an asset to another
resident company, where both companies form part of the same group of companies after the transaction. Following the 2011 TLAA, intra-group transactions are also subject to certain anti-avoidance rules aimed at limiting interest deductions in respect of debt-funded transactions which rules are encompassed in a new section 23K of the ITA. The interplay between sections 45, 23K and the statutory merger provisions is an issue which merits close attention of any party wishing to qualify for roll-over relief.

If all of the TargetCo’s dissolve upon implementation of the amalgamation or merger, as contemplated in paragraph (a) of the Corporate Definition, the intra-group relief would effectively not apply, unless AcquireCo holds at least 70% of the equity shares in TargetCo. If a TargetCo however survives in terms of paragraph (b) of the Corporate Definition and that TargetCo and one of the other AcquireCo’s form part of the same group of companies at the end of the day of the amalgamation or merger, section 45 could apply and provide roll-over relief, provided that none of the anti-avoidance rules apply. This will be the case regardless of which scenario regarding the causa is followed as a “disposal” for purposes of section 45 include the operation of law.

Unbundling transactions

In terms of section 46 of the ITA, essentially, all the equity shares of a company (the unbundled company) that are held by a company (the unbundling company) are distributed to the shareholders of the unbundling company to the extent that, in the context of unlisted companies, those shares are so distributed to a shareholder which forms part of the same group of companies as the unbundled company. The shares so distributed must also constitute at least 50% of the equity shares of the unlisted unbundled company. In terms of the 2011 TLAA section 46 is extended to also apply to unbundling transactions involving certain controlled foreign companies.
Section 46 may therefore apply to a statutory merger if TargetCo is the unbundling company and AcquireCo is a shareholder of TargetCo. This will be the position regardless of which interpretation regarding the causa is followed.

**Liquidation distributions**

A liquidation distribution in terms of section 47 essentially entails a company distributing all of its assets to its shareholder in anticipation of, or in the course of the liquidation, winding up or deregistration. On the date of the distribution, the company and its shareholder must either form part of the same group of companies, or the shareholder must be a controlled foreign company that forms part of the same group of companies of the company. Pursuant to the 2011 TLAA, liquidation distributions are now also subject to the anti-avoidance rules of section 23K of the ITA which is aimed at limiting interest deductions in respect of debt-funded transactions.

Depending on the facts and assuming that this form of tax is due, it would seem that parties entering into a statutory merger transaction could qualify for section 47 relief. This would be the case regardless which interpretation regarding the causa is applied.

**Conclusion**

From the above it seems that, regardless of which interpretation as to the causa of a statutory merger is followed, possible inconsistencies exist between the statutory merger provisions and the corporate rules with the effect that the corporate rules will not per se apply in those situations one would ordinarily expect to find roll-over relief.

From a commercial perspective, the flexibility of the statutory merger provisions to accommodate the desires of the respective parties is one of its most significant advantages. Unfortunately our tax legislation does not in all instances
accommodate such flexibility yet. Further amendments to align the corporate rules are in the pipeline. The Minister of Finance announced in the 2012 Budget Review that government is reviewing the nature of company mergers, acquisitions and other restructurings with the view of possibly amending the ITA and/or Companies Act over a two-year period.

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