Year in Review – 2012 Tax Developments in South Africa

During 2012 a number of significant amendments were made to the tax legislation in South Africa. This report provides a brief description of certain of these amendments which may be of interest to foreign companies that conduct business in South Africa as well as those seeking investment opportunities in South Africa.

Withholding Tax on Interest

From 1 July 2013, a new withholding tax on interest will be imposed in South Africa. The tax is a final withholding tax in respect of any interest paid by a South African resident to any foreign person. The tax is levied on the foreign person that receives or accrues interest from a South African source; however the South African payor has an obligation to withhold the tax on payment of the interest. A foreign person is broadly defined as any person that is not a resident for South Africa tax purposes. The withholding tax on interest will be imposed at a rate of 15%. The legislation caters for certain exemptions that apply when interest is paid to a foreign person by certain entities, for example the Government of South Africa, the South African Reserve Bank, a headquarter company or in respect of any debt that is listed on a recognised exchange. Further if the foreign person is physically present in South Africa for a period exceeding 183 days in a 12 month period or has a permanent establishment in South Africa, that interest paid to the foreign person will not be subject to withholding tax. It is important to note that South Africa has a vast network of double taxation agreements that have been concluded with other jurisdictions. As such, should the interest paid to a foreign person not be exempt from the withholding tax, the withholding tax rate may be reduced in terms of the application of a double taxation agreement where applicable.

Deductibility of Interest Expenses

Generally the deduction of interest expenditure incurred in respect debt financed share acquisitions is not allowed under South African tax law. The rationale for the interest expenditure being non-deductible is that the acquisition of shares produces exempt income. As such the deduction of interest incurred to acquire shares is disallowed on the basis that the expense is not incurred in the production of income.

However as and from 1 January 2013 a special deduction of interest expenses will be allowed in respect of debt used by a company to acquire a controlling interest in an operating company. The deduction does not take into account the general rules in order to claim a deduction, for instance the expense does not have to be incurred in the production of income or while conducting a trade. However there are certain other requirements that must be complied with in order to secure the deduction of the interest expenses. A company must acquire the equity shares in an operating company utilising debt finance. An operating company is defined as any company that carries on business continuously and in the course of that business provides goods or services for a consideration. The acquiring company must acquire a controlling interest in the operating company, which requires a 70 per cent acquisition of equity shares in the operating company.

Value-for-Value Principle involving Share Issues

Generally a company that issues shares for the acquisition of assets is deemed to have acquired the assets at the lesser value of either the market value of that asset immediately after the acquisition or the market value of the shares immediately after the acquisition. The taxpayer who has disposed of the asset is deemed to have disposed of that asset for an amount equal to the market value of the shares immediately after the acquisition.

The revenue authorities have noted that certain asset-for-share transactions did not occur on a value-for-value basis, which led to schemes with uneven exchanges without triggering the appropriate tax. As such, a “value-for-value principle” was introduced. Any value mismatches involving shares from 1 January 2013 will explicitly give rise to tax in the hands of the party receiving a benefit. The new rules relating to the value-for-value principle do not require the parties to be connected persons.

In the case where the market value of the asset disposed of exceeds the market value of the shares issued, the issuing company will be subject to capital gains tax in respect of the difference of the value asset and shares issued. On the other hand if the market value of the issued shares by a company has a greater value than the asset received, the excess amount will be deemed to give rise to dividend *in specie*. The issuing company of the shares will be liable for the Dividends Tax in respect of the dividend *in specie*.

Debt Reductions or Cancellations

From 1 January 2013 new rules were implemented regarding the tax treatment relating to the reduction or cancellation of any debt owed by a taxpayer. The tax treatment will depend upon the underlying cause that resulted in the debt being reduced or cancelled. As such a uniform system has been introduced to regulate the tax treatment of debt that is reduced or cancelled for less than the full consideration.

Debt can be reduced for a variety of reasons. If debt is reduced or cancelled such reduction or cancellation should be viewed as an indirect form of cash payment under the current tax principles. As such new ordering rules have been proposed, whereby the debt reduction or cancellation can be treated as a donation which will be subject to Donations Tax, as part of a bequest from an estate which is subject to Estate Duty or treated as a disguised salary payment which is subject to Employees Tax. Should the debt reduction or cancellation not fall within any of the above categories then income tax or a capital gains tax will be triggered depending on how the borrowed funds were utilised.

If the debt was used to fund deductible expenditure or allowances, the debt reduction or discharge will be taken into account in terms of the ordinary revenue rules. Should the revenue rules not apply then as a residual category the capital gains tax rules come into play.

If the debt was used to fund the acquisition of a depreciable asset and the taxpayer claimed depreciation allowances in respect of that asset, then the acquisition cost of that asset must be reduced by the depreciation allowances previously claimed in terms of the capital gains tax rules resulting in the base cost of that asset. The base cost of the asset is then reduced by the debt amount that has been reduced or cancelled. Should the base cost be reduced to nil any remaining amount that exceeds the base cost will be treated as ordinary revenue.

If the debt was used to fund the acquisition of capital assets, ie immovable property, any debt reduction or cancellation must be used to reduce the base cost of that asset to nil. Should the debt reduction or cancellation exceed the base cost, the remaining amount does not trigger any capital gain for the taxpayer. If the capital asset is no longer held by the taxpayer at the time when the debt is reduced or cancelled then the assessed capital loss of the taxpayer is reduced.

Hybrid Equity and Third-Party Backed Share

Hybrid equity shares are usually preference shares whose dividend yield is secured by debt-based instruments, which differs from equity shares whose yield is linked to the profitability of a company. Current rules deem the dividend arising from a hybrid equity share to be income and is accordingly taxed at the appropriate income tax rate. A third-party backed share is any preference share in respect of which the dividend yield from that share is guaranteed by an unconnected third party. Again the dividend yield of the third-party backed share is deemed to be income and subject to income tax.

As an anti-avoidance measure the rules relating to hybrid equity shares have been broadened to include any share whose dividend yield is based on one or more debt-bearing financial instruments of a third-party. Previously the rules merely required that the share be redeemed within three years from the date of issue. In respect of a third-party backed share, the holder of that share is looking to a third-party to either acquire that share from the holder or make payment in respect of that share. The dividend yields from a hybrid equity share and a third-party backed share will continue to be deemed as income and taxed accordingly. However an exception was introduced in respect of both hybrid equity shares and third-party backed shares, in which any dividend yield derived from these shares is ultimately applied to directly or indirectly to acquire a pure equity stake in an active operating company that dividend yield will not be deemed to be income.

New rules relating to hybrid debt instruments were also introduced in the initial draft taxation laws amendment bill in 2012; however these rules were later withdrawn. It is anticipated that the rules regulating hybrid debt instruments will be revised and reintroduced in the 2013 taxation laws amendment bill.

Depreciation of Supporting Structures in Energy Projects

South Africa has adopted certain tax measures that support the generation of electricity from renewable resources. As such, the cost of the plant and machinery used in relation to the generation of wind power, solar energy, hydro power and biomass are depreciable over a three year period at a ratio of 50:30:20 per cent.

However no deduction exists in respect of the supporting structures to the plant or machinery in the generation of electricity from renewable resources. From 1 January 2013 the cost of the supporting structures associated with machinery and plant that are used in the generation of electricity from renewable resources will be depreciable over a three year period at a 50:30:20 per cent. In order for these supporting structures to qualify for the deduction, certain requirements must be met. The plant or machinery must be owned by the taxpayer or acquired by the taxpayer in terms of an instalment credit agreement and the supporting structure must be brought into use for the first time by the taxpayer for the purpose of that trade. The supporting structure must be mounted or affixed to the plant or machinery and must be regarded as integrated to such a plant or machinery. The purpose of this amendment is to encourage investment in renewable energy projects.