Overruled: SARS expresses an interesting view on an amalgamation transaction

The South African Revenue Service (SARS) has traditionally adopted a conservative approach in issuing rulings which approve a tenuous interpretation of provisions of the Income Tax Act, No 58 of 1962 (Act), in favour of the taxpayer. However, in Binding Private Ruling 231 (Ruling), which was issued by SARS on 10 May 2016, SARS adopted an interesting interpretation of the corporate roll-over relief provisions in s44 of the Act, which raises a number of questions. The Ruling is quite long and therefore we will only discuss the manner in which SARS applied the provisions of s44, relating to corporate roll-over relief in the case of so-called amalgamation transactions (s44 transaction).

Facts

The Applicant in this case is a South African resident company that is held 74% by a foreign company (ForeignCo) and 26% by black economic empowerment (BEE) shareholders. ForeignCo is a wholly owned subsidiary of another foreign company (HoldCo). There are also a number of Co-Applicants, including three companies that are majority-owned by BEE shareholders (BeeCo1, BeeCo2 and BeeCo3). BeeCo2 is a wholly owned subsidiary of BeeCo1. BeeCo2 and BeeCo3 also each participate in two separate unincorporated joint ventures (UJV's).

The relevant legal framework

In terms of s44(2) of the Act, a company will qualify for

certain corporate roll-over relief, in that the transfer of capital assets or trading stock will not trigger the inherent tax gain, if the transaction constitutes a s44 transaction in terms of s44(1)(a) or (b).

Section 44(1)(a) defines an amalgamation transaction as a transaction where:

1. any resident company (amalgamated company);
2. disposes of all of its assets (other than assets it elects to use to settle any debts by it incurred in the ordinary course of its trade, and other than assets required to satisfy any reasonably anticipated liabilities to any sphere of government of any country and costs of administration relating to the liquidation or winding-up); or
3. to another resident company, which is a SA resident (resultant company) in terms of an amalgamation, conversion or merger.

Section 44(1)(b) contains the exact same wording, the only difference being that the amalgamated company is a foreign company and that the shares in the amalgamated company are held as capital assets. Section 44(2)(a) contains a further requirement for the corporate roll-over relief in that the shares must be acquired by the resultant company as capital assets or as trading stock, as the case may be.

Description and purpose of the transaction

The Applicant and the relevant subsidiary Co-Applicants intend to rationalise and simplify its South African group structure by entering into four separate transactions which will eliminate the unincorporated joint ventures (UJV's) and unnecessary companies in its structure. Transactions 1, 2 and 4 entail s44 transactions, whereas Transaction 3 constitutes an asset-for-share transaction in terms of s42 of the Act.

We will only discuss SARS's Ruling with respect to

Transactions 1 and 2.

In Transaction 1, the group wishes to eliminate the intermediate holding of the Applicant's shares by ForeignCo. To do this, ForeignCo will dispose of its shares in the Applicant for a new issue of shares in the Applicant in terms of a s44 transaction. The new shares in the Applicant will be distributed by ForeignCo to its sole shareholder, HoldCo, in terms of the relevant amalgamation agreement. ForeignCo will then be liquidated in terms of that amalgamation agreement. In Transaction 2, a similar approach will be followed. BeeCo1 will dispose of its shares in BeeCo2 for a new issue of shares in BeeCo2 in terms of a s44 transaction. The new shares in BeeCo2 will be distributed by BeeCo1 to its shareholders in terms of the relevant amalgamation agreement and BeeCo1 will then be liquidated in terms of that amalgamation agreement.

SARS's Ruling

With respect to Transaction 1, SARS ruled that the transfer by ForeignCo of its shares to the Applicant under the amalgamation agreement will constitute a s44 transaction in terms of s44(1)(b) of the Act and will be qualify for the corporate roll-over relief and that the repurchased shares of the Applicant will also be cancelled upon repurchase.

There will also be no dividends tax payable on the distribution of the newly-acquired shares of the Applicant to HoldCo.

With respect to Transaction 2, SARS ruled that the transfer of assets by BeeCo1 to BeeCo2 under the amalgamation agreement between them, will constitute a s44 transaction terms of s44(1)(a) of the Act and will qualify for the corporate roll-over relief. The repurchased shares of BeeCo2 will also be cancelled upon repurchase. No dividends tax will be payable on the distribution of the newly-acquired BeeCo2 shares by BeeCo1 to its shareholders.

Comments

Although SARS rulings often do not include all the facts provided to it by the applicants, it is possible that ForeignCo and HoldCo might be liable to pay capital gains tax (CGT) in terms of paragraph 2(1)(b)(i) of the Eighth Schedule to the Act, if it disposed of its shares outside of the ambit of the corporate roll-over relief provisions in the Act. Paragraph 2 of the Eighth Schedule states that a non-resident company will be liable for CGT in South Africa if on disposal, it holds more than 20% of the shares in a South Africa resident company and 80% of the market value of the South Africa resident company's shares are directly or indirectly attributable to immovable property. This might explain why the parties wish to make use of the roll-over relief in s44. Upon closer scrutiny, it appears that some of the requirements of s44 might not have been met.

Section 44(2)(a)(i) states that where an amalgamated company disposes of a capital asset, the resultant company will only qualify for the roll over relief if the resultant company "…acquires it as a capital asset…" In Transaction 1, ForeignCo concludes a s44 transaction in exchange for the Applicant issuing new shares to it. It is the subsequent cancellation of these repurchased shares which raises issues. The cancellation is an unavoidable outcome and therefore, regardless of the intention of the Applicant, it could never have held the shares as capital assets. Should s44(2) or (3) of the Act not apply, the repurchase might constitute a 'dividend' and potentially trigger a dividend withholding tax charge. A further consequence of s44(2) or (3) not applying is that the distribution of shares by the amalgamated company will not be income tax and dividends tax neutral.

Section 41 of the Act defines a capital asset as any asset as defined in the 8th Schedule, except an asset that constitutes trading stock. The 8th Schedule defines an asset essentially as any property or any right in such property. The definitions

of trading stock in s1 and s41 of the Act essentially state that trading stock is anything acquired by the taxpayer for the purposes of sale or the proceeds of which would form part of the taxpayer's gross income upon disposal. The shares of the Applicant and the shares of BeeCo2 that are bought back in terms of Transactions 1 and 2 are therefore not acquired as capital assets or as trading stock in terms of the repurchase transactions. In terms of s44(6)(c) of the Act, the transfer of capital assets or trading stock to the shareholders of the amalgamated company will only qualify for the roll-over relief, if the requirements of s44(2)(a) are met. As it appears that these requirements have not been met, a capital gain will potentially be triggered when ForeignCo disposes of the newly issued shares of the Applicant to HoldCo.

This argument is supported by the fact that a company cannot acquire rights against itself and by s35(5) of the Companies Act, No 71 of 2008, which states that once shares have been repurchased by a company, they no longer have the status of issued shares, but have the same status as authorised unissued shares. In commercial terms, these shares are thus not reflected on the balance sheet of a company as assets.

The same comments apply to Transaction 2, in terms of which BeeCo1, the amalgamated company, disposes of its shares in BeeCo2, the resultant company, in exchange for the issue of new shares in BeeCo2.

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