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THE IMPACT OF ANTI-AVOIDANCE TAX LEGISLATION ON MERGERS IN THE MINING INDUSTRY IN SOUTH AFRICA

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ABSTRACT

THE IMPACT OF ANTI-AVOIDANCE TAX LEGISLATION ON MERGERS IN THE MINING INDUSTRY IN SOUTH AFRICA

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The mining industry is a major contributor towards the South African economy. There are several types of corporate transactions that could typically be found in the mining industry and these include merger transactions. Mergers could lead to a number of tax consequences which could include capital gains tax, the recoupment of capital allowances and dividends tax.

Merger transactions do not necessarily lead to an immediate increase in profits. Therefore, the tax authorities provide for relief in respect of merger transactions. The relief takes place in the form of tax roll-overs that effectively postpone tax consequences until such time as a true economic profit is realised in the future.

Taxpayers typically wish to minimise the amount of tax which they pay. Therefore, they may abuse the relief provided to avoid paying tax. In an attempt to protect the state's revenue and to prevent tax avoidance, the tax authorities introduce anti-avoidance provisions into the tax legislation.

The roll-over relief provided in respect of merger transactions, as well as the provisions dealing with mining capital allowances contain a number of provisions to combat opportunities for tax avoidance.

The study explains the principles of tax avoidance and anti-avoidance in the mining industry in South Africa, and indicates the need for tax relief in the context of merger transactions in the mining industry in South Africa. The study further illustrates how tax

relief presents opportunities for tax avoidance and how anti-avoidance legislation restricts these opportunities. The study also shows that there is a cycle in which an onerous tax leads to a need for relief which in turn leads to opportunities for tax avoidance which in turn leads to anti-avoidance provisions. The research conducted as part of this study shows that this cycle is an international trend that often affects the manner in which merger transactions are structured.

KEY WORDS

Tax avoidance

Anti-avoidance tax legislation

Mergers

Mining

Roll-over tax relief

South Africa

OPSOMMING

DIE IMPAK VAN TEEN-VERMYDING BELASTINGWETGEWING OP SAMESMELTINGS IN DIE MYNBEDRYF IN SUID-AFRIKA

deur
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Die mynbedryf in Suid-Afrika lewer 'n aansienlike bydrae tot die Suid-Afrikaanse ekonomie. Samesmeltings is een van verskeie tipe korporatiewe transaksies wat in die mynbedryf in Suid-Afrika aangetref word. Samesmeltings gee ook aanleiding tot verskeie belastingimplikasies, soos Kapitaalwinsbelasting, die verhaling van belastingtoelaes en die belasting op dividende.

Samesmeltings lei nie noodwendig tot 'n onmiddellike verhoging in ekonomiese voordele nie. Die belastingowerhede maak voorsiening vir belastingverligting ten opsigte van hierdie gebeure. Die verligting word gewoonlik verskaf in die vorm van die uitstel van belastingverpligtinge tot ‘n datum wanneer ‘n ekonomiese wins in die toekoms gerealiseer word.

Belastingbetalers streef gewoonlik na 'n vermindering in hul belastinglas, en mag dus die verligting wat voorsien word probeer misbruik. Die belastingowerhede daarenteen maak voorsiening vir wetgewing om hierdie pogings van die belastingbetalers om belasting te vermy, teen te werk en so die inkomste van die staat te beskerm.

Die uitstel wat aan samesmeltingsooreenkomste verleen word asook die voorsiening van mynboukapitaaltoelaes bevat verskeie voorsorg maatreëls om pogings tot belastingvermyding teen te werk.

Die studie ontleed die beginsels van belastingvermyding en teen-vermyding wetgewing in die mynbedryf in Suid-Afrika, en wys op die behoefte vir verligting ten opsigte van

samesmeltings in die mynbedryf in Suid-Afrika. Die studie toon verder ook hoe die verligting lei tot geleenthede vir belastingvermyding en hoe teen-vermyding wetgewing dit kan teenwerk. Die studie toon ook dat daar ‘n siklus bestaan, waarin die behoefte vir verligting as gevolg van n oormatige belastinglas tot geleenthede vir belastingvermyding lei, en wat op sy beurt lei tot wetgewing om die belastingvermyding te ontmoedig. Die navorsing wat as deel van hierdie studie uitgevoer is dui daarop dat hierdie siklus ‘n internasionale neiging is wat dikwels die struktuur van samesmeltingsooreenkomste affekteer.

SLEUTELWOORDE

Belastingvermyding
Teen-vermyding belastingwetgewing
Samesmeltings
Myne
Uitgestelde belastingverligting
Suid-Afrika

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CHAPTER 1

INTRODUCTION

1.1 BACKGROUND

South Africa has some of the world's richest mineral deposits and has a mining industry that generates significant tax revenues for the fiscus (Chamber of Mines of South Africa, 2010:5; South African Revenue Service, 2011:14). These taxes are an unpleasant obligation for taxpayers (Kruger & Scholtz, 2003:1) and, as such, it is in the nature of taxpayers to want to protect their pockets by minimising the tax liability. In turn, the fiscus aims to prevent this in order to protect and maximise its revenues.

In respect of the 2011 tax year, the mining sector contributed 13.15% of company tax revenue, showing a 66.1% increase year on year (South African Revenue Service, 2011:14). Thus, the mining sector is a sizeable contributor to tax revenues. The combination of the fact that there has been a steady increase in major corporate transactions in recent history and the sizeable contribution of the mining sector to the tax revenue, increases the relevance of the issues surrounding tax and tax avoidance in the context of mergers in the mining industry in South Africa.(Osae, 2010:3 and 64).

Kruger and Scholtz (2003:1) mention that tax planning is a strategic area of attention, that can save the taxpayer significant amounts in taxation if executed efficiently. This implies that if corporate transactions are planned and implemented with tax efficiency in mind, large tax savings could be realised. However, to combat this, the fiscus has introduced an array of provisions that are both applicable to taxpayers in general and specific to mining in particular. These have been in the form of anti-avoidance provisions in the Income Tax Act (58/1962) (hereinafter referred to as 'the Act').

Limited research has been conducted with regard to anti-tax avoidance in the mining sector and the impact thereof on the large number of arrangements and schemes that have been devised and are, or have been used by taxpayers.

Other research reported in Clegg and Stretch (2012(a)), De Koker and Williams (2011), McLoughlin (1979), Silke (1958) and Van Blerck (1992) have addressed the background relating to anti-avoidance, as well as to mining taxation in general. Research reported in Bruner (2004), Gaughan (2011) and Osae (2010) have discussed the background relating to merger transactions, while Clegg and Stretch (2011) and De Koker and Williams (2012) have addressed the background to tax relief provided in the instance of merger transactions, as well as relevant anti-avoidance provisions to these relief measures.

The identified background literature as well as relevant case law forms the basis of research for this study, as this is where the interaction between anti-avoidance and corporate transactions becomes apparent and detailed. An analysis of a hypothetical illustration of a typical merger transaction in the mining industry is performed, and this includes an analysis of how anti-avoidance legislation is applicable to this transaction.

1.2 PROBLEM STATEMENT

The taxation of mining is a complex field with a number of provisions in the Act dealing with mining income. These provisions often contain specific anti-avoidance provisions which may be either general in nature or specific to the mining industry. Examples of these include the General Anti-Avoidance Rule (hereinafter known as the 'GAAR') provided for in sections 80A to 80J and section 80L of the Act, the general ring-fencing provisions of section 20A of the Act and the mining ring-fences of sections 36(7E) and 36(7F) of the Act.

Some examples of corporate transactions include the deal where Tronox acquired a majority share in certain operations of Exarro (Baxter, 2011), the proposed merger between Glencore and Xstrata (Miller & Cimilluca, 2012), the Metorex restructure (Bowman Gilfillan Africa Group, 2012), the proposed acquisition of Evander by Pan African Resources (2012) and Assore's BEE deal (Standard Bank, 2011).

Although it is clear that there are numerous anti-avoidance provisions as well as corporate transactions, it is not always apparent how anti-avoidance legislation is specifically relevant and applicable to corporate transactions in the mining industry. The study of anti-avoidance provisions in respect of mergers in the mining industry provides a theoretical yet

practical overview of some instances of how mining companies might structure their deals to obtain tax benefits, and how anti-avoidance provisions seek to avoid these. The study aims to contribute to an understanding of anti-avoidance provisions in the context of mergers in the mining industry.

1.3 PURPOSE STATEMENT

The main purpose of this study was to investigate the applicability to, and impact of anti-avoidance legislation on mergers in the mining industry. This involves a critical analysis of the structuring of mergers in the mining industry in order to identify their nature and how they function. This analysis continued to the income tax and anti-avoidance legislation applicable to mergers in the mining industry. Finally an evaluation of the impact of the applicable anti-avoidance legislation on mergers in the mining industry will be performed.

1.4 RESEARCH OBJECTIVES

The primary research objective of this study is:

- To analyse the principles of anti-avoidance legislation and the impact of this on mergers in the mining industry in South Africa.

To support the primary objective, the following secondary objectives are identified:

- To identify and analyse the income tax and anti-avoidance legislation that may be applicable to mergers in the mining industry.
- To develop a practical example of how a typical merger transaction in the mining industry could be structured, and to analyse this example in order to determine the characteristics and functioning of the transaction.
- To identify opportunities for tax avoidance that may exist in the context of the merger transactions in the mining industry.
- To identify relevant anti-avoidance provisions that could restrict these opportunities for tax avoidance.
- To identify relevant real-life instances (court cases) of tax avoidance and anti-avoidance measures in merger transactions in the international arena (specifically Canada and Australia) in order to demonstrate the global nature of avoidance and anti-

avoidance measures in merger transactions and to provide additional insight into the problem of avoidance and anti-avoidance measures.

1.5 DELIMITATIONS

The study has a number of delimitations that relate to the context and the various constructs as well as the literature sources which were consulted as part of this study.

- This study is limited by context. Although anti-avoidance measures in the general context are briefly considered in order to obtain an understanding of tax avoidance and anti-avoidance measures, the study is limited to anti-avoidance legislation in respect of mergers, and this is further limited to such transactions in the mining industry in South Africa.
- This study is limited by construct in that it only focuses on the established principle that there is a relationship between tax avoidance and anti-avoidance measures, and that this relationship is evident in mergers in the mining industry. The study does not focus on rationales or explanations for anti-avoidance measures, although it briefly mentions these to provide context to the study.
- The study is further limited because it is applicable only to physical transactions in the mining industry in South Africa.
- The study is also limited with regard to the legislation that may apply to mergers in the mining industry. The study is not intended to provide an exhaustive coverage of each and every tax provision that may be applicable to mergers in the mining industry. The study only covers legislation that is relevant to demonstrating the principles of avoidance and anti-avoidance measures by means of a hypothetical example that is used in the study. The study is further limited in that only legislation that was enacted and in force at the time of the study could be considered, and, therefore, it goes without saying that any amendments not yet in force were not considered for the purposes of this study.
- Lastly, the study is limited in its application to avoidance and anti-avoidance measures in the international context. Although real-life international examples (court cases) are used by drawing on case law reports, these are general in nature and not

limited to the mining industry in the respective jurisdictions. Thus, it provides insight into avoidance and anti-avoidance measures in merger transactions in general. Furthermore, the purpose of this study is not to compare South African tax law with the tax law of other jurisdictions. Therefore, very little detail regarding the relevant foreign tax law is considered. The consideration of such law is limited to the principles covered in the reported case law, but it is necessary to provide insight and context to the scenarios being analysed.

1.6 ASSUMPTIONS

This study relies on the following assumptions:

- For the purposes of this study, it is assumed that all mergers in the mining industry in South Africa are identical. In other words, it is assumed that the way in which the transactions function do not differ from transaction to transaction.
- It is assumed that the tax consequences and related anti-avoidance implications are similar for all merger transactions in the mining industry in South Africa.

1.7 DEFINITION OF KEY TERMS

As part of this study the terms ‘tax avoidance’, ‘anti-avoidance’ and ‘corporate transactions’ have been used as key terms. For the purposes of this study, these key terms can be defined as follows:

Anti-avoidance: Anti-avoidance can be described as any measure or provision of the Act that is aimed at countering the attempts of a taxpayer to avoid tax (Stiglingh, Koekemoer, Van Schalkwyk, Wilcocks & De Swardt, 2012:788).

Corporate transactions: Corporate transactions can be described as any transaction entered into by a company that involves the actual corporate existence and nature of a company, including its structure and group structure. These include company formations, share-for-share transactions, amalgamation transactions, inter-group transactions,

unbundling transactions and liquidations, winding-up of a company and the deregistration of a company (Kruger & Scholtz, 2003:76-77). In this study, these transactions are grouped together into certain categories, namely, mergers, acquisitions and restructurings.

Tax avoidance: Tax avoidance can be broadly described as the practice of a taxpayer arranging his or her affairs in such a manner as to minimise his or her tax exposure. This is done while staying entirely within the limits of the law (De Koker & Williams, 2011:2; McLoughlin, 1979:1; Silke, 1958:1; Van Blerck, 1992:21.12).

The following abbreviations have been used in this dissertation:

Table 1.1: Abbreviations used in this document

Abbreviation	Full name
ACCC	Australian Competition and Consumer Commission
AGAAR	The Australian General Anti Avoidance Rule
AUD	Australian Dollar
BAT	British American Tobacco Services Australia Ltd
BEE	Black Economic Empowerment
CAD	Canadian Dollar
CGAAR	The Canadian General Anti Avoidance Rule
CGT	Capital Gains Tax
CIR	Commissioner for Inland Revenue
GAAR	The General Anti Avoidance Rule
PUC	Paid-up Capital
SARS	The South African Revenue Service
The Act	The Income Tax Act No 58 of 1962
The Canadian Act	The Income Tax Act of 1985
The ITAA	The Income Tax Assessment Act of 1997

1.8 THE STRUCTURE OF THE STUDY

Chapter two of the study presents a literature review which involves a study and synthesis of the existing literature in the area of taxation, mining taxation, anti-avoidance legislation in this context, as well as a brief consideration of the nature and functioning of mergers, acquisitions and restructurings.

Chapter three involves the documenting of a critical analysis of a theoretical yet practical example of a merger transaction in the mining industry in South Africa. The example will be developed based on recognised principles in regard to merger transactions, but are highly simplified in order to demonstrate the principles that are relevant to this study. The critical analysis involves a consideration of relevant transaction steps applicable to the example of a merger transaction.

Based on the principles identified as part of the critical analysis, opportunities for tax avoidance related to the transaction are identified and considered. Relevant anti-avoidance legislation is considered in the context of the analysis of the transaction in order to determine whether these opportunities for avoidance can be prevented by current legislation.

Chapter four involves the identification and analysis of international examples of tax avoidance in the context of merger transactions and how anti-avoidance legislation was able to prevent the avoidance.

Chapter five details the conclusions drawn as part of this study as well as recommendations for further study in this field of interest.

CHAPTER 2

TAX AVOIDANCE AND ANTI-AVOIDANCE IN SOUTH AFRICA

2.1 INTRODUCTION

This chapter provides a very brief introduction to the South African tax system, and also provides a brief overview of tax avoidance and anti-avoidance in South Africa. This includes a discussion on the morality of tax avoidance, as well as the necessity for anti-avoidance measures.

The chapter subsequently provides a brief overview of the mining tax system in South Africa and discusses some basic issues surrounding tax avoidance in the mining industry in South Africa.

Finally, the chapter provides an overview of corporate transactions which includes a discussion on some common types of corporate transactions that could be found in South Africa.

2.2 TAXATION AND ANTI-TAX AVOIDANCE IN SOUTH AFRICA

The tax regime of South Africa is governed by the Income Tax Act (58/1962) (hereinafter referred to as 'the Act'), which is a complicated piece of legislation, and is applied in practice subject to the interpretation of the courts (De Koker & Williams, 2011:23).

The Act provides for a number of types of taxes payable by taxpayers, and according to Stiglingh *et al* (2012:1) these include the following:

- normal income tax;
- dividends tax;
- donations tax;
- certain withholdings taxes;
- capital gains tax; and
- turn-over tax.

Normal tax is the main type of tax that is relevant to this study. Section 5(1) of the Act provides for normal tax to be paid on the taxable income of any person or company. The definition of 'taxable income' in terms of the Act involves the definition of a number of other terms, including 'income' and 'gross income'. The net effect of these is broad in that they subject the worldwide income of any South African tax resident to income tax. Furthermore, any income of a non-resident that is from a source within South Africa is also subject to income tax in terms of the Act.

The collection of tax is administered by the South African Revenue Service (hereinafter known as 'SARS'). Taxes are mainly collected by means of employees' tax and provisional tax payments (Stiglingh *et al*, 2012:3). The payment of employees' tax and provisional tax essentially allows for taxes to be paid as the relevant income is earned (Stiglingh *et al*, 2012:3). This helps to prevent a situation in which taxpayers are responsible for a very large tax obligation at the end of their year of assessment, and which might cause SARS to experience difficulties in attempting to recover payments from the taxpayer.

The liability to pay tax is not one that is enjoyed by taxpayers who obviously wish to pay as little tax as possible. De Koker and Williams (2011:9) quoted the following judgement by Judge Learned Hand in the case of Commissioner versus Newman 159 F 2d 848 (CCA-2, 1947):

> Over and over again have the courts said that there is nothing sinister in arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor, and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.

The above statement by the court supports that it is only natural that taxpayers have a particular aversion to paying tax as the payment of tax results in them being out of pocket. To protect their pockets, therefore, taxpayers wish to minimise their tax liabilities wherever they are able to do so.

According to De Koker and Williams (2011:2), the South African common law does not impose any liability to pay income tax, but that such liability arises due to the existence of specific legislation in the form of the Act. By implication this means that SARS cannot seek to tax a taxpayer on any income that does not fall within the net created by the Act.

The fact that taxation arises as a result of legislative enactment opens up a window of opportunity for taxpayers. If a taxpayer can prove that his or her income falls outside of the provisions of the Act, that income will not be subject to tax. This forms the very basis of tax avoidance in that it amounts to taxpayers arranging their affairs so as to reduce their liability to pay tax, but doing so while staying entirely within the confines of the law (De Koker & Williams, 2011:2; McLoughlin, 1979:1; Silke, 1958:1; Van Blerck, 1992:21-12).

At this point it becomes important to draw a distinction between tax avoidance and tax evasion. Tax avoidance does not involve falling foul of the law while tax evasion amounts to the taxpayer intentionally and illegally escaping a liability to pay tax by means of fraud and deceit (De Koker & Williams, 2011:2; McLoughlin, 1979:1; Silke, 1958:1; Van Blerck, 1992:21-12).

Whereas tax evasion involves criminal intent (McLoughlin, 1979:1) which may not appeal to many law-abiding citizens, tax avoidance and its legal nature, on the other hand, does appeal to human nature. In fact, Kruger and Scholtz (2003:1) argue that apart from the natural aversion to paying tax, people are frustrated by paying more tax than others who are paying less without having resorted to questionable means.

In summary, therefore, tax avoidance involves any practice where the taxpayer attempts to use the law to reduce their exposure to tax. It is critical that whatever the taxpayer does must not violate the Act in any way. Taxpayers have devised a number of ways to avoid tax over the years. These have often been tested by the courts, which may or may not have agreed with their use. The courts have been consistent as far as the attempts to avoid tax by the taxpayer have been deemed to be within the terms of the provisions of the Act is concerned. In this regard, the courts have ruled that there has been no wrongdoing on the part of the taxpayer. The courts have, however, also commented on the morality of tax avoidance. This is discussed in more detail below.

2.2.1 Legality and morality of tax avoidance

The issue of tax avoidance is not a new one, and has existed for as long as taxes have been in existence. The morality and legality of tax avoidance has been questioned and tested at length over the past number of decades. There have been numerous arguments in support of the legality of the practice of tax avoidance, as well as arguments against the principles involved in this practice.

According to Clegg and Stretch (2012(a):3), in the case of the Duke of Westminster versus the Inland Revenue Commissioner, I.R.C. 19 TC 490, [1936] AC 1,the court held that a taxpayer is within his rights to arrange his affairs so as to, within the confines of the law, reduce his tax liability. The court further held that the Commissioner of Inland Revenue, being the tax authority in this case, may not require the taxpayer to pay a higher tax in such an instance, regardless of whether he disagrees with the attempts of the taxpayer to lower his tax liability.

This dictum argues that a taxpayer is well entitled to arrange his affairs in order to avoid tax as long as this remains strictly within the confines of the law. According to Silke (1958:2) this principle was upheld by the court in the case of *Partington v The Attorney-General* (1869), L.R. 4E & I App 100 at 122, in which it was held that a taxpayer must pay tax when he comes within the confines of the law, irrespective of whether the tax will cause any hardship, but that the Crown may not tax a taxpayer if the income cannot be brought into the actual confines of the law, even if the income seems to be income that should be taxed under law. Therefore, irrespective of how taxable the income may appear to a tax authority, if it cannot be proved to be taxable under law, the income may not be taxed.

Although the view of the court in the abovementioned case defends the legality of tax avoidance, the court in the case of COT versus Ferera, 1976 (2) SA 653 (RA) (38 SATC 66) concluded that 'the avoidance of tax is evil' and is a 'nefarious practice' that can only benefit the wealthy and will lead to serious long term consequences.

Thus, there are differing opinions and arguments regarding the legality and morality of tax avoidance. Although the morality of tax avoidance will continue to be the subject of debate, it seems to be clear that as long as the taxpayer stays properly within the law, an arrangement of affairs to reduce a tax liability is a practice that is well within the rights of the taxpayer, and is acceptable to the courts.

2.2.2 Overview of anti-tax avoidance in South Africa

The collection of income tax is the responsibility of SARS. As far as the collection of taxes is concerned, SARS behaves similarly to any other business in that it wishes to maximise its revenues in the form of tax collection. Greater tax collection will result in greater funding for the fiscus which is needed for the management and development of the country.

Tax avoidance amounts to seepage of revenue that would otherwise have been owed to the fiscus. The fiscus attempts to counteract this seepage by introducing what is known as anti-avoidance provisions in the Act. These provisions have been fairly wide-reaching and there are many in the Act. The anti-avoidance measures are so wide- reaching that Kruger and Scholtz (2003:229) argue that many accountants in South Africa dare not even attempt to advise their clients to enter into any type of transaction that could lead to a tax saving.

Although there are some individuals who believe that the anti-avoidance measures are absolute, Kruger and Scholtz (2003:229) argue that some officials within SARS believe that anti-avoidance measures are not sufficient in that taxpayers can circumvent these by fairly simple means.

Anti-avoidance measures in essence exist to prevent the taxpayer from using intelligent methods to escape the payment of tax by using legal loopholes. Although accountants often argue against tax avoidance, there have, nonetheless, been continued attempts by the taxpayer to avoid tax. This tendency combined with the opinion held at SARS that anti-avoidance provisions are insufficient has led to an ever-growing number of anti-avoidance provisions. This tendency has been noted by Silke (1958:563) who states that there has been an on-going and enduring tug-of-war between taxpayers and the fiscus and that this

has resulted in measures and provisions that have caused significantly more complex legislation to be introduced than would have been the case otherwise.

2.2.3 Necessity for anti-avoidance provisions

The government of any country relies on the taxes it manages to collect funds for the running and improvement of the country. Government funds are reduced by both practices of tax evasion as well as tax avoidance (Silke, 1958:561[1]).

The erosion of the income of the fiscus by means of tax avoidance, if allowed to go on unchecked, could have serious ramifications for a government as well as its citizens. In South Africa, this has been the case for many years if one takes into account the fact that several decades ago Silke (1958:561) argued that the loss to the fiscus would be 'substantial'.

According to Silke (1958:562-565) the opportunity for tax avoidance arises as a result of loopholes that exist due to the ideal of having simplified tax legislation. Knowledge of such loopholes spreads quickly, particularly among the wealthy, and this can easily lead to greater losses to the fiscus. To counter this loss to the fiscus, he argues that the value of a powerful anti-avoidance provision must not be underestimated.

Apart from being necessary from the perspective of protecting the much needed income of the fiscus, anti-avoidance provisions are also required to ensure equality in the system of taxation. Adam Smith as quoted by Silke (1958:561) states that 'the subjects of every state ought to contribute towards the support of the Government, as nearly as possible, in relation to their respective abilities'. In this regard, Silke (1958:561) argues that a loss of tax revenue from one source, typically the wealthy, must be made up from other sources. This results in a disproportionate tax burden that should not be the case in an effective tax regime.

[1] Although this source dates back to 1958, it is of importance in obtaining an understanding of the history of tax-avoidance, the core constructs of which have not changed since the publication of this source. Modern sources has however also been used to ensure that the research is current.

Therefore, it has become clear that anti-tax avoidance is essential to any stable economy. Anti-avoidance measures keep in check those with the means to invent ways of avoiding tax, and in so doing, to maximise the ability of a government to serve its people. Furthermore, anti-avoidance measures limit the opportunities for some taxpayers to pass their burden onto others. The expectation is that in this way all taxpayers will be protected against unfair taxation and the maintenance of a stable and contented civil society will be promoted.

2.2.4 General and specific anti-avoidance provisions

There are a number of anti-avoidance measures, some of which are briefly discussed below.

Firstly, there are common-law remedies to counter tax avoidance. An example of a common law remedy pertaining to tax avoidance is that of the principle of substance over form (De Koker & Williams, 2011:8-9).

The principle of substance over form will have the effect that the camouflaging of a transaction will not conceal the effect of the true state of affairs of the transaction. Judge Innes CJ, in the case of Dadoo Limited and others versus Krugersdorp Municipal Council 1920 AD 530 at 547, said of this principle that:

> A transaction is *in fraudem legis* when it is designedly disguised so as to escape the provisions of the law, but falls in truth within those provisions. Thus stated, the rule is merely a branch of the fundamental doctrine that the law regards the substance rather than the form of things...

Another example of a common law principle applicable to anti-avoidance measures is that of the principle of a sham or simulated transaction. A sham or simulated transaction is essentially a transaction in which the design and appearance of the transaction is intentionally different to the actual nature of the transaction (De Koker & Williams, 2011:13-14). The effect and consequences of entering into a sham or simulated transaction has been voiced by the court in the case of Michau versus Maize Board, 2003

(6) SA 459 (SCA) (66 SATC 288), in which Judge Scott J held that taxpayers may not conceal the true nature of their transaction and that the court in such a case will disregard the apparent form of the transaction and give effect to the true nature of the transaction.

Although the above judgement is upheld, De Koker and Williams (2011:10) maintain that the common law does recognise that a taxpayer may choose a route of less taxation when there are multiple options for the structuring of his or her affairs. This principle established by the common law is, however, limited to the extent that there are anti-avoidance provisions in the legislation, and these were upheld by the court in the case of the Commissioner of Inland Revenue (CIR) versus Sunnyside Centre (Pty) Ltd 1997 (1) SA 68 (A).

It is clear from the above discussion that the following rule has become well established over time, namely, that a taxpayer may arrange his affairs to minimise his tax exposure, provided that he stays within the letter of the law.

The starting-point of anti-avoidance measures by means of legislative enactment is often in the form of the General Anti Avoidance Rule (hereinafter known as 'the GAAR') which is found in Part IIA of the Act. According to De Koker and Williams (2011:54-55), the GAAR does not address any particular instance of tax avoidance, but instead, is aimed at any transaction, structure, or scheme that has as its aim the avoidance of tax.

According to Clegg and Stretch (2012(a):5), any transaction, scheme or structure which has as its aim the avoidance of tax is referred to as an 'impermissible avoidance arrangement' and will result in the GAAR being invoked if a number of conditions are met. At the core of these are that the arrangement must have as its main aim the provision of a tax benefit, and that the arrangement must be lacking in commercial substance.

The consequences to the taxpayer of falling foul of the provisions of the GAAR are fairly wide, but essentially amount to SARS being able to disregard the form of a transaction designed to avoid tax, and to tax the taxpayers as if the transaction was without the intention to avoid tax (Clegg & Stretch, 2012(a):12).

The common law remedies to tax avoidance, as well as the GAAR, are general in nature. They have as their objectives the general identification and prevention of schemes and transactions that are not genuine and that are intended to deny the fiscus revenue to which it is rightfully entitled.

However, the nature of tax avoidance is such that the GAAR and the common law principles will not always be of assistance as schemes can be designed to circumvent these. Furthermore, the Act itself creates opportunities for tax avoidance in that it contains certain measures and exceptions (some of which are relief measures) aimed at providing for a fair burden to taxpayers. These are, however, subject to being exploited by taxpayers and this will result in unintended losses to the fiscus. To counter these and other instances of avoidances not remedied by the common law or the GAAR, the Act contains provisions that are aimed specifically at preventing taxpayers from avoiding tax.

Examples of anti-avoidance provisions that are aimed at preventing tax avoidance in respect of corporate transactions include those contained in sections 41 to 47 in the Act. These sections are designed to provide roll-over relief to the taxpayer when entering into a transaction that would give rise to tax liabilities without corresponding income or economic benefits. Such transactions typically involve companies within a group or a company and its shareholders. Transactions covered by these sections include asset-for-share transactions, amalgamation transactions, intra-group transactions, unbundling transactions and liquidation and deregistration transactions (Stiglingh *et al*, 2012:496).

The relief provided by the abovementioned sections could potentially be abused by taxpayers for undue benefits (Stiglingh *et al*, 2012:505). Therefore, the sections contain specific anti-avoidance provisions to prevent this.

This discussion and analysis indicates that there is a well established regime of anti-avoidance. This was introduced in the common law and developed into being enacted in numerous sections in the Act. The fact that there are specific anti-avoidance provisions that deal with corporate transactions indicates that anti-avoidance measures would have a specific impact on corporate transactions, particularly as these transactions can be used to obtain a tax benefit.

2.3 TAX AND TAX AVOIDANCE IN THE MINING INDUSTRY IN SOUTH AFRICA

2.3.1 Introduction to tax in the mining industry

The mining industry is a rather unique industry in the manner in which it develops and operates. Mining is typically characterised by substantial capital expenditure over a number of years preceding the commencement of operations. During the initial period of capital expenditure, little or no revenue is earned (Van Blerck, 1992:D-16,D-17).

Due to the capital-intensive nature of the mining industry, as well as the historical importance of the mining industry in South Africa, a special system of taxation exists that applies to the mining industry. According to Van Blerck (1992:6-2), the mining tax system is differentiated from the taxation of general companies by means of the use of different tax rates as well as by differences in the determination of taxable income.

The differential tax rates of a mining company are put in place to provide relief to mining companies during times of unprofitability, which is typically the case during periods of intense capital expenditure but little operational activity (Van Blerck, 1992:D-11). This is compensated for by disproportionately high tax rates during times of high profitability (Van Blerck, 1992:D-11). The current statutory tax rate for normal companies is 28%, but the maximum tax rate applicable to gold mine companies is 43%. This demonstrates that a mining company could potentially be required to pay a premium of up to 15% (this is the worst case scenario and depends on the type of mine involved, as well as certain other variables).

One of the main differences in the determination of taxable income of mining companies when compared to other types of company lies in the treatment of capital expenditure (Van Blerck, 1992:6-2). Capital expenditure for mining companies is defined in section 36 of the Act and includes, amongst others, the expenditure incurred on shaft sinking and purchasing of mining equipment.

However, section 15(a) read together with section 36 of the Act allows for a mining company to deduct all qualifying mining capital expenditure from taxable income as

defined in the Act, after the set-off of any balance of assessed losses from the previous year of assessment. Essentially what this means is that while a mining company has sufficient balance of capital expenditure which has not been utilised against taxable income in terms of the abovementioned section 15(a), that company will not have any tax liability in respect of mining income.

Thus, it is clear that there are specific tax benefits for mining companies if the differential mining tax rates and capital allowances available to the mining industry are taken into account. The fiscus provides mining companies with tax breaks due to the fact that they are capital intensive, and to encourage the further development of the mining industry. While the intention of the fiscus might be to stimulate the mining industry, the mining tax rules, however, present mining companies with a number of opportunities to avoid tax. These are discussed in more detail below.

2.3.2 Tax avoidance in the mining industry

The nature of tax avoidance in the mining industry is not different to that of other industries *per se*. The special mining tax system does, however, create some additional opportunities for avoiding tax. For example, a company that receives income from both mining activities and non-mining activities could seek to classify one as the other in order to obtain a tax benefit (Van Blerck, 1992:15-5).

When a mining company has a large balance of unredeemed capital expenditure, it could seek to classify its non-mining income as mining income because the balance of capital expenditure could be offset against this mining income, resulting in the company being liable to pay either no tax or a reduced tax (Van Blerck, 1992:15-5). However, on the other hand, if a mining company has no balance of unredeemed capital expenditure to use against taxable income from mining, it could seek to classify some of its mining income as non-mining income. This would enable the taxpayer to take advantage of the lower corporate tax rate rather than the typically higher mining tax rate (Van Blerck, 1992:15-3).

Another example of instances in which mining companies could use the mining tax system to their advantage is to spread taxable income and losses between different mines in a

group in order to use possible tax benefits sitting unproductively in certain mines within the group (Van Blerck, 1992:15-5).

In addition, it stands to reason that mining companies could go as far as acquiring another mine with either large assessed losses or a large balance of unredeemed capital expenditure. These tax benefits sitting in the acquired company would then be used against tax exposures in the existing mines. This makes use of the same principles mentioned above, that is, of off-setting losses between different mines owned by one entity or by using balances of unredeemed capital expenditure between mines.

The above examples are only some examples of instances where the mining tax system provides the mining industry with opportunities to avoid tax, whereas it is actually designed to support the development and operation of the mining industry while providing for higher tax rates to compensate for this.

However, the opportunities for tax avoidance that have been made use of by taxpayers in the mining industry have not gone unnoticed by the fiscus. In order to prevent mining companies mixing mining and non-mining income, the fiscus introduced a ‘ring-fence’ between these two types of income (Van Blerck, 1992:15-3). This ring-fence is provided for in section 36(7E) of the Act, and was brought into effect in 1984 (Van Blerck, 1992:15-5).

Section 36(7E) of the Act provides for the following:

> The aggregate of the amounts of capital expenditure determined under subsection (7C) in respect of any year of assessment in relation to any mine or mines shall not exceed the taxable income (as determined before the deduction of any amount allowable under section 15(a), but after the set-off of any balance of assessed loss incurred by the taxpayer in relation to any such mine or mines in any previous year which has been carried forward from the preceding year of assessment) derived by the taxpayer from mining, and any amount by which the said aggregate would, but for the provisions of this subsection, have exceeded such taxable income as so determined, shall be carried forward and be deemed

> to be an amount of capital expenditure incurred during the next succeeding year of assessment in respect of the mine or mines to which such capital expenditure relates.

The effect of the abovementioned section of the Act is that a balance of unredeemed capital expenditure held by a mining company is only available to be offset against mining income and not non-mining income (Van Blerck, 1992:15-5). This effectively prevents a mining company from avoiding tax by using capital allowances against non-mining income. The section also effectively prevents the use of capital expenditure to create assessed losses in respect of the mining income stream. This is done by limiting the deduction of capital expenditure to the total of taxable income earned from mining operations (Van Blerck, 1992:15-5).

With effect from 1984, the fiscus 'ring-fenced' the mining income from each particular mine within a group (Van Blerck, 1992:15-5). This was done by the introduction of section 36(7F) of the Act, which states that:

> The aggregate of the amounts of capital expenditure determined under subsection (7C) in respect of any year of assessment in relation to any one mine shall, unless the Minister of Finance, after consultation with the Minister of Mineral and Energy Affairs and having regard to any relevant fiscal, financial or technical implications, otherwise directs, not exceed the taxable income (as determined before the deduction of any amount allowable under section 15(a), but after the set-off of any balance of assessed loss incurred by the taxpayer in relation to that mine in any previous year which has been carried forward from the preceding year of assessment) derived by the taxpayer from mining on that mine, and any amount by which the said aggregate would, but for the provision of this subsection, have exceeded such taxable income as so determined, shall be carried forward and be deemed to be an amount of capital expenditure incurred during the next succeeding year of assessment in respect of that mine...

The intention of section 36(7F) is to prevent companies from eroding tax revenues by using the capital allowances of non-profit making mines against profit-making mines excessively. The section further prevents the creation of losses in respect of any particular mine by limiting the deduction of capital expenditure to the taxable income of that mine (Van Blerck, 1992:15-5).

The above serves to point out that the mining sector has its own problems in respect of tax avoidance. It further goes to show that in cases where the taxpayer makes use of an opportunity presented by the Act to minimise a tax liability, the fiscus is bound to step in quickly to counter these measures. Thus, it becomes apparent that corporate transactions in the mining industry will carry specific tax implications, and that anti-avoidance provisions will impact on these corporate transactions.

2.4 CORPORATE TRANSACTIONS IN SOUTH AFRICA

The term ‘corporate transactions’ as defined for the purpose of this study, encompasses a number of transactions involving the alteration of the entity, form and structure of an organisation. According to the Act, the provisions dealing with corporate rules deal with company formations, share-for-share transactions, amalgamation transactions, inter-group transactions, unbundling transactions and liquidations, winding-up of a company and the deregistration of a company (Kruger & Scholtz, 2003:76-77). The discussion of corporate transactions for the purposes of this study will, however, be limited only to mergers, acquisitions and restructurings in the context of the mining industry in South Africa.

The transactions generally require that an amount should be made payable for the transfer of either assets or shares, and as such, tax liabilities will generally be created by them. At this point, it is important to provide a brief discussion of these transactions and how they function as this will facilitate an understanding of the tax implications applicable to the transactions. Table 2.1 will briefly describe the types of corporate transactions which might be seen in the mining industry, the characteristics of these transactions as well as the rationale for entering into these transactions.

Table 2.1: Types of corporate transactions in the mining industry, their characteristics and the rationale for entering into these transactions

Type of corporate transaction	Characteristics	Rationale for type of transaction
Merger	• Could be in the form of two mining companies merging, with only one of the existing companies surviving as the combined legal and operating entity. The other entity would cease to exist. The surviving entity would encompass the operations, assets and liabilities of both previously separate entities. • Could also be in the form of two mining entities joining to form a new legal entity which will encompass the operations, mineral rights and other assets and liabilities of both previous entities. Both the previously separate merging entities will cease to exist as individual entities after the merger. • Consideration for the merger may either be in the form of cash or shares, or a combination of both. (Gaughan, 2011:12-15)	• Mining companies may wish to take over another mining company by means of a merger in order to try and gain market share and expand its operations by eliminating its competition through merging with the competitor. • Mining companies may wish to diversify their mining business by buying other types of mining companies, or by buying mining companies in different locations. For example, a gold mining company may wish to acquire a platinum mining company, or another gold mining company in a different location to its existing operations. • Mining companies may also wish to take advantage of certain synergies generated when two mining companies merge. These synergies arise as a result of the two companies being able to pool resources, maximise and combine the strengths of both companies and by streamlining their mining and other processes in order to drive efficiencies and so saving significant costs while boosting earnings and the bottom line.

		(Gaughan, 2011:14-15)
Acquisitions	• Typically will involve one mining company buying or acquiring another mining company. • The acquisition will normally be done by a larger mining company buying a smaller mining company, but may also be in the form of a smaller mining company buying a larger mining company. • The acquisition may either take place in the form of the one mining company buying at least a controlling number of shares of the other mining company, or may take place by means of the purchase of the mineral rights and other assets and liabilities of the target mining company. (Osae, 2010:10) • Consideration for the acquisition may either be in the form of cash or shares, or a combination of both. (Gaughan, 2011:15)	• Similar rationale as in the case of a merger, in that it allows for the expansion of a mining company's operations, market share and revenues while providing beneficial synergies.
Restructuring	• The term 'corporate restructuring' is a broad term that involves a mining company taking a looking glass to itself and reorganising its structure in order to optimise itself. (Gaughan, 2011:389)	• Restructurings are typically entered into because of one of the following reasons: • Because certain parts of a mining company might not be yielding positive results; • Because the mining company's strategy or direction has changed; • Because the existing structure of the mining company is creating

		certain inefficiencies; • To remedy a situation of excessive debt owed by a mining company; or • To redress a previously unsuccessful merger or acquisition. (Gaughan, 2011:389)

Source: Gaughan (2011:12-15,389); Osae (2010:10).

The mergers, acquisitions and corporate restructuring transactions discussed above are normally very large, involving significant amounts of money, and can have significant tax implications. In the Act there are specific relief measures which are available to companies in respect of these types of transactions (Stiglingh *et al*, 2012:496).

These corporate transactions as well as their tax implications are only some of the instances of transactions in the corporate world that involves the actual nature and structure of corporations and groups. Indeed, there are more of these types of transactions, each creating its own set of tax implications. Where relevant, this study expands upon these tax implications.

As already mentioned, corporate transactions give rise to specific tax implications. As most corporate transactions involve a either an entire business, or a business' assets being sold in one way or another, in general these tax implications mainly involve Capital Gains Tax (hereinafter known as 'CGT') being levied in terms of the provisions of the Eighth Schedule to the Act on the disposal of assets and shares by companies (Kruger & Scholtz, 2003:40).

In addition, tax considerations, such as assessed losses of companies being bought and sold and the treatment of the cost of financing used to fund the transactions must be taken into account.

2.5 CONCLUSION

There are both unintentional loopholes and intentional relief measures in the Act that are continuously exploited by the taxpayer who wishes to protect his pocket by minimising tax liabilities. The fiscus, however, also wishes to protect its cash flow and does not approve the attempts of certain taxpayers to misuse the Act to deny the fiscus its rightful revenue. Therefore, provisions and measures have been included in the Act to attempt to limit the opportunities for the taxpayer to avoid paying tax.

This chapter studied the background of corporate transactions, tax avoidance and anti-avoidance measures, as well as the background to mining tax and the relevant allowances and possible avoidance opportunities resulting from these allowances. The next chapter contains a more detailed analysis of the relevant tax legislation in the context of mergers in the mining industry in South Africa, and proposes and studies a hypothetical illustrative example of a merger in the mining industry in South Africa, as well as related avoidance opportunities and anti-avoidance provisions to restrict these opportunities.

CHAPTER 3

ANTI-AVOIDANCE IN MERGERS IN THE MINING INDUSTRY

3.1 INTRODUCTION

The corporate transaction under scrutiny in this study is a merger. Merger transactions invoke a number of tax implications as well as a number of anti-avoidance provisions in the Income Tax Act (58/1962) (hereinafter referred to as 'the Act'). In this study, the corporate roll-over relief provisions of section 44 of the Act in particular are considered. This section of the Act primarily deals with amalgamation transactions. These are also known as 'mergers'. In addition to the provisions of section 44 of the Act, the provisions relating to the capital expenditure allowances which are available to mining companies are also considered. Finally, a hypothetical illustrative example of a merger transaction in the mining industry in South Africa, together with relevant tax implications is developed and analysed in order to demonstrate the principles that are the subject of this study.

3.2 SECTION 44 OF THE INCOME TAX ACT (58/1962)

3.2.1 Overview

Mergers normally involve one company transferring its assets and liabilities to another company for a consideration in some form (Bruner, 2004:535; Gaughan, 2007:12). The gain that is usually seen in a merger upon the disposal of a merging company's assets and liabilities to a newly merged company will be taxable under normal tax principles (De Koker & Williams, 2012:64). However, merger transactions often result in gains that are not truly realised, with the transferred assets typically being used to generate the same income that was previously generated, although in a different company structure. Essentially, the transactions normally result in a gain that is not immediately of economic benefit to the parties to the transactions (Stiglingh *et al*, 2012:496).

The fiscus has recognised that these transactions do not give rise to an immediate usable profit on the transfer of assets, and as such introduced sections 41 to 47 of the Act to provide relief in this regard.

Section 44 of the Act applies in respect of an amalgamation transaction, which is defined in section 44(1) as any transaction in terms of which a company disposes of all of its assets to another resident company by means of an amalgamation, conversion or merger. It is a specific requirement of section 44 that the company which disposes of its assets must be terminated. It further expands the definition of the term ‘amalgamation transaction’ to include a transaction in which a foreign company disposes of all its assets to another foreign company by means of an amalgamation, conversion or merger. The inclusion of foreign companies in the definition is however dependent on both companies being part of the same group of companies prior to the transaction, with at least 95% of the equity shares of both companies being owned by parents within that group. The inclusion of foreign companies in the definition is further dependent on the merged entity being a controlled foreign company (as defined in section 1 of the Act) in relation to any company that is both a South African tax resident and is part of the same group of companies (before and after the transaction) as the two previously unmerged entities.

The above definition effectively implies that relief will be provided in the case of a transaction in which there are no immediate and economic profits generated by the transactions, but rather just a restructure of assets from one entity to another.

3.2.2 Relief provided

The relief that is provided to taxpayers under section 44(2) and section 44(3) of the Act depends on the nature of the assets that are disposed of in terms of the merger.

In the case of a company disposing of capital assets to another company (which must also acquire the assets as capital assets) as part of a merger, the company is deemed by section 44 to have disposed of the assets at their base cost, which will then result in no CGT or income tax being payable (Clegg & Stretch, 2012(b):42). Furthermore, all the other tax characteristics of the assets, such as any cumulative and remaining tax allowances,

base costs and dates of acquisition are transferred to the merged entity (Clegg & Stretch, 2012(b):42; De Koker & Williams, 2012:82-83).

In the case of a company disposing of trading stock to another company (which must also acquire the assets as trading stock) as part of a merger, the company disposing of the trading stock is deemed to have disposed of the trading stock at its original price (De Koker & Williams, 2012:83). The merged company is again deemed to have acquired the identical tax characteristics of the trading stock transferred from the disposing company, such as the cost of the trading stock and the dates of acquisition.

In addition to the above roll-over relief provisions, Stiglingh *et al* (2012:509-510) states that section 44 provides for similar relief in relation to the following:

- Qualifying section 24C allowances that had previously been granted to the merging company.
- The disposal of shares in the merged (new) entity by the merging entity, to its shareholders. In this case the shares would have typically been received by the merging entity as consideration for the disposal of the assets by the merging entity.
- The disposal of shares in the merging entity by the shareholders of the merging entity. As part of the merger transaction, the shareholders will receive shares in the newly merged entity as compensation for them losing the shares in the merging entity, which will cease to exist. The 'disposal' of the shares in the merging entity for the shares in the newly merged entity will not carry any tax consequences for the shareholders.

The effect of all the relevant roll-over provisions provided for by section 44 of the Act is that no tax is payable upon the merger, with the merged company being in the same position regarding the assets, as the disposing company was. Therefore, should the merged company then sell the assets to a third party subsequent to the transaction, the tax implications that were previously deferred will realise based on the original costs and acquisition dates (as well as related tax allowances) of those assets.

3.2.3 Anti-avoidance measures

The roll-over relief provided by section 44 of the Act is intended to provide for a tax neutral position in a transaction that is essentially economically neutral, from a profit perspective (Stiglingh *et al*, 2012:496). Despite this, it goes without saying that the tax neutral position is beneficial to the taxpayer and is, therefore, open to abuse. For this reason, section 44 contains a number of anti-avoidance provisions to prevent the relief being applied inappropriately.

The requirements of section 44(4) are basic attempts to combat tax avoidance. One of the requirements provides that the roll-over relief will only be available to the extent that an issue of shares or the assumption of the merging entity's debt is used as consideration for the merging entity disposing of all its assets to the merged entity. The use of an assumption of debt to pay for assets is subject to restrictions in accordance with section 44(4)(b), with the restrictions essentially preventing the creation of debt specifically for a taxpayer to be able to benefit from the roll-over relief of section 44 (De Koker & Williams, 2012:84).

The rationale for this anti-avoidance provision is arguably that the issue of shares or the assumption of debt as consideration for the assets essentially makes the transaction economically neutral, with no real profit being realised. For example, should the merged entity have paid for the assets of the merging entity in cash, the merging entity would have distributed a cash amount as consideration for the loss of the shares in the merging entity (which would cease to exist subsequent to the merger transaction). The distribution of this cash amount would have resulted in the shareholder ultimately realising a cash profit, which would be subject to tax.

To avoid the above situation in which a taxpayer might seek the relief of section 44 while still realising a cash amount out of the transaction, section 44(4) makes the roll-over relief only applicable when shares are used as consideration for the transaction. To the extent that if any part of the consideration is anything other than shares, the roll-over relief provided for in section 44 will not apply to that portion of the transaction (De Koker & Williams, 2012:86).

In addition to the risk of the abuse of section 44 when taxpayers use consideration other than equity shares or an assumption of debt as settlement for a merger transaction, another risk faced from an avoidance perspective is that companies may enter into a merger transaction in terms of section 44 purely to obtain the tax benefit in the short term, with a subsequent external sale of the assets that were the subject of the transaction. According to the *Explanatory Memorandum on the Revenue Laws Amendment Bill, 2002* (South African Revenue Service, 2002), the treatment of the transaction in such a way would have resulted in a taxpayer deferring and shifting gains from the merging company into the merged company, which might then have been able to immediately sell such assets in order to use the gain against an available loss in the merged company. This would have resulted in a situation where tax would have been avoided by the gain having been shifted for use against a previously unrelated loss.

In order to combat this risk of avoidance, section 44(5) of the Act provides that where a merged company disposes of any asset that was subject to relief in terms of the provisions of section 44 of the Act within 18 months of having acquired the assets in terms of a merger transaction, the following applies:

- In the case of a capital asset, any gain or loss realised on a subsequent disposal of such an asset shall be 'ring-fenced' and will, therefore, not be available to be used against any other capital gains or losses of the merged company. Further, any gain realised on such a sale will be taxed in terms of the provisions of the Eighth Schedule to the Act (Clegg & Stretch, 2012(b):43). The ring-fencing of capital gains and losses are, however, limited to the gains and loss that were rolled forward at the date of the transaction, with any subsequent gains or losses being available to be utilised against other gains or losses of the merged company (De Koker & Williams, 2012:85).
- In the case of trading stock, the proceeds (limited to the value of the trading stock at the time of the merger transaction) will be deemed to have been received in respect of a separate trade, resulting in the taxable income from that trade not being available to be off-set against an assessed loss from another trade (Clegg & Stretch, 2012(b):43). This ring-fence does not apply to any trading stock that is normally and regularly

disposed of by a taxpaying company taxpayer during its ordinary course of business (De Koker & Williams, 2012:85).

- In the case of an allowance asset, any recoupments or other amounts included in income as a result of such a subsequent sale (again limited to the amount that would have been included in income at the time of the merger transaction), will be deemed to have been received in respect of a separate trade. Again this will result in the taxable amounts from the disposal not being available to be used against an assessed loss from another trade (De Koker & Williams, 2012:86).

The effect of ring-fencing is that taxpayers are not able to make use of an opportunity to avoid tax by entering into a merger transaction for the sole purpose of shifting gains or losses in order to use these to minimise a tax position.

Section 44 of the Act is also subject to a number of other provisos and exclusions which are aimed at preventing the abuse of this section for avoidance purposes. These include a provision in section 44(13) that states that a merger transaction will not qualify for roll-over relief should the merging company not be liquidated, wound-up or deregistered within a period of 18 months subsequent to the merger transaction.

The nature of the transaction and the nature of the tax relief provided present opportunities for tax avoidance since it would appear as if the transactions can be structured to obtain an undue benefit. However, it can also be seen from the above discussion that section 44 is interspersed with anti-avoidance provisions that are designed to protect the intended benefits of the section, with the taxpayer being taxed on the transaction that was previously subject to relief, as soon as one of the anti-avoidance provisions are fallen foul of.

3.3 MERGER TRANSACTIONS

The taxation provisions relating to merger transactions are no different in their applicability to the mining industry than they are to other industries. However, there are some specific allowances available to the mining industry together with some related recoupments that would be relevant in the case of a merger transaction in the mining industry.

The tax provisions that are relevant to merger transactions in the mining industry in South Africa and, more specifically the applicable anti-avoidance provisions, are best explained in the context of an example. Therefore, this section contains an analysis of a hypothetical illustrative example of a merger transaction in the mining industry in South Africa. The analysis will consider the basic transaction steps that are relevant to the study of anti-avoidance in merger transactions in the mining industry, and considers the tax implications of the transactions had there been no tax relief in terms of section 44. The relevant relief provided in terms of section 44 are then applied to the hypothetical illustrative example of a transaction, following which opportunities for avoidance in the context of the transaction are considered. Finally, the relevant anti-avoidance provisions to restrict these opportunities are considered in order to demonstrate how anti-avoidance provisions are able to prevent tax avoidance in merger transactions in the mining industry in South Africa.

3.3.1 Hypothetical illustrative example of a merger transaction

For illustrative purposes, Figures 3.1 and 3.2 are used for the purposes of this study to demonstrate a possible merger transaction in the mining industry.

Figure 3.1: Diagrammatic representation of a possible merger transaction in the mining industry: Pre-merger

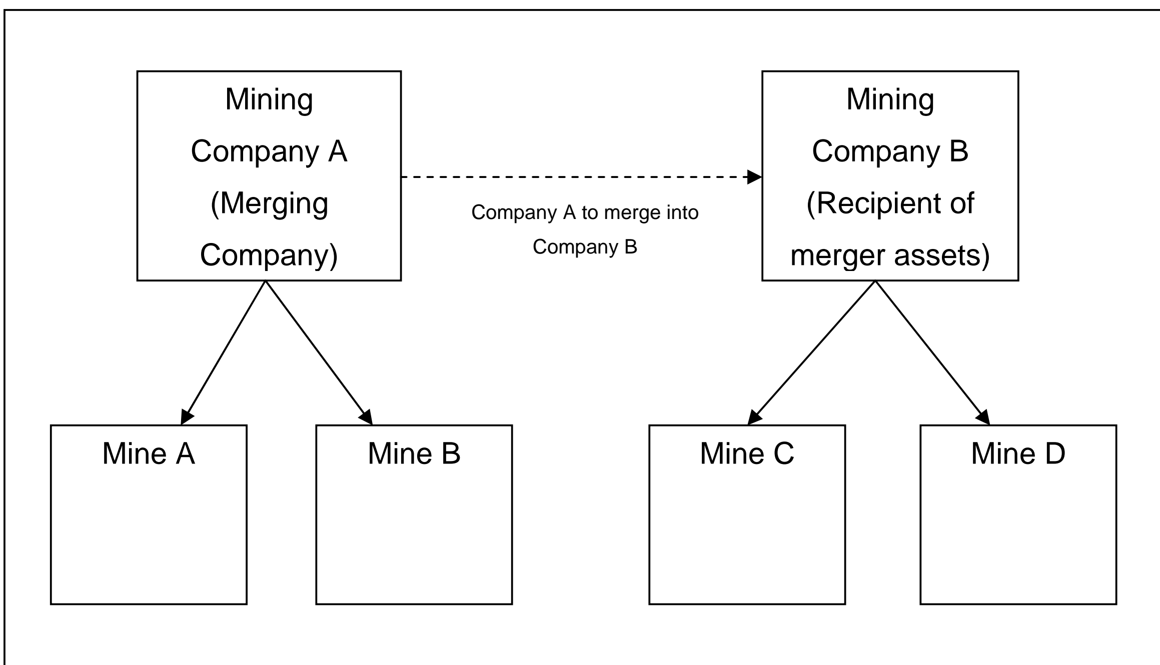
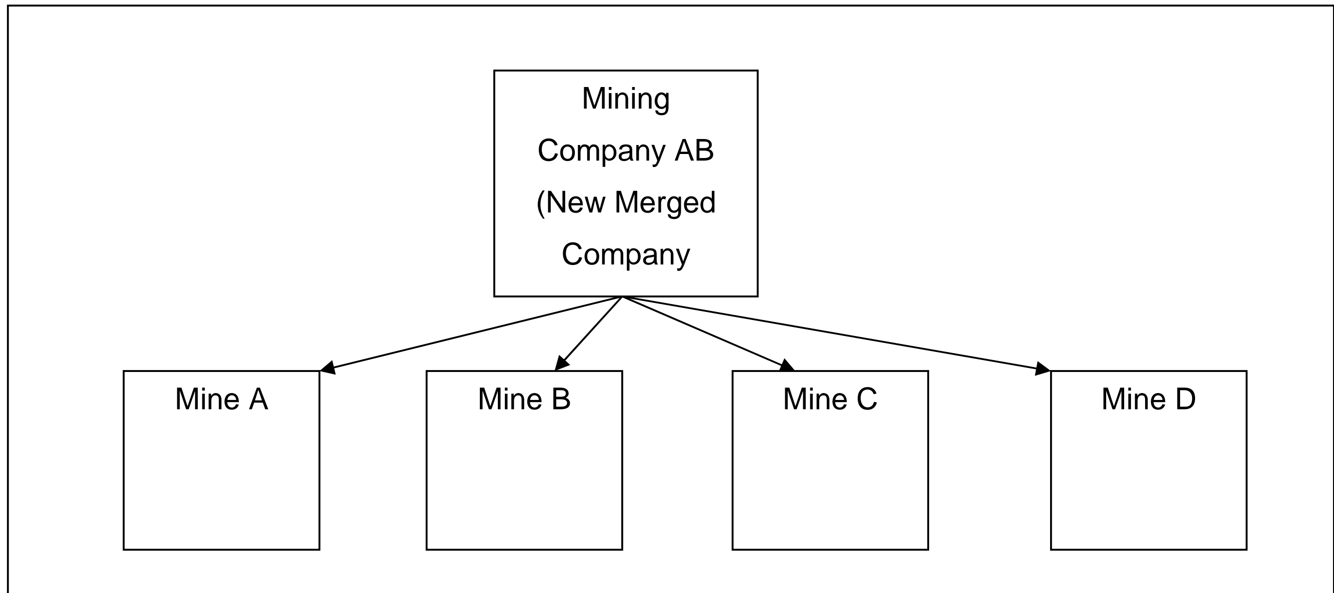


Figure 3.2: Diagrammatic representation of a possible merger transaction in the mining industry: Post-merger



The following set of facts applies to the hypothetical merger transaction deal in Figure 3.1. It should be noted that this structure is in line with the terms of the requirements of section 44 of the Act, and is similar to a structure illustrated by De Koker and Williams (2012:82).

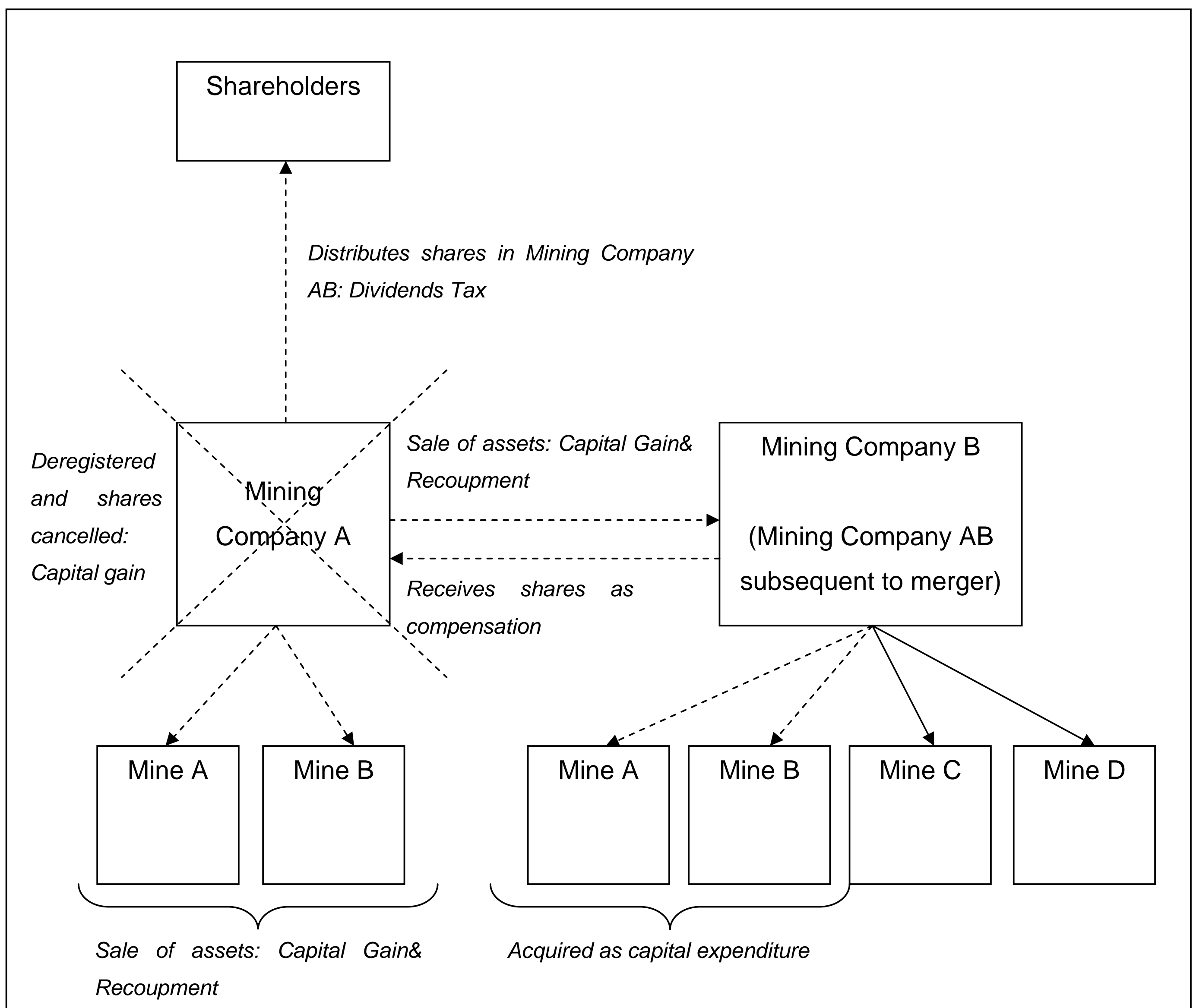
- Mining Company A holds 100% of the assets in Mine A and Mine B.
- Mining Company B holds 100% of the assets in Mine C and Mine D.
- Both Mining Company A and Mining Company A are South African companies and South African tax residents.
- All the Mines qualify for the mining capital expenditure allowance in terms of section 15 read together with section 36 (11) of the Act.
- Mining Company A disposes of all its assets (including both Mine A and Mine B) to Mining Company B.
- Mining Company B compensates Mining Company A for its assets by means of an issue of share capital in Mining Company B to Mining Company A, to the value of the assets disposed of.
- Mining Company A distributes these shares in Mining Company B to its shareholders, who are now shareholders of Mining Company B to the same value as their previous shareholding in Mining Company A.

- Mining Company A is deregistered subsequent to the finalisation of the transaction, with only the new mining company AB remaining.

3.3.2 Tax implications of the hypothetical merger transaction without section 44 relief

The tax implications of the above illustrated merger transaction, without the provisions of section 44, are discussed with reference to Figure 3.3.

Figure 3.3: Tax implications of illustrative merger transactions without section 44



The disposal by Mining Company A of its assets (Mine A and Mine B) would typically give rise to a capital gain in terms of the provisions of the Eighth Schedule to the Act.

The disposal would further give rise to a recoupment in terms of paragraph *j* to the definition of 'gross income' in section 1 of the Act. In terms of this recoupment provision, the excess of capital expenditure claimed in terms of section 15(a) of the Act over the balance of unredeemed capital expenditure at the date of the transaction, would be recouped and included as income in the hands of Mining Company A.

Mining Company B would be deemed to have acquired the assets (Mine A and Mine B) as capital expenditure in terms of the provisions of section 37 of the Act.

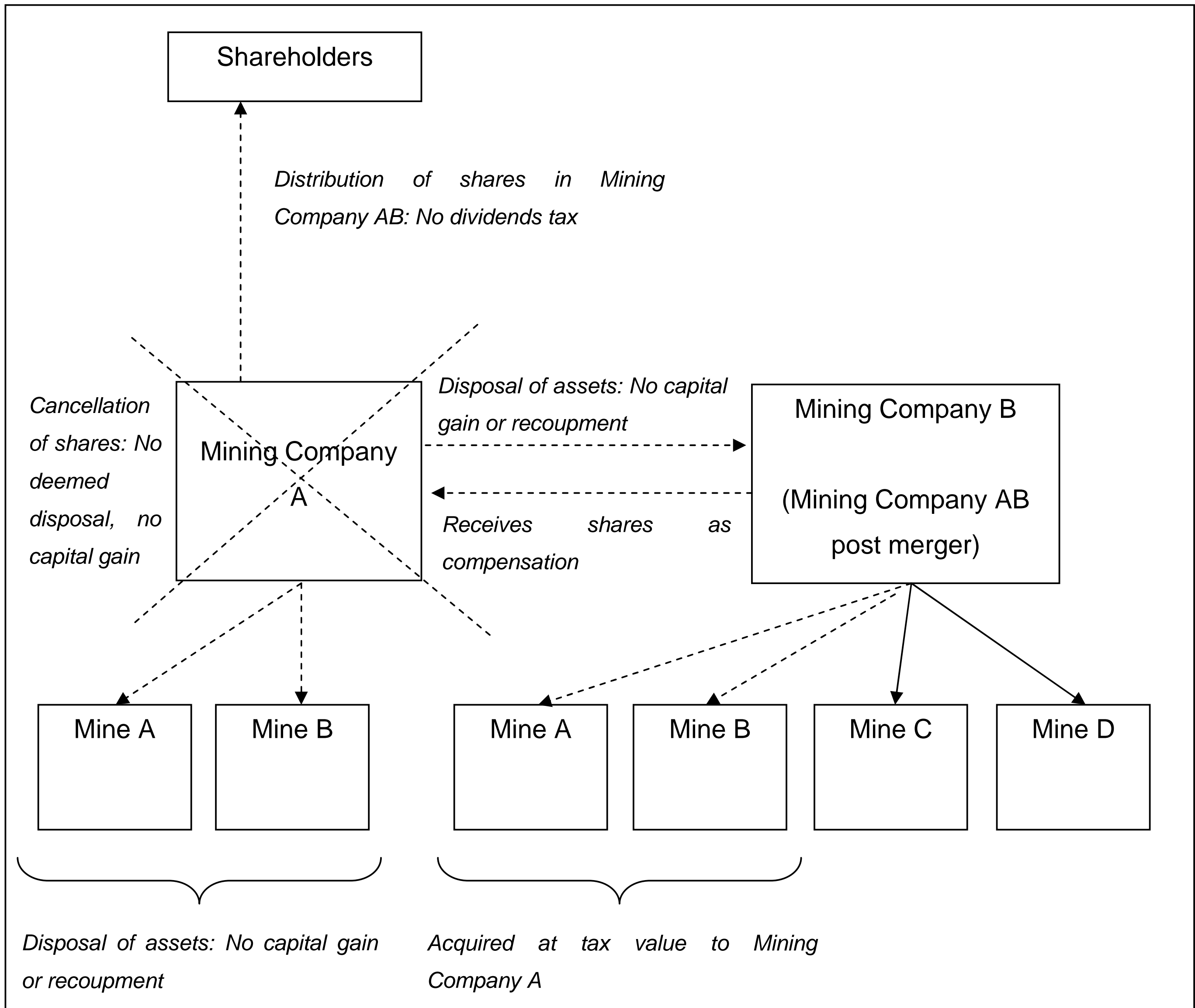
Mining Company A would distribute the shares in Mining Company AB that it received as compensation for the disposal of its assets as part of the merger, to its shareholders. This would then be subject to Dividends Tax in terms of Part VIII of the Act.

Mining Company A would be wound up and deregistered, with its shares being cancelled. This would be considered a deemed disposal in terms of the provisions of the Eighth Schedule of the Act, and would give rise to a taxable capital gain in the hands of the shareholders of Mining Company A.

3.3.3 Tax implications of the hypothetical merger transaction with section 44 relief

As can be seen from the tax consequences above, there are several tax implications that would have arisen as a result of this merger transaction had the transaction not been subject to relief. Due to the typical nature of these intended merger transactions in that they often do not realise a true economic profit, section 44 neutralises the tax implications of the transactions, as shown in Figure 3.4.

Figure 3.4: Tax implications of the hypothetical merger transactions with section 44



The capital gain that would have been realised on the disposal of Mining Company A's assets to Mining Company B, in the absence of section 44, would be rolled-forward. Essentially, therefore, this capital gain will only become taxable upon subsequent sale of the assets to an unconnected party.

The excess mining capital expenditure recoupment will not be taxable at the time of the merger transaction, and Mining Company A's capital expenditure balances and allowance history will be transferred to the new Mining Company AB. The effect of this is that Mining Company AB will continue to apply the capital expenditure against taxable profit in terms of section 15(a) of the Act as if the assets and the balance of unredeemed capital expenditure was still owned by Mining Company A. Should Mining Company AB subsequently sell the assets, any possible excess recoupment will be calculated based on the capital expenditure history transferred from Mining Company A.

The distribution of the shares of Mining Company AB that were issued to Mining Company A as compensation for the disposal of the assets to the shareholders of Mining Company A will be free from Dividends Tax, in terms of section 44(9)(a).

The cancellation of the shares of Mining Company A, as part of the deregistration of the company, will not constitute a deemed disposal in the hands of the shareholders of Mining Company A.

3.3.4 Opportunities for avoidance with anti-avoidance provisions to combat opportunities in the context of the hypothetical merger transaction

The above relief combined with the capital expenditure allowance available to mining companies provides for certain opportunities to avoid tax in the absence of anti-avoidance provisions. Some of these opportunities, as well as the corresponding anti-avoidance provisions to combat these opportunities, are discussed in Table 3.1.

Table 3.1: Opportunities for avoidance with anti-avoidance provisions to combat opportunities in the context of the illustrative merger transaction

Opportunity for tax avoidance	Anti-avoidance provisions to combat opportunity
• Should Mining Company B have a large taxable income in respect of a particular year of assessment, without any balance	• To prevent companies from entering into merger transactions to use the balance of unredeemed capital expenditure of other

of unredeemed capital expenditure to use against the taxable income in terms of section 15(a) of the Act, it could enter into the merger transaction with Mining Company A if it has a large balance of unredeemed capital expenditure in terms of section 36(11) of the Act, as well as little or no taxable income. The result of this transaction will be that the new Mining Company AB will be able to access the balance of unredeemed capital expenditure of Mining Company A, and use it against its taxable income. This will directly lead to less tax being payable by Mining Company AB. Although Mining Company B can incur its own capital expenditure without having to merge with another mining company, the nature of mining capital expenditure is such that it is unlikely that the capital expenditure will have been incurred in time to be able to use it against taxable income in that year of assessment.	mining companies, section 36(7F) of the Act was introduced. The effect of this anti-avoidance provision on this type of attempted tax avoidance, would be to 'ring-fence' the balance of unredeemed capital expenditure of Mine A and Mine B of Mining Company A respectively, and to 'ring-fence' the capital expenditure to Mine C and Mine D of Mining Company B respectively. In other words, upon the two companies merging to form the new Mining Company AB, the balance of unredeemed capital expenditure of the mines of Mining Company A, will not be available to be used against the taxable income of the mines of Mining Company B.
• Mining Company A might be in a position in which it desires to dispose of mining assets, but will realise a taxable capital gain on such disposal. Mining Company B, on the other hand, might be in a position in which its asset disposals will realise a capital loss with no capital gains to use the loss against. Should Mining Company B not anticipate that there will be disposals of assets giving rise to taxable capital gains in the foreseeable future, the capital loss will remain	• In order to combat any attempts by taxpayers to avoid tax by shifting gains and losses by means of a merger transaction, the fiscus introduced the provisions of section 44(5). In terms of this anti-avoidance provision, should the new Mining Company AB decide to sell the assets acquired from Mining Company A within 18 months of the conclusion of the transaction, the gains or losses from the disposal of those assets will be 'ring-fenced' and will not be available to be

unproductive in the hands of Mining Company B. To enable both companies to benefit from a tax perspective, the companies might enter into a merger transaction to form the new Mining Company AB. The result of the merger transaction will be that Mining Company AB will have received the history of Mining Company A's mining assets, which will enable it to immediately sell the mining assets of both Mining Company A and B and to use the resultant capital gains and losses against each other. The shifting of the capital gains to the new Mining Company AB will, therefore, have resulted in Mining Company A directly paying less tax, while it would have allowed Mining Company B to use a loss that would otherwise have remained unproductive.	used against any other capital gains or losses realised on disposal of Mining Company B's assets. Effectively therefore, CGT will still be payable on any gains realised on disposal of Mining Company A's assets with any capital losses being realised on the disposal of Mining Company B's assets remaining unproductive until other capital gains are realised from future disposals of other assets of Mining Company B. Furthermore, any excess recoupment determined in terms of paragraph *j* to the definition of 'Gross Income' in section 1 of the Act, that was previously rolled forward will be included in income in the year of disposal of the assets.
• Should it have been the desire of the shareholders of Mining Company A to completely dispose of the company (rather than to merge for bona fide business reasons), they could have opted to enter into a merger transaction to obtain the benefits of the relief of section 44. In terms of this opportunity, Mining Company A could have disposed of all its assets to Mining Company B in terms of a merger transaction, but for a cash consideration. Subsequent to the completion of the sale, Mining Company A would declare a dividend to its shareholders in the amount of the proceeds received for the sale of its	• The combination of anti-avoidance provisions contained within both section 36 and section 44 of the Act will have the effect that attempts by the shareholders of Mining Company A to dispose of its assets by means of a merger transaction, in an attempt to avoid tax, will not be successful. The relief provided by section 44 will not be applicable to the merger transaction should cash have been used as consideration for the transaction, while the provisions of section 36(7E) and section 36(7F) will prevent Mining Company B from avoiding tax by using the balance of unredeemed capital expenditure of Mining Company A against

assets, and the company would be wound up and liquidated. The relief provided by section 44 would imply that Mining Company A would not be subject to income or CGT on any gains realised on the disposal of the assets to Mining Company B. On the other hand, Mining Company B would obtain the benefit of the history of the mining capital expenditure allowances of Mining Company A and would also be able to use the balance of unredeemed capital expenditure of Mining Company A against its own taxable income. In addition to this, section 44 would have the effect that the distribution of the cash dividend to the shareholders of Mining Company A would not be subject to dividends tax, nor would the shareholders be subject to CGT on a deemed disposal arising from the cancellation of Mining Company A's share capital upon winding up and deregistering. The overall effect of this is that both Mining Company A, Mining Company B and the shareholders of Mining Company AB would obtain direct benefits involving tax avoidance by means of the use of available legislation.	its taxable income. The result of the various anti-avoidance provisions on this attempt to avoid tax would be that Mining Company A would be subject to both income and CGT on the disposal of its assets to Mining Company B. Mining Company A would be required to withhold dividends tax from the distribution to its shareholders, of the proceeds of the sale of its assets. Furthermore, upon subsequent liquidation and deregistration of Mining Company A, the shareholders would be subject to CGT on the deemed disposal of the shares of Mining Company A. In addition to this, Mining Company B would not have acquired the history of Mining Company A's mining capital expenditure, but would be deemed to have acquired the assets in terms of section 37 of the Act. Mining Company B would also not be able to use this capital expenditure against the taxable income of either of its Mine C or Mine D, due to the provisions of section 36 (7F). From this, it is clear that the anti-avoidance provisions very effectively prevent what could have resulted in multiple points of tax avoidance as part of one transaction. Instead, the transaction becomes taxable many times more than would have been the case should the anti-avoidance provisions have not existed.

Table 3.1 serves the purpose of demonstrating some of the opportunities for avoidance that may arise as a result of the manipulation of the relief that may be provided by the Act, in the context of the hypothetical illustrative example of a merger transaction in the mining

industry in South Africa. The table further points out that the Act provides for anti-avoidance provisions to combat most of these possible opportunities for avoidance.

3.4 CONCLUSION

This chapter served to illustrate how a generic merger transaction in the mining industry in South Africa might give rise to a number of adverse tax implications without the benefit of any tax relief. The chapter then went on to explain how the Act provides needed relief to the transactions in order to prevent a situation where they might be taxed unfairly. The analysis of the hypothetical illustrative example of a transaction then proceeded to demonstrate the principle that relief provisions are the subject of abuse by taxpayers by identifying a number of opportunities for avoidance that arise as a result of misuse of the relief provisions. Finally, the hypothetical illustrative example of a merger transaction provided an analysis of the anti-avoidance provisions that may have been applicable to combat the attempts to misuse the relief to obtain an undue tax benefit.

Thus, this chapter shows that there is, in certain cases, a cycle to tax avoidance. In simplified terms, the fiscus would, firstly, introduce tax relief due to an economic need for relief. Taxpayers may then make use of opportunities to use the relief for purposes that may be against the spirit of the law, although it may still be within the limits of the law. The fiscus would become aware of this avoidance, and would then either apply existing anti-avoidance provisions to combat the avoidance, or would introduce new provisions to protect its tax base.

CHAPTER 4

INTERNATIONAL CONSIDERATIONS

4.1 INTRODUCTION

The issue of tax avoidance in the context of merger transactions is not unique to South Africa. Many jurisdictions also provide tax relief in the case of a merger transaction, and as is the case of South Africa, this relief has been subject to abuse.

In order to provide additional insight into the matter of anti-avoidance in the context of merger transactions, relevant court cases from the following jurisdictions were analysed:

- Australia
- Canada

The above two jurisdictions were selected for analysis due to their relative relevance to this study. As in the case of South Africa, Australia also has a strong mining sector with this sector contributing 8.4% to the Australian Gross Domestic Product during 2009 -2010 (Australian Bureau of Statistics, 2012:2).Canada has relevance to this study due to the relative similarity in the roll-over relief provided in terms of section 87 of the Canadian Income Tax Act of 1985 (Canada. Department of Justice, 1985) (hereinafter known as the Canadian Act), to the roll-over relief provided under South African law. Furthermore, the roll-over relief provided for under Australian law is also relevant in demonstrating the principles in respect of anti-avoidance measures in relation to merger transactions.

The analysis of the court cases are intended to provide diverse examples of real-life instances of avoidance and anti-avoidance in the international context, and to demonstrate the diverse nature of both avoidance and anti-avoidance in relation to merger transactions.

4.2 AUSTRALIA: BRITISH AMERICAN TOBACCO AUSTRALIA SERVICES LTD V FEDERAL COMMISSIONER OF TAXATION (2009) 77 ATR 518

The case of British American Tobacco Australia Services Ltd versus the Federal Commissioner of Taxation (2009) 77 ATR 518(Federal Court of Australia, 2009) involves a global merger in which British American Tobacco Australia Services Limited (hereinafter known as 'BAT') claimed CGT roll-over relief in terms of Australian tax legislation. The Australian Federal Commissioner of Taxation took issue with the claiming of the roll-over relief, on the basis that it deemed the transaction to be one entered into in an attempt to avoid tax.

The court case has been summarised in a diagrammatic representation as shown in Figure 4.1 (pre-merger) and Figure 4.2 (post-merger).

Figure 4.1: Diagrammatic representation of the facts of British American Tobacco Australia Services Ltd v Federal Commissioner of Taxation 77 ATR 518 – Pre-merger

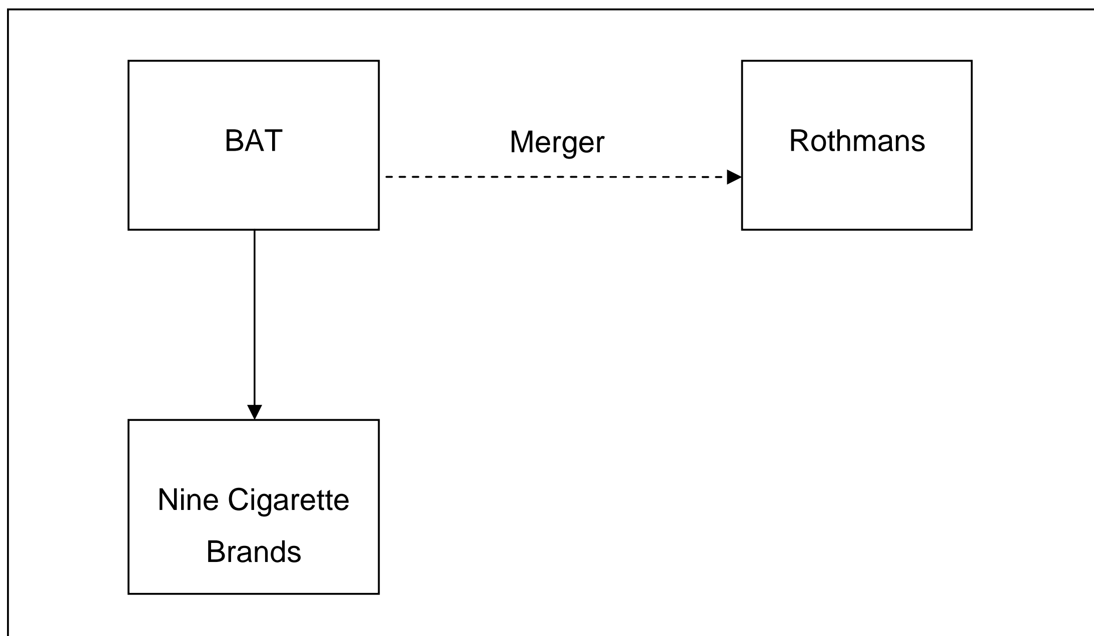
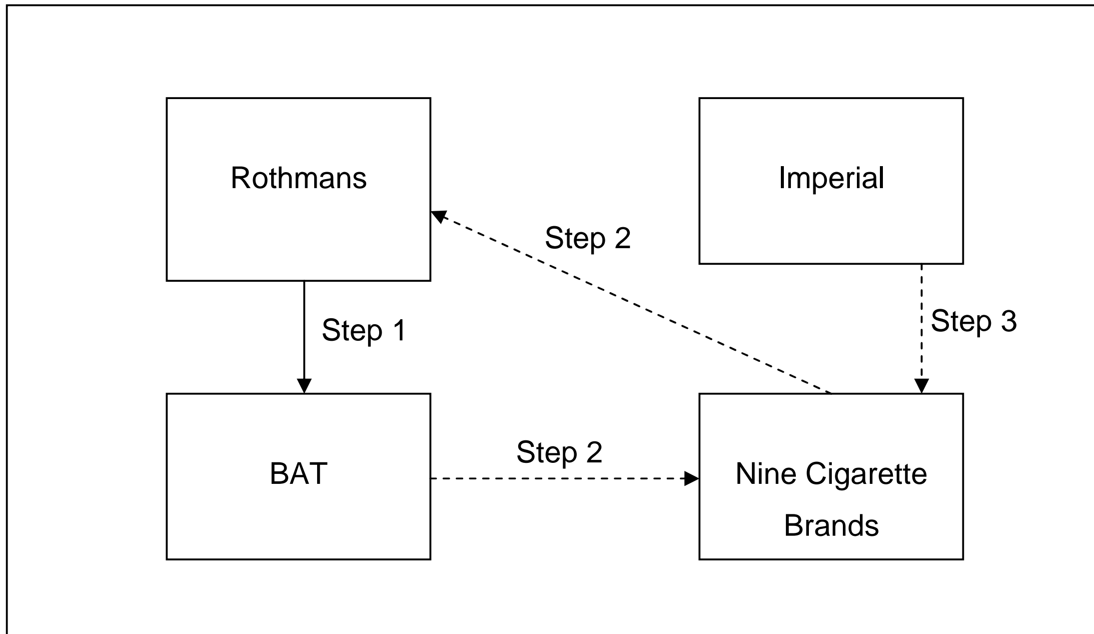


Figure 4.2: Diagrammatic representation of the facts of British American Tobacco Australia Services Ltd v Federal Commissioner of Taxation 77 ATR 518 – Post-merger



As can be seen in Figure 4.1, the transaction that was the subject of the court case involved BAT merging with Rothmans Holdings (hereinafter known as 'Rothmans'). Prior to the merger transaction BAT was the owner of nine cigarette brands. As shown in brief and simplified terms in Figure 4.2, the merger transaction involved the following steps which are relevant to this study:

- **Step 1**: BAT and Rothmans entered into a transaction according to which the two entities merged. It was decided that Rothmans, in its position as the larger entity in the Australian jurisdiction, would take the lead in the transaction and would, therefore, acquire BAT as part of the transaction. The nine cigarette brands which are owned by BAT remain the property of BAT in its post-merger state. It should be mentioned that the court case refers to both BAT and Rothmans after the merger as transacting entities, indicating that BAT did not cease to exist, as would have been the case in most merger transactions. Thus, the transaction seems to have characteristics of an acquisition, but remains relevant for the purposes of this discussion.

- **Step 2**: BAT sells the nine cigarette brands to Rothmans for a consideration of AUD $181.7 million.
- **Step 3**: Rothmans sells the nine brands to Imperial Tobacco (hereinafter known as 'Imperial') for a consideration of AUD $181.7 million.

At this point, it should be mentioned that the sale of the nine cigarette brands took place as a solution to the requirements of the Australian Competition and Consumer Commission (hereinafter known as 'the ACCC'). The ACCC believed that the transaction would lessen competition and, therefore, required that the merged entity divest of some of its brands.

The above transaction steps would have given rise to a number of tax implications had there not been any tax relief available in terms of the Income Tax Assessment Act of 1997 in Australia(hereinafter known as the 'ITAA'). In particular, Part 3 of the ITAA would have resulted in CGT being payable as follows:

- Upon the merger of BAT with Rothmans, CGT would be triggered by the disposal of BAT to Rothmans.
- Upon the sale of the nine cigarette brands from BAT to Rothmans, CGT would be incurred by the disposal of the brands.
- Upon the subsequent sale of the nine cigarette brands by Rothmans to Imperial, the disposal of the brands would again result in CGT being payable.

According to the *Mergers and Acquisitions guide*(Australian Taxation Office 2012:15), the ITAA provides CGT roll-over relief in the instance of a merger or acquisition related transaction in terms of the following provisions:

- Subdivision 122-A and subdivision 122-B provides for roll-over relief upon the transfer of assets by individuals or partners to a company respectively. This will typically arise when a sole proprietor or a partnership wishes to transfer their business to a separate legal entity in the form of a company. In terms of this roll-over relief, any capital gains incurred upon such transfer (and subject to the requirements of the respective provisions) will be disregarded until such time as it is disposed of by the company.

- Section 124-G provides for roll-over relief upon disposal of shares in one company in exchange for shares in another company. This typically takes place in the case of a restructure within a group. Any capital gain realised (subject to the requirements of the provision) will be disregarded until the shares are sold subsequent to the restructure.
- Subdivision 124-M provides for relief known as scrip-for-scrip roll-over relief. This relief is typically elected in the case of a merger or an acquisition, and involves the disregarding of a capital gain realised when a shareholder’s shares are exchanged for shares in another company. This relief is only available when the replacement shares are in fact shares in the company which acquires or merges with the company of which the shares are being replaced, and if the acquiring company owns at least 80% of the shares of the merging or acquired company after the transaction.
- Section 126-B provides for roll-over relief in the case of assets being transferred within the same group of wholly owned companies. The rolled over capital gain will only realise once the assets are disposed of outside the group.

The court case, which is the subject of this discussion, did not specify the relief obtained in respect of step 1 (i.e. the acquisition of BAT by Rothmans as part of the merger).However, the fact that the court case, as shown in Figure 4.2, reflects the situation at both BAT and Rothmans and to transactions between them after the merger, indicates that Rothmans purchased BAT from its shareholders. This would suggest that the roll-over relief in terms of section 124-M of the ITAA would have been used, whereby the shareholders of BAT would have become shareholders of Rothmans. Therefore, any capital gain on the disposal of the shares to Rothmans would have been disregarded.

Subsequent to the acquisition of BAT by Rothmans, BAT elected to make use of the roll-over relief for which provision is provided in section 126-B of the ITAA in respect of step 2 above. Therefore, when it disposed of the nine cigarette brands to Rothmans, the capital gain on these were disregarded, as it was a transfer within the same wholly-owned group.

Rothmans subsequently disposed of the nine cigarette brands to Imperial. While a capital gain was realised at this point, Rothmans had capital losses available which it used to offset against the capital gains realised.

The result of this was that BAT was able to avoid any tax liability in its sale of the nine brands, while Rothmans also managed to escape liability by using its available capital losses.

The Australian Commissioner of Taxes considered the structuring of the transaction, in particular the sale of the nine brands after the merger, to have constituted a scheme to create a tax benefit and, therefore, disallowed the tax treatment sought by the taxpayer. The fact that the nine cigarette brands were only disposed of after the merger, and then accomplished via Rothmans to Imperial, created a direct tax saving for BAT. Had BAT sold the nine cigarette brands prior to the merger, or had BAT sold the nine brands after the merger but directly to Imperial, a CGT liability would have been incurred.

The provisions that the Australian Commissioner of Taxes used to disallow the roll-over relief claimed by BAT, was to use the Australian General Anti Avoidance Rules (hereinafter known as 'the AGAAR') contained in Part IVA of the Income Tax Assessment Act of 1936. BAT attempted to defend its treatment by relying on, amongst others, the fact that the ACCC had made the approval of the transaction subject to the divestment of the nine brands and that the requirements for the applicability of the AGAAR to the case were not met. However, the court ruled against BAT, and found that there was no reason why the nine brands could not have been disposed of prior to the merger deal, and that the timing of the transaction steps and, indeed, the arrangement of the transaction steps was done in such a manner as to obtain a direct tax benefit. The effect of the ruling was that BAT was liable for an additional tax charge of some AUD 118 million as well as additional taxes and penalties. The ruling went on appeal in 2010 in the case of British American Tobacco Australia Services Limited versus the Commissioner of Taxes [2010] FCAFC 130 (Federal Court of Australia (Full Court) 2010) in which the court again ruled against the taxpayer.

This court case which is the subject of this study demonstrates another example of how taxpayers have attempted to misuse the relief provided by taxation authorities in order to gain significant tax benefits. Although the arrangement was made within the confines of the law, it was not in the spirit of the relief provided by the law and is a good example of tax avoidance. It is also clear that taxation authorities are not unaware of these schemes, and that they will act to counter them. The court case also highlights the fact that the

matter of anti-avoidance in the context of mergers or corporate transactions (and, in fact, tax in general) is not unique to South Africa or any other particular jurisdiction, but is a problem for tax authorities around the world.

Although the Australian Commissioner of Taxes did not use a specific anti-avoidance provision contained in the relief provisions in this particular court case, the use of the AGAAR still very effectively countered the avoidance. Similarly, in South Africa, the use of the GAAR provided for in Part IIA of the Income Tax Act (58/1962) should be able to counter such an attempt at avoidance, because the GAAR in the Act also aims at combating any scheme or arrangement that is aimed at obtaining a tax benefit or at avoiding tax.

4.3 CANADA: COPTHORNE HOLDINGS LTD V CANADA, 2011 SCC 63, [2011] 3 S.C.R. 721

In the case of Copthorne Holdings Ltd versus Canada, 2011 SCC 63, [2011] 3 S.C.R. 721 (Supreme Court of Canada, 2011) two companies (referred to in the reported case as Copthorne I and VHHC Holdings Ltd respectively) were initially part of the same group of companies and were parent and subsidiary in relation to each other respectively. In terms of a restructure, the structure of the group changed so that the two companies were no longer parent and subsidiary in relation to each other, but rather sister companies. Thus, both companies were owned by the same non-Canadian resident shareholder.

According to the reported case transcript, in a situation where two companies which are parent and subsidiary in relation to each other merge, it is customary for the paid-up capital (hereinafter known as ‘PUC’) of the subsidiary company to be cancelled. However, in an instance where two companies which are fellow subsidiaries merge, it is customary for the PUC of the two companies to be combined.

In the current instance, the Copthorne I and VHHC Holdings Ltd, in their capacity as two sister companies (together with additional companies in the group), were amalgamated subsequent to being reorganised within their group structure. The approach was to

combine the PUC of the two companies rather than to cancel the PUC of VHHC Holdings Ltd.

The amalgamated company then proceeded to redeem a large number of its shares, with a payment in respect of the redeemed shares being made to the non-resident shareholder. The payment to the non-resident shareholder was not treated as taxable income by the non-resident shareholder, but rather as a return of capital.

According to the reported case transcript, there was no provision in Canadian law to bring this payment in respect of the redeemed shares into the tax net. Therefore, the result of this transaction would have been that the shareholder could have effectively disposed of the redeemed shares, but this disposal would be done completely free of tax.

The tax saving in question was achieved by firstly restructuring the group so that the two companies could become sister companies resulting in a horizontal amalgamation with a combination of their respective PUCs. Had the companies remained in a parent and subsidiary relationship, the PUC of VHHC Holdings Ltd (CAD $67 401 280) would have been cancelled as a result of the merger. The cancellation of the PUC would have given rise to a deemed dividend. The amount of the deemed dividend would have been calculated as the difference between the payment to the non-resident shareholder and the PUC amounting to CAD $67 401 280.However, the manner in which the transaction was arranged resulted in a share redemption rather than a share cancellation, with the share redemption being non-taxable.

Regardless of the fact that the return of capital would normally not be subject to tax under Canadian law, the Canadian tax authorities considered the transaction to have fallen foul of the Canadian General Anti-Avoidance Rule (hereinafter known as 'the CGAAR') provided for in terms of section 245 of the Canadian Act. The Canadian tax authorities, therefore, assessed the amalgamated corporation on the amount of withholding tax on the deemed dividend which it considered to have been due.

The taxpayer (being the amalgamated corporation) appealed against this assessment in both the Canadian Tax Court and the Australian Federal Court of Appeal, with both courts

upholding the assessments and dismissing the appeals. The taxpayer subsequently appealed against the assessment in the Canadian Supreme Court.

According to the reported case, the Canadian tax authorities were of the opinion that the application of the CGAAR to the transaction would have resulted in section 87(3) of the Canadian Act being applicable.

According to the *Income Tax Interpretation Bulletin IT-474R2* (Canada Revenue Agency, 2008:2), section 87 of the Canadian Act deals with qualifying amalgamation transactions, and in very simplified terms provides that a new amalgamated company that was formed as the result of the amalgamation of two or more Canadian taxpaying companies shall be a continuation of the previously unmerged companies. Thus, section 87 of the Canadian Act is a roll-over provision which provides both relief and guidance on future tax treatments for amalgamated companies.

Section 87 of the Canadian Act contains a number of anti-avoidance provisions. While it is beyond the scope of this study to investigate these, they are relevant in the context of the court case which is the subject of this discussion. In this regard, Learned Judge Rothstein stated that section 87(3) of the Canadian Income Tax 'ensures that the PUC of the shares of an amalgamated corporation shall not exceed the PUC of the shares of the amalgamating corporations.' He also stated that 'section 87(3) provides that the PUC of the shares of the amalgamated corporation will be reduced if it exceeds the PUC of the shares of the amalgamating corporations.'

Effectively, this implies that where two companies merge (in a horizontal merger), the combined PUC of the new amalgamated company may not exceed the PUC of the two previously unmerged companies. The limitation of the PUC of the new amalgamated entity should prevent an inflated PUC in the new company which may provide an undue benefit to the respective shareholders. In the words of Judge Rothstein in the court case under discussion:

> Since PUC may be withdrawn from a corporation without inclusion in the income of the shareholder, it seems evident that the intent is that PUC be

> limited such that it is not inappropriately increased merely through the device of an amalgamation.

Judge Rothstein, however, pointed out that section 87(3) has a more important effect in that it will cause the PUC of the shares of amalgamating companies to be aggregated, unless those shares were held by another amalgamating company. Therefore, in the instance of a parent and subsidiary amalgamating the shares held by the parent company will be cancelled rather than aggregated.

Therefore should Copthorne I and VHHC Holdings Ltd had been parent and subsidiary in relation to each other respectively, the PUC of VHHC Holdings Ltd would have been cancelled. Such a cancellation may give rise to a deemed dividend subject to withholding tax under the Canadian Act. Therefore, by firstly restructuring so that Copthorne I and VHHC Holdings Ltd became fellow subsidiaries, the PUC of VHHC Holdings Ltd was preserved by means of being combined with the PUC of Copthorne I upon amalgamation. Thus, the newly merged company was able to redeem the shares as a return of capital that was free of tax.

The above is confirmed by the words of Judge Rothstein:

> Again, having regard to the fact that PUC may be withdrawn from a corporation not as a dividend subject to tax but as a non-taxable return of capital, the indication is that the parenthetical clause is intended to limit PUC of the shares of the amalgamated corporation to the PUC of the shares of the amalgamating parent corporation. While the creation of PUC in the shares of downstream corporations is valid, its preservation on amalgamation may be seen as a means of enabling the withdrawal of funds in excess of the capital invested as a return of capital rather than as a deemed dividend to the shareholder subject to tax.

The application of the CGAAR in section 245 of the Canadian Act led to the Canadian tax authorities applying section 87(3) to a transaction that would otherwise not have been subject to the same ruling. The CGAAR, as in the case of the

respective provisions in the South African and Australian GAAR, target schemes that are aimed at obtaining a tax benefit. In this regard, Judge Rothstein states that:

> According to s. 245(3) of the Act, a transaction will be an avoidance transaction if it results in a tax benefit, and is not undertaken primarily for a *bona fide* non-tax purpose. An avoidance transaction may operate alone to produce a tax benefit, or may operate as part of a series of transactions which produces a tax benefit.

In this case, the court found that the manner in which the transaction (or series of transactions) was structured was done in such a way as to obtain a tax benefit that was not in the spirit of the Canadian Act. Taking into account the provisions of the CGAAR, the court found that the provisions of section 87(3) of the Canadian Act should be applied to the transaction, and as such, the court confirmed the taxing of the deemed dividend by the Canadian tax authorities. The appeal was dismissed.

This case provides another example of how taxpayers have used mergers and corporate transactions and the structuring thereof to avoid tax. Once again, it has become clear that this is an occurrence that takes place in various ways all over the world, but that it has a universally common theme. Furthermore, the court case demonstrates how the responsive provisions of the various tax laws of jurisdictions around the world prevent tax avoidance. In this particular case, it was a combination of both specific and general anti-avoidance rules that resulted in the prevention of avoidance. Although South Africa does not have identical provisions regarding the cancellation of shares versus the non-cancellation of shares upon amalgamation, the Income Tax Act (58/1962) does have GAAR provisions that should enable such a transaction to be identified so that the transaction can be analysed and dealt with accordingly.

4.4 CONCLUSION

This chapter provided an insight into the issues of anti-avoidance in the international arena. The two court cases that were analysed show how taxpayers use diverse

means in their attempts to avoid paying tax. They also show how tax authorities use diverse means in their attempts to prevent the avoidance. A study of the judgements made in these court cases revealed that there are various provisions in different jurisdictions that provide relief in respect of corporate transactions and merger transactions, but that these different jurisdictions were effectively able to prevent the abuse of those provisions to obtain an undue tax benefit. In the same way, the South African tax law is able to prevent tax avoidance, whether it is by means of the GAAR or by means of the more specific anti-avoidance provisions contained in the Act.

CHAPTER 5

CONCLUSION

5.1 INTRODUCTION

This chapter concludes the study, summarises the findings and explains how answers to the research problem and the objectives of the study were achieved. The chapter indicates how the nature of tax avoidance and anti-avoidance measures in the context of mergers in the mining industry in South Africa was analysed, and how tax avoidance and anti-avoidance measures impacts on these transactions. Finally, this chapter makes recommendations for future studies related to this topic.

5.2 SUMMARY OF FINDINGS AND ANSWER TO RESEARCH OBJECTIVES

The purpose of this study was to investigate the relevance and impact of anti-avoidance legislation on mergers in the mining industry in South Africa. To achieve the main purpose of the study, a review of the literature was conducted to research the background to tax avoidance and anti-avoidance, as well as provide a background to corporate transactions, including mergers. The literature review included an examination of the ethical considerations related to tax avoidance, and a table summarising the types of corporate transactions, how they function and the rationale for entering into the respective transactions.

A review of the literature relating to mining taxation was also done in order to provide the necessary background to tax avoidance which could arise as a result of the provisions relating to the taxation of mining companies. The focus in respect of mining taxation was on the mining capital expenditure allowances provided for in section 15(a) of the Income Tax Act (58/1962) (hereinafter known as ‘the Act’)and section 36(11) of the Act. Regarding anti-avoidance in relation to the mining industry, the focus was on the ring-fences provided for by section 36(7E) and section 36(7F) of the Act.

The study then aimed to research more specifically the tax legislation which is relevant to mergers in the mining industry in South Africa, and this included both the provisions which are the subject of avoidance as well as the anti-avoidance provisions which are designed to prevent such avoidance. In this regard, the focus was on section 44 of the Act, which specifically provides for roll-over relief in the case of a qualifying merger transaction. The relief provided by section 44 was discussed in detail, but the ways in which this section might be abused to avoid tax, together with the anti-avoidance provisions of section 44 to combat such attempts at tax avoidance, was also explained. It was shown that the relief intended by section 44 might be abused by taxpayers, but it was also shown that anti-avoidance provisions in the Act are effective in preventing this abuse.

Hereafter, a hypothetical illustrative example of a merger transaction was presented and analysed in order to synthesize the researched principles and demonstrate how tax avoidance and anti-avoidance interact in a practical scenario. The analysis of the illustrative example included a consideration of tax implications without any tax relief provided by the Act as well as an analysis of the relief provided by the Act, followed by a consideration of opportunities for avoidance that might arise from these relief provisions. The relevant anti-avoidance provisions that could prevent these attempts at tax avoidance were also considered. The analysis of the illustrative example demonstrated in theoretical yet practical terms, how the principles identified in the extended literature review may be applied in a physical transaction. The analysis illustrated the necessity for tax relief in a merger transaction in the mining industry since the transaction could give rise to unfair and burdensome tax implications without relief. Thus, whereas the illustrative example went on to discuss the relief that is applied by the Act, the analysis found that a simple merger transaction in the mining industry would present a number of opportunities for tax avoidance. These opportunities arose from section 44 on the one hand, and the mining capital expenditure allowances on the other hand, as well as from a combination of both section 44 and the mining capital expenditure allowances. The analysis demonstrated conclusively how the anti-avoidance provisions in the Act were well able to prevent these identified opportunities.

Finally, two international court cases were analysed. These cases dealt with attempts by taxpayers to avoid tax in the context of merger transactions, and the courts had to make decisions in this regard. The inclusion of the international court cases emphasised the

relevance of tax avoidance issues in the context of merger transactions, and, indeed, corporate transactions in general, and provided additional insight into the topic. The analysis of the two international court cases (one held in Australia and one held in Canada) showed that tax avoidance and anti-avoidance measures is a common theme throughout the world. Although the relief provisions of the respective jurisdictions are diverse, the tax avoidance schemes revealed in the respective court cases were equally diverse. In every case, anti-avoidance legislation succeeded in preventing what could have been an unjust tax advantage.

5.3 CONCLUSIONS

The researcher was able to answer the main research problem as to whether anti-avoidance legislation has an impact on merger transactions in the mining industry in South Africa. The study found that the nature of merger transactions are such that they do not result in economic gain and, therefore, these transactions would be unfairly taxed should there not be any relief available.

The study then went on to discuss the tax relief which is provided by legislation and how this relief results in opportunities for tax avoidance which, in turn, results in a need for anti-avoidance provisions to restrict these opportunities. Thus, the study pointed out that tax relief, tax avoidance and anti-avoidance measures are all related in that the one tends to lead to the other. Therefore, anti-avoidance legislation clearly has an impact on merger transactions in the mining industry in South Africa.

The effect was demonstrated by means of a detailed discussion of the tax relief applicable, and by the use of an illustrative example to show how taxpayers can use merger transactions to obtain undue benefits in the absence of anti-avoidance provisions. Furthermore, the discussion of the anti-avoidance provisions and the hypothetical illustrative example showed that the potential abuse of relief has resulted in anti-avoidance provisions which require a very specific structuring of a merger transaction in order to obtain the intended tax relief.

Finally, the study highlighted the impact of anti-avoidance on merger transactions by analysing two international court cases. The analysis demonstrated that taxpayers in any jurisdiction actively alter the structuring of their transactions to obtain a tax benefit, and that the tax authorities act by using anti-avoidance legislation to bring these transactions back within the confines of the spirit of the tax law.

The study has, therefore, shown that anti-avoidance does have an impact on merger transactions, both within and outside the mining industry. As long as there are relief provisions in a tax Act, taxpayers will attempt to minimise their tax liability, and the tax authorities will continue to act to prevent these attempts.

5.4 RECOMMENDATIONS AND FUTURE RESEARCH

The following recommendations and future opportunities for research related to this topic have been identified:

- In order to conduct a further analysis of the impact of tax avoidance and anti-avoidance on the mining industry in South Africa, a study investigating a number of detailed real-life case studies in the mining industry in South Africa should be conducted. This will enable researchers to take into account the opinions and considerations of role players in the industry and it might shed more light on the reasons for taxpayers' attempts to structure their transactions to obtain a tax benefit. It will also indicate to what extent taxpayers have been successful in this regard and will provide a more accurate view of the prevalence and importance of transaction structuring to lessen tax liabilities in the mining industry in South Africa.
- A comparative study should be conducted on both the mining tax allowances and the merger tax relief applicable to South Africa and another jurisdiction. This should include both a South African and an international real-life case study. This will identify in more detail the ways in which the issues of avoidance and tax-avoidance are dealt with in differing jurisdictions and will identify the diverse manner in which transactions are structured around the world and the importance of obtaining a tax benefit for taxpayers when the structure of a transaction is determined.

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