



Evaluation of the need to introduce a system of group taxation in South Africa

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In a group structure, individual companies comprising a group are effectively managed as a single 'economic unit'. The economic unit concept refers to a group of companies that are collectively integrated on a financial, an organisational or an economic basis by virtue of common control, so that they are working towards a common purpose or goal. The South African income tax dispensation currently makes no provision for group taxation. Each legal entity within a group is taxed as a separate taxpayer. This study aims to evaluate whether there is a need for a system of group taxation in South Africa. In order to do so, the definition of a group was considered, the different tax treatment of divisions as opposed to a group structure were investigated, the current income tax dispensation for inter-group transactions was analysed, and anomalies arising from that were highlighted. The recommendations of the Katz Commission in its Third Interim Report, which addressed the issue of group taxation, were also examined to determine whether the report supports the implementation of a system of group taxation in South Africa. The impact of a system of group taxation for meeting the requirements of the canons of taxation, as well as the implications for the fiscus and the taxpayer, were also examined. The analyses and the conclusions clearly show that the status quo with regard to the inherent tax anomalies arising from the taxation of intra-group transactions is unsustainable, and that a system of group taxation should be implemented in South Africa.

Introduction and problem statement

According to the Katz Commission (South Africa 1995: 96), in a group structure, the individual companies comprising a group are effectively managed as a single 'economic unit'. The economic unit concept refers to a group of companies that are collectively integrated on a financial, an organisational or an economic basis by virtue of common control, so that they can be said to be working towards a common purpose or goal (Howitt 1992: 2). A group of companies is managed (including the strategic and financial decision-making) in the interests of the group as a whole (South Africa 1995: 96). Currently, the South African income tax dispensation makes no provision for a system of group taxation (Kannenberg 1999: 1). Each legal entity within a group is taxed as a separate taxpayer, in terms of section 5(1)(d) of the Income Tax Act (Act 58 of 1962).

The introduction of the Corporate Rules as Part III of the Income Tax Act by the Second Revenue Laws Amendment Act (Act 60 of 2001), promulgated on 12 December 2001, provided some relief in respect of transactions between group companies and between founding shareholders and their

company (Huxham & Haupt 2004: 254). These measures are generally based on the view that where the group has retained a substantial interest in the assets that are transferred, it is appropriate to permit a tax-free transfer of assets to the entity in the group where they can be most efficiently used for business purposes (Department of Finance 2001: 6). These Corporate Rules provide some relief with regard to asset and share transactions for group companies, and they might be the first step in the direction of a group tax system, but no relief is provided for other important day-to-day transactions, such as timing mismatches in transactions between group companies.

When a single economic unit is treated as several separate tax entities, this encourages some manipulation of the taxable income of the various entities within the group, by means of profit shifting, in order to reflect the economic reality of the group's results. This also encourages groups to enter into elaborate tax schemes that either defer taxable income, or

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accelerate tax deductions, or change the tax base of the underlying asset in order for the group to obtain an overall tax benefit. A system of group taxation should act as a deterrent to such manipulation and schemes, as it disregards all intra-group transactions for tax purposes and eliminates tax anomalies that arise from intra-group transactions. Management is therefore less likely to be influenced by the tax effects of intra-group transactions, and more likely to concentrate on promoting growth in economic activity, thereby increasing the general tax base (South Africa 1995: 97; Middelman 2003: 3).

It is clear that merely by changing the legal form of a business operation, without altering its economic substance, very different tax effects can be achieved. According to the Margo Commission (South Africa 1986: 199), divisionalisation is not always ideal because of issues such as the advantage of limited liability, compliance with certain regulated industry requirements, and certain rights and licences that are exclusive to a particular entity. Hence, separate legal entities will continue to exist, and group structures will continue to be present in our economy. A taxation system that taxes a group of companies as an economic unit is therefore essential for an equitable and sound system of taxation.

Group taxation is a system of taxation whereby a group of companies is effectively taxed as a single economic unit and the tax liability is met by a representative member. There are two principal systems of group taxation (South Africa 1995: 98):

- The loss transfer regime allows for a tax loss incurred by one company within a group to be set off against the income derived by another company, or other companies, within the same group. Each company in the group retains its own personality.
- The consolidation regime treats a group of companies as a single taxpayer. It effectively neutralises the tax effect of intra-group transactions, much like the consolidation process for accounting.

A system of group taxation for South Africa has been considered on various occasions. In 1986, the Margo Commission (South Africa 1986) investigated the issue and recommended that a system of group taxation should not be implemented in South Africa. The reasons advanced for not implementing such a system of taxation included loss of significant revenue to the state, the fact that minority shareholders could be prejudiced, as well

as the complexity of the system and an increased administrative burden (South Africa 1986: 200–201). However, the majority of the bodies and corporations that made written representations to the Margo Commission argued strongly in favour of group taxation (South Africa 1986: 199).

The matter was subsequently investigated by the Katz Commission, which expressed the following opinion: “The Commission is mindful of the view amongst some that the issue of group taxation is not a priority. It disagrees with this view, and regards the current position as a structural defect in the system that cannot be passed over in any serious tax reform process” (South Africa 1995: 96).

The South African Chamber of Business (SACOB) fully supported this recommendation by the Katz Commission. SACOB acknowledged that the costs related to and the complexities of introducing a system of group taxation could not be ignored, but argued that these problems could be overcome. SACOB also stated that it believed that the benefits of adopting a system of group taxation significantly outweigh the disadvantages. The adoption of such a system would achieve greater fiscal control, minimise some of the economic distortions that currently exist at a corporate level, facilitate the corporate unbundling process and bring South Africa into step with the tax treatment of companies in industrialised countries (SACOB 1996: 4–5).

Although the proposal was accepted in principle by the South African Revenue Service, the decision to introduce a system of group taxation was held in abeyance until the new South African Revenue Service was fully operational (South Africa 1996: 2–25).

Research objective and methodology

The objective of this study is to evaluate the need to introduce a system of group taxation in South Africa. In order to achieve this objective, the following process was followed:

- The definition of a group was analysed.
- The anomalies arising from the different tax treatment of divisions as opposed to a group structure were investigated.
- The current income tax dispensation for inter-group transactions was analysed, and anomalies arising from that were highlighted.
- The recommendations made by the Katz Commission in its Third Interim Report, presented in

December 1995, which addressed the issue of group taxation, were examined to determine whether the Commission supports the implementation of a system of group taxation in South Africa.

- The effect of a system of group taxation in satisfying the requirements of the canons of taxation was examined.
- The impact of the implementation of a system of group taxation on the fiscus and the taxpayer was examined.

The study consisted of a review of relevant literature. The literature that was consulted included tax legislation, textbooks, studies undertaken by local and overseas research institutions and the respective commissions, articles published in legal and business journals and relevant court cases. The information was summarised, documented, evaluated and, where appropriate, examples were included to convey the issues clearly.

This study addresses group taxation only at a conceptual level. The focus is on broad principles and issues, rather than detailed design and implementation. The study does not include an in-depth analysis of the administrative issues that may also need to be considered in a further study. The study is limited to income tax in terms of the Income Tax Act (Act 58 of 1962), including legislation promulgated up to 31 December 2003 (Revenue Laws Amendment Act, Act 45 of 2003). A detailed discussion of the Corporate Rules (sections 41 to 47 of the Act), which were recently introduced into South African income tax legislation, falls outside the scope of this study. Donations tax (sections 54 to 64 of the Act) is also not referred to in this study, as donations made by a company to any other company that is a member of the same group of companies are exempt from donations tax (section 56(1)(r) of the Act). Secondary tax on companies (STC) (sections 64B and 64C) is also not covered in detail, as a company can elect that dividends declared by the company to a shareholder (a resident company) that forms part of the same group of companies be exempt from the payment of STC. The dividend should, moreover, be paid out of profits earned during the period when the shareholder formed part of the group (section 64B(f) of the Act).

The study deals only with groups of companies that are all registered, managed and controlled in South Africa. Aspects relating to transfer pricing and thin capitalisation (section 31 of the Act), as well as other aspects of international tax, have been

ignored. The study does not include indirect taxes (such as value added tax, regional services levies, transfer duty and stamp duty).

Defining a group

Previously, a group of companies was defined in the Companies Act (Act 61 of 1973) as consisting of a holding company (which was not itself a wholly owned subsidiary) and its subsidiaries (paragraph 4(q) of Schedule 4 of the Companies Act of 1973). A company is a subsidiary company of another company in terms of the Companies Act (section 1(3)), if

- that company is a member of it and holds a majority of the voting rights; or
- it has the right to appoint or remove directors that hold the majority of the voting rights (at meetings of the board); or
- it has the sole control of a majority of the voting rights in it, in terms of an agreement with other members or otherwise.

With the introduction of the Corporate Rules (sections 41 to 47 of the Income Tax Act), the following definition of a 'group of companies' was also incorporated into section 1 of the Income Tax Act:

'group of companies' means two or more companies in which one company (hereinafter referred to as the **'controlling group company'**) directly or indirectly holds shares in at least one other company (hereinafter referred to as the **'controlled group company'**), to the extent that —

- (a) At least 75 per cent of the equity shares of each controlled group company are directly held by the controlling group company, one or more other controlled group companies or any combination thereof; and
- (b) The controlling group company directly holds 75 per cent or more of the equity shares in at least one controlled group company

The definition of a 'group of companies' in the Companies Act differs substantially from that in the Income Tax Act. According to the Companies Act (paragraph 4(q) of Schedule 4), a company is a member of a group if the holding company holds the majority (more than 50%) of voting rights, but in

terms of the Income Tax Act (section 1), a company is a member of a group if 75% of the equity share capital is held by the controlling group company. The Companies Act recognises control in terms of voting rights, while the Income Tax Act focuses on control in terms of shareholding. The definition set out in the Income Tax Act is the one preferred for the purposes of this study.

The Katz Commission (South Africa 1995: 101–102) stated in its report that, in order to qualify for group relief provisions, a group should comprise a holding company and all its wholly owned subsidiaries (limited to South African companies, but excluding close corporations, because the company law requirements are stricter for companies). The test for whether a company is wholly owned is determined with reference to interests, direct or indirect, in the equity share capital of the companies concerned. Equity shares (to a maximum of 10% of the total equity share capital of the company) held by full-time employees (including executive directors) in terms of a share incentive scheme should be taken into account for the wholly owned test. However, the Katz Commission (South Africa 1995) also stated that once a consolidation system has been successfully implemented, the ownership requirement could possibly be reduced to, say, 75% of the equity share capital. The main reason for the proposal that only wholly owned groups qualify for group tax relief is reduced cost and complexity (South Africa 1995: 100).

The essence of all these definitions of a holding company and its subsidiaries is therefore one of control (whether in terms of voting rights or shareholding). According to Cilliers, Benade, Henning, Du Plessis & Delport (1992: 432), the basic characteristic of a group is that the management of the various independent holding and subsidiary companies comprising the group is coordinated in such a way that management takes place on a central and unified basis in the interests of the group as a whole. This is due to the control implicit in the relationship between the holding and the subsidiary company or companies. This control makes it possible for the group to be managed as an economic unit. Although, in terms of company law, each company within a group is a separate legal entity, the courts have dealt with the group as a whole as an economic entity. This piercing of the corporate veil is indicated especially where a holding company has 100% holding and control of its subsidiary, and can therefore control every aspect of the subsidiary (Cilliers et al. 1992: 435).

If the South African sensitivity towards a concen-

tration of economic power is taken into account, a system that requires 100% ownership within the group might not be acceptable. Minority shareholders should be accommodated within a group tax regime. However, to align the group with a divisionalised company, a minimum intra-group interest of 75% should be prescribed. This is in line with the current requirements of the Income Tax Act. It ensures that the holding company can still pass special resolutions (which will enable the holding company to manage the group in much the same way as a divisionalised company) and is substantial enough to qualify the holding company conceptually as the effective owner of the subsidiary's business (Kannenberg 1999: 3).

Divisionalisation versus a group structure

A divisional structure refers to a structure where separate businesses are housed in separate divisions within one company. From a legal point of view, this type of structure comprises a single legal entity. Transactions between the individual divisions are effectively ignored when reporting at the company level for accounting and tax purposes.

This differs from a group structure, as defined in the previous section. The group structure comprises separate legal entities within the group. Each entity houses one or more of the various businesses. Transactions between these separate legal entities have an effect for tax purposes that does not always correspond with the accounting treatment of these transactions. For accounting purposes, these intra-group transactions are effectively set off on consolidation, and give rise to similar results as transactions between divisions within the same company.

This can be clearly demonstrated where, for example, a business has generated a tax loss:

- If the business is structured as a division within a company, this tax loss is set off against the taxable income of the other divisions within the same company to derive the aggregate taxable income or loss for the company (where the legal entity is the taxpayer). As divisions within a single company do not each have a separate legal identity, the accounting and tax treatments will correspond for the legal entity.
- If the business is structured as a separate company within a group, the loss cannot be set off against the taxable income of the other group companies. For tax purposes, the group has to

pay tax in respect of each of the tax-paying entities within the group. The benefit of the tax loss can only be utilised in future when that specific entity has generated taxable income. The economic substance is that the group as a whole has made a net loss or smaller net profit before tax, but tax is levied on greater profits (which is illustrated when the results are consolidated for the compilation of the financial statements).

This anomaly often leads to 'financial engineering', that is, artificial manipulation of the affairs of companies in order to minimise the tax liability of the group as a whole. The principle of 'financial engineering' is usually altogether unproductive, and the efforts expended by executives in pursuit of these alleged benefits could be more profitably spent in more productive areas (*Taxpayer* 1985: 170).

According to the Margo Commission (South Africa 1986: 199), an argument that is often put forward against group taxation is that the tax effects of intra-group transactions can be neutralised by implementing a divisionalised structure within a single entity, as opposed to a group structure. Apart from the tax considerations, the compliance and administration costs of a divisional structure are claimed to be considerably less. In spite of these advantages, there may be sound commercial reasons why separate legal entities are required as opposed to a divisional structure.

Some of these considerations are cited in the Margo Commission report on group taxation (South Africa 1986: 199), including the following:

- The retention by companies in the group of valuable licences and rights that would lapse when these entities cease to exist
- The requirement by certain regulated industries that operations must be kept in separate entities
- The compliance of loan covenants and agreements that may restrict a transfer of assets
- Strategic business reasons that may include future listing, new risk ventures or foreign investment opportunities
- The protection of limited liability
- The need of new risk ventures for protection of limited liability
- The attraction for foreign investors who may wish to incorporate separate companies for specific operations.

It is therefore clear that in practice there may be legitimate commercial reasons for businesses to be

housed in separate legal entities rather than in one divisionalised company. However, this does not detract from the fact that, from an ownership point of view, the entities within a group are managed as a single economic unit.

It is clear from the foregoing considerations that both group and divisional structures will continue to exist for reasons other than the tax implications of such structures. It is therefore important that the tax anomalies arising from intra-group transactions inherent in our current tax system be addressed.

Anomalies arising from the current tax treatment of intra-group transactions

This section analyses the tax effects of certain intra-group transactions and compares these to the tax effects that arise where the same transactions are carried out between the different divisions of the same company, in order to illustrate the need for the implementation of a group tax system.

A transaction between two parties generally gives rise to an expense or liability in the hands of the one party and income or an asset in the hands of the other party. For tax deduction purposes, the expense side of the transaction must meet the provisions of section 11(a) of the Income Tax Act (Act 52 of 1962, as amended, read together with section 23, particularly section 23(g), which prohibits a deduction to the extent that the deduction is not laid out or expended for trade purposes). In terms of section 11(a) of the Act, expenditure and losses may be deductible if they meet the following requirements:

- They have actually been incurred
- They have been incurred in the production of that entity's income
- They are not of a capital nature
- They are derived from carrying on a trade.

For the income to be recognised as gross income for tax purposes, the requirements of the gross income definition in terms of section 1 of the Act must be met. For income to be taxable, it must fall into the gross income definition in section 1. The requirements are that there should be:

- A total amount
- In cash or otherwise
- Received by or accrued to or in favour of
- During the year of assessment
- Excluding receipts of a capital nature.

However, as discussed in the following sections, income or gains from the disposal of qualifying assets (which do not constitute gross income as they are of a capital nature) are subject to the provisions of the Eighth Schedule of the Act. The taxable gains in respect of the disposal of these assets are included in taxable income in terms of section 26A of the Act.

For the purposes of this study, only the requirements pertaining to a resident of South Africa have been considered.

Anomalies could arise from the tax treatment of transactions between companies within the same group. For the purposes of this paper, the following categories have been identified:

- The timing mismatches of income and expenditure between group companies
- The taxability versus deductibility mismatches of certain transactions because the requirements of the deduction provisions are not met or do not correspond
- The taxability versus deductibility mismatches due to capital versus revenue differences of the same transaction
- A shift of income and expenditure between taxable and loss-making entities
- Capital gains tax and other tax consequences arising on certain intra-group transactions.

Timing mismatches of income and expenses between group companies

A timing mismatch of income and expenditure may result in income's being taxed in one year in the hands of one party, while the corresponding expenditure may only be deductible in the hands of the other party in a subsequent year. This is demonstrated by the following example:

Company A and Company B form part of the same group of companies. Company A makes an advance payment to Company B for administrative services to be rendered for the whole of the next year. This payment occurs at the year-end (Year 1), at which point, Company B has not rendered any services.

Company B is taxed on the full receipt in Year 1, as this payment constitutes gross income in its hands, since it is an amount actually received. Company B is not able to claim a deduction against this income, as it has not incurred any expenditure in producing this fee income by the year-end. Company A is not able to claim a deduction for the payment in Year 1,

as the deduction is limited in terms of the provisions of section 23H of the Act (if the payment exceeds R50 000). Although the expense has been incurred by Company A, as the fee has been paid – based on the judgement in *Caltex Oil (SA) Ltd v SIR* (1975(1) SA 665 (A)) – section 23H of the Act limits the deduction in respect of any expenditure incurred where the related benefits are received over a period longer than six months. Effectively, where the related benefits are received over a period of more than six months, the expenditure is only deductible as and when the benefits are received. Company A can therefore only obtain the deduction in the subsequent year, when the services have actually been rendered by Company B. Although the inclusion of the receipt, in Year 1, in Company B's taxable income is followed by a deduction in the subsequent year for Company A, from the group's perspective, this has resulted in a negative cash outflow in the first year, as a result of the tax payable by Company B on the administration fee received.

The foregoing transaction would have no net accounting or tax effects between divisions within the same company.

Mismatch arising from not satisfying the requirements of sections 11(a) and 23(g)

The tax effects of intra-group transactions may be mismatched where the requirements of section 11(a), read together with section 23(g), are not met on the expenditure side of the transaction, although the gross income definition in terms of section 1 of the Act is applicable in respect of the income side of the transaction. Two main types of instance may arise.

The first scenario arises where the group company that incurs the expense or loss side of the transaction may not deduct the expense or loss in determining its taxable income, as the expense or loss does not meet the requirements of section 11(a), read with section 23(g), but the corresponding receipt or accrual is taxed in the hands of the group company receiving it. From a group perspective, this results in an inconsistency. This transaction's economic benefit has a zero-sum effect, whereas, from a tax perspective, it has created taxable income in the hands of one group entity, without the corresponding relief of a deduction in the hands of the group entity that has incurred the expense.

The requirements of sections 11(a) and 23(g) have already been set out. For the expense or loss to be deductible, it must be a 'non-capital expense' or

loss actually incurred in the production of income derived from trade. Over the years, the courts have established the meaning of this phrase. In *Port Elizabeth Electric Tramway Co Ltd v CIR* (1936 CPD 241), Judge Watermeyer AJP stated that, in the ordinary sense, this phrase does not refer to expenditure that produces income, but rather to business operations, and that expenditure is attendant upon these operations. He also stated that if a business operation is conducted *bona fide* for carrying on a trade that earns income, the expenditure is deductible, as it is incurred in the production of income derived from a trade. How closely linked the expenditure must be to the operations was formulated by Judge Watermeyer AJP in that case as follows:

... in my opinion, all expenses attached to the performance of a business operation *bona fide* performed for the purposes of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are *bona fide* incurred for the more efficient performance of such operations provided they are so closely connected with it that they may be regarded as part of the costs of performing it.

From this case, it is clear that, as a general rule, ordinary business expenditure (as well as expenditure necessary for the performance of the business operation), because it is not of a capital nature, satisfies the production of income and trade requirements. It may be difficult for the remaining category of business expenses, namely expenses attached to business operations by chance, to satisfy the requirements in question.

In the case of group companies, this may happen where an incidental payment made by one group company to another group company is not deductible by the group company that incurs the expense, but the amount is taxed in the group company to which it accrues. An example of such expenditure is a payment for damages or negligence. In this instance, the transaction for the group is not tax neutral. The amount is taxed in the group company to which it accrues or by which it is received, but is not deductible by the group company incurring the expense, as it may not satisfy the production of income and trade tests.

The second instance, although it is similar to the first, in that the requirements of section 23(g) or section 11(a) are not met, is different in that the expense or loss is not deductible by the group company that incurred it, as the expenditure is not

related to the production of income from its trade, even though from a group perspective it may have been deductible in relation to another group company, as the expenditure may have been related to the production of income from trade by another member of the same group. The corresponding receipt or accrual is taxed in the hands of the group company that receives the payment. This gives rise to the same tax effect as already discussed, namely, that the transaction is not tax neutral for the group as a whole (Kannenberg 1999: 23–25). This happens if, for example, Company A (a subsidiary in the group) does all the administration for the group, and charges all the group companies for administration services rendered. Company B (the holding company) may earn only exempt income (dividends) and not be able to deduct the administrative fee charged by Company A, as the expense is not related to the production of income, in terms of section 11(a), read together with section 23(f) of the Act. (It should be noted that the ‘trade’ requirement set out in section 11 of the Act is also not met.) If, however, this amount were allocated to other companies in the group that do earn taxable income, it would be deductible.

From the preceding, it is clear that, in some instances, intra-group transactions give rise to anomalous tax effects because each group company is treated as a separate taxpayer.

Mismatch of the capital versus the revenue nature of transactions between group companies

The requirements of the gross income definition and general deduction formula imply that an income or expense may not be of a capital nature in order for the amount to be taxable or deductible. However, receipts or accruals of a capital nature are dealt with under the provisions of the Eighth Schedule and, where applicable, 50% (for a company) of the capital gain may be subject to tax.

Over the years, the courts have established clear guidelines in determining what is regarded as an amount of a capital nature and what is regarded as an amount of a revenue nature. From a gross income perspective, a receipt or accrual is either capital or revenue; there is no half way house between the two (*Pyott Ltd v CIR* (1944 AD 610)). Generally, a revenue receipt is income that arises from a business enterprise or activity, personal exertion, or the employment of capital, either by using it or by letting it (Huxham & Haupt 2004: 22). In distinguishing between receipts of a capital nature and those of a revenue nature, an analogy

is often used – in *CIR v Visser* (1937 TPD 77), Maritz J stated: “Income is what capital produces, or is something in the nature of interest or fruit as opposed to principal or tree.”

Over the years, the courts have laid down various tests to be applied in deciding whether a receipt is revenue or capital. The dominant test is that of the intention of the taxpayer (Arendse, Coetzee, Jordaan, Kolitz, Stein & Stiglingh 2004: 21; Huxham & Haupt 2004: 23), which was originally referred to in *CIR v Stott* (1928 AD 252). Various factors would influence the determination of the intention of the taxpayer, including whether there has been a change of intention between the time when an asset was acquired and the time when the asset was disposed of. This test was further expanded by the courts, to include the test that had its origins in the *California Copper Syndicate* case (1904), as to whether the intention of the taxpayer was that of a scheme of profit-making.

From the general deduction perspective, an amount is not deductible if it is of a capital nature. The main test for determining the capital or revenue nature of an expense or loss was established in *New State Areas Ltd v CIR* (1946 AD 610). If the expense or loss is incurred as the cost of performing the income-earning operations of the taxpayer, it is by nature revenue. If it is part of the cost of establishing, enhancing or adding to the taxpayer's income-earning structure, it is of a capital nature.

Although the broad principles used to distinguish between the capital and revenue nature of expenditure and receipts or accruals are similar, the application of these principles may result in the opposing sides of a transaction being treated inconsistently. This can be illustrated by means of a simple example:

A group of companies includes two subsidiaries. One is a property investor receiving rental income, and the other is a property developer. When the property developer develops and sells a property to the property investor, the developer is taxed on the receipt resulting from the sale of the property to its subsidiary, as the property is regarded as its stock in trade. The property investor in turn may not receive any tax relief on the acquisition cost of the property if the property does not qualify for any capital allowances, as is the case, for example, with office accommodation and shopping malls. The group has experienced a zero net cash flow, but has been taxed on the profit portion of the development.

It may therefore happen that the expenditure component of an intra-group transaction is viewed

as a capital expenditure, while the receipt or accrual component is viewed as income. When parties to a transaction are viewed in isolation, it is possible that different facts and circumstances will be considered, or that these may be interpreted differently, resulting in anomalous results in respect of each component of the transaction.

Shifts of income between group companies with assessed losses

Section 20(1) states:

For the purposes of determining the taxable income derived by any person from carrying on any trade, there shall, subject to section 20A, be set off against the income so derived by such person

(a) any balance of assessed loss incurred by the taxpayer in any previous year

The definition of a ‘person’ in section 20(1) is restricted to a separate legal entity in terms of common law principles. A company is therefore prohibited from setting off an assessed loss arising from a fellow subsidiary company against its income. This gives rise to conflicting results compared to the situation where the same group entities are structured in the form of divisions within a single legal entity. In this case, the setting off of all the divisional income and losses is allowed.

For this reason, group companies often enter into elaborate schemes and transactions in an attempt to shift around income and losses between group entities in order to achieve the same tax effect as would have arisen if these separate legal entities had been set up as a divisional structure (Kannenberg 1999: 140). So, for example, expenditure may be channelled through a profitable entity within the group, creating income in the hands of the loss-making group entity. However, a deduction may not be allowed if the requirements of sections 11(a) and 23(g) of the Act are not met. Furthermore, section 103(2) of the Act specifically prohibits the utilisation of an assessed loss in a company by introducing income into that company.

The requirements of section 103(2) that apply to companies can be summarised as follows:

- Whenever the Commissioner is satisfied that any agreement affecting any company or any change in shareholding in a company has been effected,

- and has resulted directly or indirectly in income or any capital gain accruing to the company,
- solely or mainly for the purpose of utilising any assessed loss, any capital loss or any assessed capital loss,
- in order to avoid or reduce liability for any tax, duty or levy on income on the part of that company,
- then the setting-off of any such assessed loss or balance of assessed loss against such income (or any taxable capital gain) shall be disallowed, or
- the setting-off of such capital loss or assessed capital loss against such capital gain shall be disallowed.

What is envisaged is the situation where, as a result of an agreement or change in shareholding, income is injected into a company that has an assessed loss. However, section 103(2) only applies when the change of shareholding or agreement is carried out solely or mainly to utilise the assessed loss and thereby to reduce or avoid tax, since there is no abnormality requirement in section 103(2). If, for example, it can be proved that a company was acquired or an agreement was entered into for good commercial reasons and that the setting-off of income against the assessed loss was merely incidental to the main purpose, section 103(2) does not apply (Huxham & Haupt 2004: 357–358).

Should section 103(2) not apply, section 103(1) may be applied in cases where it can be shown that the transaction, operation or scheme was entered into solely or mainly to avoid, reduce or postpone any tax liability, as result of the abnormality of the transaction or scheme.

In practice, one of the most common ways to manipulate the tax liability of each group entity is often to make year-end adjustments to management or administrative fees charged between group entities (South Africa 1995: 97). There is often no basis for excessive charges, and should these be subject to enquiry from the revenue authorities, companies may in these instances find it difficult to demonstrate that a service has in fact been rendered in return for the management fee, or that the fee is not excessive for the nature of the service rendered (Middelmann 2003: 21).

Capital gains and other tax consequences of certain intra-group transactions

In terms of the Eighth Schedule of the Income Tax Act, the capital gains tax provisions apply to the

disposal of assets on or after 1 October 2001. It should be noted that the introduction of the taxation of capital gains has not removed the necessity for determining the nature of the proceeds from the disposal of assets. If the asset is acquired with a revenue intention, proceeds on disposal are included in gross income and are taxable in full. If the intention is of a capital nature, the qualifying portion of the proceeds is subject to the provisions of the Eighth Schedule.

A detailed analysis of the Eighth Schedule falls outside the scope of this study, but some of the limiting provisions in respect of intra-group transactions are briefly analysed.

Paragraph 39 of the Eighth Schedule states that where an asset is disposed of between connected parties (generally this includes group companies), any capital loss must be disregarded. The loss may only be set off against capital gains arising from the disposal of assets between the same connected parties. This is the same effect as when the asset is transferred between two divisions within a single company. Any loss (as well as any gain) resulting from the transfer of assets is disregarded. Disposals to parties that do not form part of the same group of companies have normal capital gains tax consequences.

The limitation with regard to intra-group capital asset disposals gives rise to an inconsistency between the tax treatment and the economic reality in a group scenario. From a group perspective, where a company transfers an asset at a loss and it has other capital gains, these gains may not be reduced by this loss. Therefore a liability may arise in this entity, which results in an anomalous tax effect. This has been partially addressed by the introduction of the Corporate Rules and specifically section 45. Section 45 is only discussed briefly here, as a detailed discussion of these Corporate Rules falls outside the scope of this paper.

'Intra-group transactions' are discussed in section 45 of the Act. They are defined as any transaction in terms of which any asset is disposed of by one company (referred to as the transferor company) to another company which is a resident (referred to as the transferee company), and both companies form part of the same group of companies, as defined in section 1 of the Act (see the section in which the definition of 'group' is discussed), at the end of the transaction date. The transfer of assets from one company in the group to another may result in certain tax implications, such as recoupments, possible capital gains tax implications, transfer

duty, secondary tax on companies and donations tax. Section 45 provides for tax relief, if jointly elected by both companies, in respect of qualifying intra-group transactions. The transferor company is deemed to have disposed of the assets for proceeds equal to the base cost of the assets, which are transferred to the transferee company and deemed to be the base cost of the assets for the transferee company. Relief is therefore provided in respect of any possible normal tax implications (including capital gains tax), as it also applies to stock (section 45(2)).

Allowances previously claimed on fixed assets (defined in section 41 as 'allowance assets') are not recovered or recouped in the calculation of the taxable income of the transferor company. The two companies are deemed to be the same person, entitling the transferee company to the same qualifying allowances to which the transferor company would have been entitled. Future recoupments are for the account of the transferee company (section 45(3)).

The same principle applies in respect of qualifying section 24C allowances, if, for example, construction contracts are transferred as a going concern (section 45(3)(b)) (Arendse et al. 2004: 354–355). The relief measures provided for in section 45 are, in some instances, not available, for example, if the transferee company is exempt from income tax (section 45(6)(b) of the Act); or if the transferee company is not able to claim the same capital allowance or deduction as the transferor company (section 45(3)(a) of the Act), where, for example, Company A has used the asset for manufacturing purposes and claimed a section 12C allowance, but Company B, buying the asset, does not utilise the asset for manufacturing and can therefore only claim a section 11(e) allowance.

Section 45 therefore addresses most intra-group transfers of assets, but, as already mentioned, some types of transfers can still result in situations where a company transfers an asset at a loss and, although it has other capital gains, these gains may not be reduced by this loss, as the loss can only be utilised against capital gains made in transactions with a company within the same group (paragraph 39 of the Eighth Schedule).

Summary of anomalies arising within the present system of taxing group companies

It is clear from the foregoing discussion that the current tax treatment of intra-group transactions might result in certain anomalies. If these anomalies

are favourable, this may promote an attempt to exploit transactions that may have no commercial substance but are tax beneficial and may result in a loss to the fiscus. If these anomalies are unfavourable, they may result in a situation where efficient business decisions are not made because of their potential negative tax effects on the group. Tax-induced economic activity can result in a misallocation of resources and have a detrimental effect on economic growth. Furthermore, such anomalies do not promote equity and neutrality within groups (Kannenberg 1999: 138). It is thus clear that the status quo is unsustainable.

Although the provisions of the Corporate Rules (sections 41 to 47 of the Act) offer some relief in respect of some intra-group transactions, these provisions do not cater for all circumstances. Only six types of transaction are catered for, namely:

- Company formations (section 42 of the Act)
- Share-for-share transactions (section 43 of the Act)
- Amalgamation transactions (section 44 of the Act)
- Intra-group transactions (section 45 of the Act)
- Unbundling transactions (section 46 of the Act)
- Liquidation transactions (section 47 of the Act).

The Corporate Rules were introduced as relief measures in respect of transactions between group companies or between founding shareholders and their company (Huxham & Haupt 2004: 254). These rules are based on the principle that the transfer of assets within a group structure should be tax neutral where effective ownership has remained the same (Middelmann 2003: 22). Unfortunately, these rules do not always provide for tax neutrality as intended. If one of the anti-avoidance provisions is triggered, taxable income may arise in the transferee company which cannot be set off against its assessed loss (if it has an assessed loss) or in determining its aggregate capital gain or loss (Middelmann 2003: 27).

The third interim report of the Katz Commission

The Third Interim Report of the Katz Commission (South Africa 1995) was presented in December 1995. The report addresses the issue of group taxation and makes a number of recommendations in this regard. A number of advantages and disadvantages of a system of group taxation were identified by the Katz Commission.

Advantages identified by the Katz Commission

The Katz Commission (South Africa 1995: 96–97) identified the following advantages of a system of group taxation:

- A closely held group of companies, although the group may consist of separate companies, can constitute a single economic unit for the purposes of strategic and financial planning. A tax system that ignores this reality can create economic and business distortions that can be addressed by a form of group taxation.
- One of the distortions created is the divisionalisation of companies into a single legal entity purely for tax reasons. This results in a loss of protection in respect of limited liability, and influences operational, management, compensation and competition policies. Such problems can be avoided with a system of group taxation.
- The alternative situation also results in certain distortions, for example, when a group of companies cannot be divisionalised for strategic reasons and hence the tax neutrality enjoyed under divisionalisation is not achieved. Once again, a group tax system addresses these anomalies.
- Management may invest large resources in establishing techniques that often have no commercial substance, mainly in order to avoid tax through the use of certain intra-group transactions, such as unsubstantiated management fees and transfer pricing. This undermines the integrity of the tax system, as these actions were induced by a desire to avoid tax rather than commercial considerations – the very influence that a tax system should avoid.
- Manipulation of intra-group transactions is not easy to police, and is often difficult to detect, even though complicated anti-avoidance measures may be in place. Furthermore, because there is no recognition in the tax law of the reality of a group's economic interest, tax avoidance and evasion do not end with merely trying to match profit or losses within a group. Although intra-group transactions usually have no real economic or commercial effect, they do have a tax effect as a result of common ownership or control. Further abuse is therefore possible by manipulating the cost bases to engineer timing, capital or revenue mismatches, or simply to 'lose' one end of a transaction.
- Under the current tax system, companies are assessed separately. This implies that the assessor often does not have access to all the

information pertaining to all the companies within a group, because these companies may be registered in separate offices. A group tax system would ensure a full audit trail of all intra-group transactions, as well as the correct tax effects of transactions with outside parties. This would increase the power of the revenue authorities to police the system.

- Group taxation is sometimes regarded as being disadvantageous, as it encourages the formation of conglomerates. The Commission comments that in recent times this is no longer a valid argument, and that, in fact, the reverse is more common. Group taxation facilitates the unbundling of large organisations into more efficient multi-company structures. In the current tax system, this is discouraged, as it results in higher tax liabilities through higher profitability in each of the sub-units, as well as the loss of the benefit of large tax losses. The Commission is aware of the importance of facilitating the ownership and control of companies by emerging investors, both in the existing market and in the privatisation process.
- Because South Africa is now part of the international trade and investment community, it is important to align the current tax system with international practices, as foreign investors expect to find some form of group tax in South Africa.

Disadvantages identified by the Katz Commission

The Katz Commission (South Africa 1995: 98) identified the following disadvantages of a system of group taxation:

- A system of group taxation is complex.
- The cost to the fiscus is perceived to be high.
- There is a need for anti-avoidance measures.

Recommendations

The Commission proposed a gradual approach to the introduction of a system of group taxation, beginning with a simplified consolidation method. The suggested initial system of group taxation is not a fully-fledged consolidation system, but one that is able to progress towards a full consolidation system, once the impact of the shift to group taxation on the fiscus can be evaluated and administrative problems have been identified and addressed. This form of implementation should minimise the impact of the complexity of such a

system, as well as the cost. The consolidation system introduced should broadly follow international principles.

The Commission found that the claims that the fiscus would incur substantial losses were largely exaggerated and unfounded. Not all tax losses are available to group companies, and not all groups have profits that can be set off against such losses. The potential cost to the fiscus of setting off these losses could be largely countered by excluding losses prior to the first consolidation.

The Commission further found that a group tax system avoids the engineering of artificial transactions for the purposes of avoiding tax (which are difficult to control and police and undermine the entire corporate tax system). The Commission is of the opinion that the fiscus suffers more under the current tax system. The Commission recommended a compromise with the pure full consolidation system in respect of three areas (South Africa 1995: 100):

- There should be the requirement that only wholly owned groups qualify for consolidation in order to reduce cost and complexity. The fear that the 100% holding requirement will 'squeeze' out minorities is, in the Commission's view, a lesser problem.
- Any losses that arose prior to the consolidation of a group of companies should be excluded.
- A full consolidation method need not initially be implemented.

Canons of taxation

Fiscal policy has a critical impact on the political economy of any country, and many variables must be taken into account in the pursuit of an efficient, equitable and politically acceptable system of taxation. In this context, a number of so-called canons of taxation (which include equity, certainty, convenience, efficiency and neutrality) have been internationally accepted as representing the characteristics of a good tax system (Emslie, Davis, Hutton & Olivier 2001: 1).

The canons of taxation, first formulated by Adam Smith in 1776 (in a book titled *The Wealth of Nations*), are summarised by Huxham & Haupt (2004: 2) as follows:

- (i) The subjects of every State ought to contribute towards the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they

respectively enjoy under the protection of the State. The expense of government to the individuals of a great nation is like the expense of management to the joint tenants of a great estate, who are all obliged to contribute in proportion to their respective interests in the estate.

- (ii) The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all be clear and plain to the contributor.
- (iii) Every tax ought to be levied at the time, or in a manner which it is most likely to be convenient for the contributor to pay it.
- (iv) Every tax ought to be so contrived as to both take out, and keep out, of the pockets of the people as little as possible over and above what it brings into the public treasury of the State.

These salient features of a good tax system are examined in the following sections, taking into account the comments made by the Katz Commission (South Africa 1995: 96–100), as discussed in the previous section, in order to establish whether a group tax system in South Africa would promote these features. Since it appears that a consolidation system would be the preferred choice if a group tax system were to be implemented in South Africa (see the recommendations made by the Katz Commission, as discussed in a previous section), the features of a consolidation system are also to be taken into account in the remainder of the article.

Equity and neutrality

The equity of a tax system is defined with regard to two related concepts. The first is the ability to pay, where one can distinguish between horizontal and vertical equity. Horizontal equity requires that similar individuals be treated similarly, or that a person in the same situation as another be treated equally. Vertical equity requires that taxpayers with a higher level of economic wellbeing should bear greater tax burdens. The second concept is the benefit principle, which states that those who benefit from the use of particular commodities or services should pay for them, according to the Margo Commission (South Africa 1986: 50–51).

Neutrality requires that taxpayers should not be influenced by the tax system in choosing one course of action over another, solely because the tax effects of one course of action are more beneficial under one of the options. A neutral tax

system is one that minimises the impact of the tax structure on economic behaviour, including business organisation, work effort and saving (South Africa 1986: 50).

A group tax regime addresses both these characteristics. This is clear from the manner in which the members of a group of companies are treated similarly and equally, as they are seen to form part of the same economic unit. With a system of group taxation, the same tax neutrality should therefore be enjoyed as that under divisionalisation (South Africa 1995: 96–97).

The current income tax system in South Africa clearly does not achieve this. Each company within a group is treated as a separate taxpayer, and all intra-group transactions result in tax effects. These tax effects often do not give rise to consistent results between the transacting group entities (refer to the anomalies examined in a previous section), and therefore do not emulate the group economic unit principle. However, intra-group transactions may be entered into solely for the purpose of exploiting favourable tax treatments, which does not necessarily result in sound economic decisions. Tax-induced business decisions may result in a misallocation of resources and are therefore disadvantageous to the economy.

Certainty and simplicity

Certainty and simplicity are also included among the characteristics of a good tax system and are interrelated. Certainty requires that taxpayers should be reasonably certain what their tax liabilities should be. A complex tax system results in uncertainty and increased costs because of the need for consultation with advisors. Simplicity requires that a tax should be easily assessed, collected and administered in order to minimise costs to both the taxpayer and the fiscus (South Africa 1986: 51). It refers to the ease of operation of a tax system from a technical point of view (Kannenberg 1999: 151).

A group tax regime is generally regarded as technically complex (South Africa 1995: 98), because intra-group transactions are subject to special treatment in order to neutralise their tax effects. However, this complexity depends on the manner and extent of implementation.

There are also some characteristics of a group tax system that could simplify tax treatment:

- There is no need for a separate exercise to identify intra-group transactions for the pur-

poses of completing the group's tax return, because, in terms of generally accepted accounting practices, these intra-group transactions require specific detailed disclosure.

- In respect of income and expenditure in intra-group transactions, income and expenditure are mostly eliminated on aggregation of the group's results. So, for example, intra-group management fees received by one group company and included in its taxable income, will be set off against the management fees paid by the other group company, which claims it as a deduction, thereby eliminating this transaction.

Another important factor that should be considered is that income tax legislation could be simplified by the implementation of a group tax system, in that certain anti-avoidance provisions and the Corporate Rules (sections 41 to 47 of the Income Tax Act) would, to a large extent, become redundant. More consistent assessments would also be issued, as there are no separate assessments for each entity by various assessors under a group tax system.

It can therefore be concluded that a group tax system should achieve certainty and simplicity to a far greater extent than the current system. The Revenue authorities would have access to more information pertaining to the entire group, fewer returns would need to be submitted, and certainty regarding intra-group transactions would be greater, which should release management resources that can be concentrated on the economic activities of the group.

Cost and efficiency

The cost and efficiency of a tax system are directly linked to certainty and simplicity. A system that is more efficient administratively results in reduced costs (South Africa 1986: 51).

A system of group taxation appears to be more efficient and cost effective than the current tax regime, for a number of reasons:

- A group tax system is generally more efficient from an administrative point of view, since only one tax return needs to be completed for the group, and consolidated information provided by the financial statements can be incorporated, to a large extent, without any changes. Costs for the taxpayer should therefore also be lower.
- The initial cost to the fiscus to facilitate the implementation of a system of group taxation

(South Africa 1995: 98) should be set off against the benefits of the lower costs that result from fewer corporate tax returns being lodged.

- The submission of fewer corporate tax returns should also result in a decrease in administration and turnaround time for the fiscus.
- The assessor is privy to the information of the group as a whole, including the disclosure of all intra-group transactions, resulting in the provision of a more efficient service (South Africa 1995: 96–97).
- As intra-group transactions are tax irrelevant under a group tax system, the exploitation by taxpayers who try to manipulate such transactions to obtain a tax benefit is greatly reduced, thereby reducing the need for the revenue authorities to police such activities (South Africa 1995: 96–97).
- Management tends to invest resources in establishing techniques that often have no commercial substance, with the main purpose of avoiding tax through the use of certain intra-group transactions, such as unsubstantiated management fees (South Africa 1995: 96–97). A group tax system aligns the tax treatment of a group of companies for tax purposes with the economic unit principle, ensuring that companies utilise their resources effectively, not only taking into account their best interests, but also the best interests of the economy as a whole, thereby driving economic growth. This is critical in South Africa's developing economy.

Convenience

A group tax system appears to be more convenient for both the fiscus and the taxpayer, in the sense that only one tax return need be submitted and assessed for every company that elects to be treated as a group company for income tax purposes.

Summary

The foregoing analysis indicates that there appears to be a certain trade-off between the canons of taxation. A good tax system is one that achieves the best balance between equity, neutrality, certainty, simplicity, costs and efficiency. The only disadvantage that may be cited may be the complexity of the initial introduction of a group tax system. However, it is possible to design a system that is compatible with the current South African tax system and the administrative capacity of the South African revenue authorities.

Desirability for the fiscus and the taxpayer

From the preceding analysis, it is clear that a group tax regime would be beneficial to the South African tax system, and consequently to the South African economy. A number of aspects (some of which have already been mentioned) arising from the implementation of a group tax regime have been identified with regard to the desirability to both the fiscus and the taxpayer.

Desirability for the fiscus

The following are some of the reasons that a group tax regime would be desirable to the fiscus:

- A group tax system promotes efficient utilisation of management resources. Because it disregards all intra-group transactions for tax purposes, it eliminates tax anomalies that arise from these types of transactions. Management is therefore less likely to be influenced by the tax effects of these types of transactions, and is more likely to concentrate on promoting growth in economic activity, thereby increasing the general tax base (South Africa 1995: 71).
- A group tax system also promotes efficient utilisation of revenue authority resources. Revenue authorities are likely to spend less time policing intra-group transactions, and can therefore dedicate more time to other important areas, such as non-compliance.
- The information available to revenue authorities is substantially increased under a group tax (consolidation) system, as it provides information in respect of the entire group structure. All entities are effectively assessed by a single person, as opposed to the current situation where companies within the same group may be assessed by various assessors and even by different revenue offices (South Africa 1995: 71). This reduces the risk of exploitation of the system by the taxpayer and increases the consistency of assessments. It also improves turnaround time, and ultimately cash collection by the revenue authority.
- An argument often raised against the implementation of a group tax system is that the South African revenue authorities are ill-equipped to handle the complexities of such a system. However, over the last few years, the South African revenue authorities have shown that they are committed to transformation, and that in fact they are more than capable of competing with the fiscal systems of many

developed economies. This can be seen, firstly, from the way in which they have implemented new systems to improve the efficiency and effectiveness of assessments and administration of the South African tax system. Secondly, over the last few years, they have started to employ highly trained and skilled people and have accordingly increased salary packages to compete with the private sector.

- South Africa is now part of the international trade and investment community, and it is necessary to align the current tax system with international practices, as foreign investors expect to find some form of group tax in South Africa. This can ultimately contribute to an increase in the tax base, arising from new business derived from foreign investment.

Desirability for the taxpayer

The following are some of the reasons a group tax regime would be desirable to the taxpayer:

- A group tax (consolidation) system that ignores intra-group transactions for tax purposes promotes efficient utilisation of management resources. Management is able to concentrate on making business and operational decisions on commercial merit, and is not driven by the tax effects (South Africa 1995: 97).
- A group tax (consolidation) system supports the economic unity principle, as only transactions with outside parties give rise to tax consequences, and intra-group transactions are tax neutral.
- A group tax (consolidation) system reduces administration and compliance costs for income tax purposes by requiring only one return to be submitted for a group of companies.
- A group tax (consolidation) system promotes certainty, in that companies do not need to waste resources in consulting with special tax advisors regarding the intricate structures engineered to take advantage of intra-group transactions, as these are disregarded for tax purposes (South Africa 1986: 51).

Conclusion

The South African tax system has recently undergone radical transformation with the introduction of a residence-based tax system and capital gains tax, in order to achieve its globalisation policy. All the major developed economies, such as Australia, the United Kingdom and the United States of America, have some form of group taxation in their

income tax dispensation. A foreign investor would thus expect to find a form of group taxation in South Africa. As South Africa makes progress as an emerging market, it is inevitable that a system of group tax will have to be introduced in order to integrate fully and compete globally. This will encourage foreign economic activity in the country and ultimately broaden the tax base.

On the basis of the analysis performed and the conclusions reached, it is evident that the status quo in respect of the inherent tax anomalies arising from intra-group transactions is not sustainable, and that a system of group taxation should be implemented in South Africa. A tax system that provides for a form of group taxation and recognises the economic unit principle will promote consistent results and will encourage sound business decisions, based on economic merit.

A tax system that includes a group tax regime would promote the canons of taxation more effectively than the current taxation system. It would be beneficial to both the fiscus and the taxpayer, and would ultimately support the growth of the South African economy. Although the introduction of a system of group taxation is not without its costs and complexities, it is both achievable and necessary for the advancement of the South African economy.

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