

THE TAX ISSUES OF VARIOUS ASPECTS OF THE COMPANIES ACT 71 OF 2008

MINI DISSERTATION (MND 803)

by

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1. Introduction

1.1 Background

The South African Companies Act 71 of 2008,¹ which replaced the Companies Act 61 of 1973², came into effect on 1 May 2011.

The conceptual framework of the Income Tax Act 58 of 1962³ has historically attempted to be in harmony with company legislation, i.e. with the Companies Act 1973. For instance, the Companies Act 1973 determines the meaning of "share capital" which concept is then relied upon in the Income Tax Act when determining the tax implications of dividend distributions and returns of capital.

1.2 Problem statement

The tax implications of aspects of the Companies Act, as a new legislation, may not always be clear. This dissertation analyses the tax implications of various aspects of the Companies Act. Where there is a lack of clarity, the dissertation suggests practical alternatives supported by existing principles in tax legislation. The dissertation also highlights conceptual and practical issues arising from the differences between the two statutes.

1.3 Objectives

As the Companies Act is a new piece of statute having only come into effect on 1 May 2011, many of the concepts would not have been considered from a tax perspective. As this dissertation is based on the tax issues of aspects of the Companies Act, the dissertation groups the topics using concepts in company law, and then proceeds to discuss the tax issues in each topic.⁴ The company law topics discussed in this dissertation are thus as follows:

1.3.1 types of companies in terms of the Companies Act,⁵

¹ This statute will be referred to in this dissertation as the "Companies Act".

² This statute will be referred to in this dissertation as the "Companies Act 1973".

³ This statute will be referred to in this dissertation as the "Income Tax Act". Unless otherwise specified, any reference to "section" in this dissertation is a reference to the sections in the Income Tax Act, any reference to "Schedule" is to the schedules of the Income Tax Act, any reference to "regulation" is to the regulations published in terms of the Companies Act³ and to "Form" is to the prescribed forms in Annexure 1 of the regulation.

⁴ The dissertation has the benefit of using the discussion on the Companies Act in FHI Cassim, MF Cassim, R Cassim, Jooste, Shev, Yeats *Contemporary Company Law* (2012).

⁵ See 2 below.

- 1.3.2 securities (shares);⁶
- 1.3.3 securities (debt instruments);⁷ and
- 1.3.4 corporate finance, specifically on "distributions" as defined in the Companies Act.⁸

1.4 **Significance of the research**

This research is important as the Companies Act is a new piece of legislation and as such, relatively little has been written and explored on its tax implications. The novelty of the Companies Act means relatively little is available specifically on the topic. Comments will be made based on existing general principles in the event of a lack of clarity.

1.5 **Ethics**

The dissertation does not involve statistical analysis or participation from the university, companies or participants. There are no ethical considerations for the dissertation from this perspective.

The broader ethical consideration which applies to all dissertations is to ensure that resources used are referenced correctly. This has been done in this dissertation. The required declarations have also been signed and submitted.

1.6 **Research methodology**

The research will use statutes as the first port of call, with the versions of the Income Tax Act and Companies Act current as at 30 June 2013 being the main pieces of primary legislation as supplemented by case law interpreting the provisions in these statutes. Other tax statutes which will be considered, where relevant, include the Value-Added Tax Act 89 of 1991⁹ and the Securities Transfer Tax Act 25 of 2007.¹⁰

The dissertation will also consider subordinate legislation such as regulations, and other persuasive authority such as practice notes, interpretation notes and binding rulings. Existing tax and corporate law textbooks will also be relied upon.

⁶ See 3 below.

⁷ See 4 below.

⁸ See 5 below.

⁹ This dissertation will refer to this statute as the "VAT Act".

¹⁰ This dissertation will refer to this statute as the "STT Act".

2. Types of companies in terms of the Companies Act

2.1 Categorisation of companies

The Companies Act provides for two broad categories of companies - profit and non-profit companies. Within the category of profit companies, there are four further types of companies - private companies, public companies, state-owned companies and personal liability companies.¹¹

In line with its policy of including as many types of entities within the tax net as possible, the definitions of "company" in the Income Tax Act¹² and VAT Act¹³ includes associations, corporations or company incorporated or formed in and outside South Africa, co-operatives and close corporations, but does not include a foreign partnership. In short, even entities which are not "companies" in terms of the Companies Act are treated as "companies" for the purposes of the Income Tax Act and VAT Act. In addition, the Income Tax Act provides for specific tax treatment of entities known as personal service providers,¹⁴ REIT,¹⁵ small business corporations¹⁶ and headquarter companies,¹⁷ and all these entities are largely companies which have certain specified attributes.

This dissertation will discuss the differences between the manner in which companies are classified in the Companies Act and the Income Tax Act and the conceptual and practical implications arising from these differences. A preliminary conceptual point to note is that although a tax statute may use the concept of a company established in terms of the Companies Act, there will still be further requirements in a tax statute which will need to be fulfilled to claim a relief or exemption, or which requirements when fulfilled will give rise to tax implications with the objective of targeting anti-avoidance.

In this topic on types of companies in terms of the Companies Act, this dissertation will discuss the following sub-topics:

¹¹ Section 8(1) of the Companies Act.

¹² Section 1(1).

¹³ Section 1 of the VAT Act. The VAT Act defines a "company" by referring to the definition of the term in the Income Tax Act.

¹⁴ As defined in paragraph 1 of the Fourth Schedule.

¹⁵ As defined in section 1 and which tax implications are discussed in section 25BB as introduced in terms of the Taxation Laws Amendment Act 22 of 2012 with effect from 1 April 2013.

¹⁶ As defined in section 12E(4).

¹⁷ As defined in section 1 read with section 9I.

- 2.1.1 public and private companies in terms of the Companies Act and public and private companies in terms of the Income Tax Act;¹⁸
- 2.1.2 external companies and foreign companies in terms of the Companies Act and tax issues relating to these entities;¹⁹
- 2.1.3 domesticated companies in terms of the Companies Act and becoming tax resident in South Africa;²⁰ and
- 2.1.4 non-profit companies in terms of the Companies Act and public benefit organisations in terms of the Income Tax Act.²¹

2.2 **Public companies and private companies**

In terms of the Companies Act, the purpose of incorporation of a profit company is financial gain for its shareholders.²² There are four categories of profit companies - private companies, public companies, state-owned companies and personal liability companies.

A private company is prohibited from offering its shares to the public and its Memorandum of Incorporation will contain a restriction as to the transferability of its securities.²³ There is no restriction on a public company on the transferability of its securities, unless its Memorandum of Incorporation provides otherwise, and it may offer its shares to the public.²⁴ A state-owned company is also a public company. A personal liability company meets the requirements of a private company and is a company where the directors have joint and several liability for the debts of the company.

There is no difference for normal tax purposes whether a company is classified as a private company or public company. However, section 38 requires a company to be recognised as a public company or a private company for each year of assessment.²⁵

A private company in terms of the Companies Act will always be recognised as a

¹⁸ See 2.2 below.

¹⁹ See 2.3 below.

²⁰ See 2.4 below.

²¹ See 2.5 below.

²² See definition of "profit company" in section 1 of the Companies Act.

²³ Section 8(2)(b).

²⁴ FHI Cassim, MF Cassim, R Cassim, Jooste, Shev, Yeats *Contemporary Company Law* (2012) 78.

²⁵ Section 38(1).

private company in terms of section 38.²⁶ A public company in terms of the Companies Act will not necessarily be recognised as a public company in terms of this section. All companies which are not recognised as public companies in terms of section 38(1) are automatically recognised as private companies.²⁷ All close corporations are also recognised as private companies in terms of section 38.

The importance of the classification in the Income Tax Act is as follows. Donations made by a public company are exempt from donations tax.²⁸ Donations made by a private company are liable to donations tax, except for the general exemption of donations tax for donors (which are not natural persons) for casual gifts which are less than R10 000.²⁹ Further, as an anti-avoidance measure, remuneration paid to directors of a private company may be made on a deemed amount of remuneration rather than the actual amount of remuneration.³⁰

2.3 External companies and foreign companies

2.3.1 Provisions in the Companies Act and interpretation issues

An external company should be distinguished from a foreign company. A foreign company is a company which is incorporated and established outside South Africa.³¹ An external company is a sub-category of a foreign company.³² An external company is a foreign company which conducts business or non-profit activities in South Africa³³ and as such is required to register with the Companies and Intellectual Property Commission³⁴ within 20 business days after it first begins to conduct business or non-profit activities.³⁵

Section 23(2)(a) of the Companies Act provides that a foreign company must be regarded as conducting business, or non-profit activities in South Africa if the company -

"(a) is a party to one or more employment contracts within the Republic; or

²⁶ Section 38(2)(b).

²⁷ Section 38(3).

²⁸ Section 56(1)(n).

²⁹ Section 56(1)(2)(a).

³⁰ Paragraph 11C of the Fourth Schedule.

³¹ Section 1 of the Companies Act.

³² FHI Cassim, MF Cassim, R Cassim, Jooste, Shev, Yeats *Contemporary Company Law* (2012) 94.

³³ In the manner set out in section 23(2) of the Companies Act.

³⁴ The "Commission" is defined as the "Companies and Intellectual Property Commission" in section 1 of the Companies Act and is established in terms of section 185 of the Companies Act.

³⁵ Section 23(1) of the Companies Act.

(b) subject to subsection (2A), is engaging in a course of conduct, or has engaged in a course or pattern of activities within the Republic over a period of at least six months, such as would lead a person to reasonably conclude that the company intended to continually engage in business or non-profit activities within the Republic."

Section 23(2A) provides that when applying section 23(2)(b), a foreign company must not be regarded as conducting business or non-profit activities in South Africa solely on the ground that the foreign company is or has engaged in one or more of the following activities:

- 2.3.1.1 the holding of a meeting or meetings of shareholders or directors of the company, or any of its internal affairs in South Africa;
- 2.3.1.2 opening and maintaining a bank or other financial accounts in South Africa;
- 2.3.1.3 establishing or maintaining offices or agencies in South Africa for the transfer, exchange or registration of the company's securities;
- 2.3.1.4 creating or acquiring debts in South Africa, or mortgages or security interests in any property in South Africa;
- 2.3.1.5 securing or collecting any debt, or enforcing any mortgage or security interest in South Africa; or
- 2.3.1.6 acquiring any interest in any property in South Africa.

Section 23(2)(a) read with section 23(2A) thus provides that once a foreign company is a party to an employment contract within South Africa, then it has an obligation to register as an external company. If it carries out any one or more of the activities listed in section 23(2A)(a) to (f) of the Companies Act, then it is necessary to ascertain based on the manner and regularity of the activities undertaken whether the pattern of activities of the foreign company is such that would lead a person to reasonably conclude that this company intends to continually engage in business or non-profit activities in South Africa.

It is unclear what "*a party to one or more employment contracts within the Republic*"³⁶ means, whether the legislature intended to adopt a wide interpretation to include all employment contracts with services rendered in South Africa regardless of the circumstances of the employer and employee and the

³⁶ Section 23(2)(a) of the Companies Act.

choice of law of the contract, or whether the legislature intended to adopt a narrower interpretation to govern only employment contracts with services rendered and choice of law of the contract in South Africa and between a foreign company employer and an employee based in South Africa, for instance a South African national or permanent resident who usually lives in or is based in South Africa.³⁷

It is submitted that the latter narrower interpretation is likely to be correct as this approach is in line with the purpose of requiring the registration of foreign companies as external companies in the first place, that of providing a means for serving process. This rationale can be seen in the requirement on an external company to maintain continuously at least one office in South Africa³⁸ and to nominate the name and address of the person in South Africa who has consented to accept service of documents on behalf of the external company and has been appointed by the external company to do so.³⁹

An employee of a foreign company who is based in South Africa should have the convenience of serving process against the employer in South Africa without having to file process in the place where the foreign company is incorporated. If the employee is not based in the South Africa and is based in the same country that the foreign company is incorporated, the employment contract is likely to be entered into in that foreign country, even if the services are rendered in South Africa. The employee is likely to be in South Africa on a temporary basis and is likely to return to his or her country of origin on the termination of the contract. The choice of law in that contract may well be the law of the foreign country and any disputes in terms of the contract are likely to be dealt with by the legal profession and the judiciary in the foreign country unless there are urgent circumstances which make it necessary to involve the South African labour dispute resolution system. The employee is less likely to be inconvenienced by having to serve process in the foreign country and not in South Africa.

³⁷ Brownell "What constitutes an "employment contract within South Africa" - section 23(2) of the Companies Act 71 of 2008" April 2012 *De Rebus*. Brownell prefers the latter interpretation. In contrast, in Tardif and Jonker "Is external company registration in South Africa a permanent establishment trap? available at http://newsletters.usdbriefs.com/2011/Tax/WTA/a111118_1.pdf, obtained on 28 June 2013, interpret section 23(2)(a) using the wide interpretation.

³⁸ Section 23(3)(a) of the Companies Act.

³⁹ Regulation 20(1)(e) and item 4 in Form CoR20.1. This rationale can also be seen in the English case of *South India Shipping Corp Ltd v Export-Import Bank of Korea* [1986] 2 All ER 219 referred to by the author in Brownell "What constitutes an "employment contract within South Africa" - section 23(2) of the Companies Act 71 of 2008" April 2012 *De Rebus*.

The requirement of maintaining an office in South Africa is also an administrative burden which should not be imposed on all foreign companies that have employees in South Africa. This would not augur well towards the purpose of creating flexibility and simplicity in the formation and maintenance of companies.⁴⁰ On this basis the latter narrower interpretation can be said to be more foreign investor friendly.

2.3.2 **Tax issues arising from a foreign company conducting business or having an employee in South Africa**

A foreign company considering entering into an "employment contract within South Africa" or carrying on business in South Africa should consider the following tax issues which could arise if the company needs to register as an external company and correspondingly, maintain at least one registered office in South Africa:

2.3.2.1 Will the registered office in South Africa give rise to a permanent establishment of the foreign company in South Africa?⁴¹

2.3.2.2 Will the foreign company be supplying goods or services in the course or furtherance of an enterprise in or partly in South Africa, and therefore may need to register as a VAT vendor?⁴²

2.3.2.3 Will the foreign company need to register as an employer for income tax purposes?⁴³

2.3.2.4 Will the employee be subject to South African normal tax? If the employee is a South African tax resident, the remuneration received from the foreign company will be subject to employee's tax on the monthly remuneration paid by the foreign company.⁴⁴ However, if the employee is not a South African tax resident, will the employee be subject to employee's tax?⁴⁵

⁴⁰ Section 7(b)(ii) of the Companies Act.

⁴¹ See 2.3.3 below.

⁴² See 2.3.4 below.

⁴³ See 2.3.5 below.

⁴⁴ Paragraph 2 of the Fourth Schedule.

⁴⁵ See 2.3.6 below.

2.3.2.5 What are the consequences of not registering as an external company or not maintaining a registered address in South Africa?⁴⁶

These tax issues will be discussed further below.

2.3.3 **Permanent establishment in South Africa**

The concept of permanent establishment is relevant to the foreign company if the country in which it is tax resident has an effective double tax agreement with South Africa.⁴⁷ The foreign company is not a tax resident in South Africa. Therefore, it will only be subject to South African tax on income arising from a South African source. An applicable double tax agreement will provide relief to the foreign company by providing that South Africa will only have taxing rights on its profits attributable to the foreign company's permanent establishment in South Africa.⁴⁸

A permanent establishment is a fixed place of business through which the business of an enterprise is wholly or partly carried on.⁴⁹ A permanent establishment includes a place of management, a branch or an office.⁵⁰ Nevertheless, the existence of these items in a country is not conclusive proof that a foreign company has a permanent establishment in that country.

A "permanent establishment" is deemed to exclude (i) the use of facilities for storage, display or delivery of goods belonging to the foreign company; (ii) maintenance of stock for purposes set out in (i); or (iii) maintenance of a fixed place of business for purchasing, collecting information, or activities which are of a preparatory or auxiliary character.⁵¹

A person (such as an employee), other than an agent of independent status, who has the authority to enter into agreements on behalf of the foreign company in another country and who habitually exercises this authority can create a

⁴⁶ See 2.3.7 below.

⁴⁷ Most double tax agreements entered into by South Africa are based on the OECD Articles of the Model Tax Convention on Income and Capital (as they read on 22 July 2010). Available at <http://www.oecd.org/tax/treaties/47213736.pdf>. Accessed on 12 February 2013. Therefore, comments on double tax agreements will be limited to the clauses in this treaty. This treaty will be referred to in this dissertation as "OECD Model Tax Convention".

⁴⁸ Article 7(1) of the OECD Model Tax Convention.

⁴⁹ Article 5(1) of the OECD Model Tax Convention.

⁵⁰ Article 5(2)(a), (b) and (c) of the OECD Model Tax Convention.

⁵¹ *Ibid.*

permanent establishment for the foreign company in the other country.⁵² On the other hand, business transacted through a broker, general commission agent or any other agent of independent status acting in the ordinary course of business shall not create a permanent establishment for that foreign company.⁵³ A local subsidiary is also not automatically a permanent establishment of the foreign holding company.⁵⁴

A foreign company is required to register as an external company if it is a party to any employment contract within South Africa.⁵⁵ As an external company, it is required to maintain a registered office in South Africa and to appoint a person to accept service of documents.⁵⁶ It appears as if once a foreign company meets the criteria requiring it to register as an external company, it will need to maintain a registered office in South Africa and with this office, it has a fixed place of business in South Africa and this creates a permanent establishment in South Africa. Further, if the employee which is the subject matter of the employment contract within South Africa requiring the foreign company to register as an external company in the first place, has authority to act on behalf of the foreign company and to enter into agreements in South Africa, then the foreign company will also on this basis, be deemed to have created a permanent establishment in South Africa. However, it is submitted that this is not always the case and it is possible for the foreign company to manage its operations in South Africa in a manner which will minimize the risk of creating a permanent establishment in South Africa. In addition, it is the presence of an office and the carrying on of business through that office which creates a permanent establishment in a country. These two factors must be present before a company creates a permanent establishment in a foreign country.

In BPR 102 *Registration of an external company and identifying a permanent establishment*,⁵⁷ SARS held that a foreign company registering as an external company in terms of the Companies Act 1973 will not create a permanent establishment for that company in South Africa, on condition that the company's place of effective management is outside South Africa and that it will not have any employees or conduct any business activities in South Africa (other than

⁵² Article 5(6) of the OECD Model Tax Convention.

⁵³ Article 5(6) of the OECD Model Tax Convention.

⁵⁴ Article 5(7) of the OECD Model Tax Convention.

⁵⁵ Section 23(2)(a) of the Companies Act.

⁵⁶ Section 23(3)(a) of the Companies Act.

⁵⁷ BPR 102 "Registration of an external company and identifying a permanent establishment" 4 May 2011.

maintaining the external company status for exchange control purposes) and it will also not have a dependent agent operating on its behalf in South Africa.

It is important to note that BPR 102 is a binding private ruling, and thus only binding between the parties to the ruling. The ruling is at best a guide as to how SARS would make a decision when faced with a similar question again. Further, the ruling was made based on section 322 of the repealed Companies Act 1973. This section required a foreign company to register as an external company within 21 business days after the establishment of a place of business in South Africa.⁵⁸ In contrast to the current requirements in the Companies Act, a foreign company did not need to register as an external company on being a party to an employment contract within South Africa but on establishing a place of business in South Africa. There was also no requirement in the Companies Act 1973 for the external company to maintain a physical office in South Africa once it is registered as an external company, as is the requirement currently in section 23(3)(a). "Establishing a place of business" in South Africa has a different meaning to "must continuously maintain at least one office" in South Africa.

To minimise the risk of creating a permanent establishment in South Africa, it is submitted that where possible, a foreign company should not be a party to an employment agreement within South Africa. An alternative to this arrangement is to enter into a service level agreement with an existing South African company and to use the employees of the latter company to render services which the foreign company requires in South Africa. The person rendering the service will be under the supervision and control of the South African company and be remunerated by the South African company. The South African company will be the employer of this person. As it is not a party to an employment contract within South Africa, the foreign company will be assessed in a holistic manner using the factors listed in section 23(2A)(a) to (f) of the Companies Act as to whether it intends to continually engage in business in South Africa.⁵⁹ Importantly, the South African company should not be a dependent agent of the foreign company in South Africa, as this will also create a permanent establishment in South Africa for the foreign company.

If the South African company and the foreign company are connected persons,⁶⁰ the service level fee paid by the foreign company to the South African company

⁵⁸ Section 322(1) of the Companies Act 1973.

⁵⁹ Section 23(2)(b) of the Companies Act.

⁶⁰ As defined in section 1.

should be a benchmarked arm's length fee. The contractual arrangement should also be one which is as much as possible entered into by the South African company in the ordinary course of its business, and which it enters into as an independent agent.

If it is necessary for the foreign company to enter into an employment agreement with an employee in South Africa, the employee should not have the authority to act on behalf of and should not have the authority to enter into agreements and habitually enter into agreements for the foreign company. If the employee concerned is usually based in or living in South Africa, it is submitted that the foreign company is a party to an employment agreement within South Africa, and thus will need to register as an external company within 20 business days of the employee rendering services in South Africa. The foreign company will thus need to continuously maintain at least one office in South Africa. The foreign company may meet the requirement of maintaining a registered office by appointing an agent to be its administrator and to accept documents in South Africa. The appointment of an agent of independent status⁶¹ will not create a permanent establishment of the foreign company in South Africa.

If the employee is a resident of the same country in which the foreign company is incorporated and the services rendered is temporary and ad hoc, it is submitted that the foreign company is not within the ambit of what is referred to as "being a party to an employment contract within South Africa". The foreign company should not be seen to continually engage in a business in South Africa as envisaged in section 23(2)(b) of the Companies Act. Therefore, there is no need for it to register as an external company in South Africa.

The question arises as to whether any income received by the foreign company as a result of the services rendered by the employee in South Africa is income from a South African source. For instance, the foreign company is contracted by a South African company to provide consulting services in South Africa. The South African company will pay the foreign company a consulting fee and the foreign company's employees will render services in South Africa. It is submitted that the originating cause of the income is the services rendered, and the location of the services is South Africa.⁶² As such, the income is from a South African source and is subject to South African income tax, unless there is relief from the

⁶¹ The foreign company could meet this requirement by appointing an independent agent that is an accounting firm which provides company secretarial services.

⁶² *CIR v Lever Brothers & Unilever Ltd* (1946) 74 SATC 213.

double tax agreement. The relief provided in a double tax agreement will be in Article 7 of the OECD Model Tax Convention which provides that income of a foreign resident arising from a South African source will not be subject to tax in South Africa unless such income is attributable to a permanent establishment of the foreign resident in South Africa.

The employee of the foreign company in South Africa could create a permanent establishment of the foreign company in South Africa if the employee is in South Africa for more than 183 days in any twelve month period and the foreign company retains control and responsibility over the employee. No permanent establishment is created if the employee is seconded to a local affiliate in the source country and it is the local affiliate which is the *de facto* employer, although not the *de iure* employer. The local affiliate in the source country gives the employee instructions and pays the remuneration of the employee.⁶³

There is currently no withholding tax on services in South Africa. However, the 2013 Budget Review proposes to introduce a withholding tax on services paid by a resident to a non-resident at the rate of 15% (or a reduced rate in terms of an applicable double tax agreement) with effect from 1 March 2014.⁶⁴ Therefore, in future, any consulting fee payable by a resident to a non-resident will be subject to withholding tax at 15% (or reduced rate in terms of an applicable double tax agreement).

If the foreign company is not a resident in a country with a double tax agreement with South Africa, there is no relief for any service fees paid by a resident company to the foreign company.

2.3.4 **Supply of goods and services in furtherance of an enterprise wholly or partly in South Africa**

A foreign company meeting the criteria for registration as an external company in South Africa and maintaining a registered office in South Africa will not automatically be required to register as a VAT vendor. The foreign company will still need to meet the requirements of registration set out in the VAT Act, which in addition to supplying goods and services in furtherance of an enterprise wholly or

⁶³ OECD "Model Tax Convention on Income and on Capital condensed version" (2012) 251 and De Koker and Brincker *Silke on International Tax* Loose-leaf 18.2.

⁶⁴ National Treasury "Budget Review 2013" (2013) 56. Available online at <http://www.treasury.gov.za/documents/national%20budget/2013/review/Preliims%202013.pdf>. Accessed on 20 June 2013.

partly in South Africa,⁶⁵ include meeting the taxable supply threshold requirements of ZAR 1 million for 12 months for a compulsory registration.⁶⁶ In addition, there are other administrative requirements which need to be met before the foreign company may apply to be registered as a VAT vendor, for instance, the company will need to appoint a representative vendor,⁶⁷ and open a South African bank account.⁶⁸

However, will a foreign company which meets the requirements of registering as a VAT vendor also need to register as an external company? Notably, opening and maintaining a bank account (as is required for an application to be a VAT vendor) by itself should not result in an inference that the foreign company is continually engaging in business in South Africa.⁶⁹

It is submitted that as one of the requirements of applying to be a VAT vendor is the requirement of a supply of goods or services in the furtherance of an "enterprise", which is generally defined as "... any enterprise or activity carried on continuously or regularly ..." in South Africa or partly in South Africa, it is likely that such a foreign company will also need to register as an external company. The exception of this is when a foreign company operates in South Africa on a once-off project basis. In this instance, the foreign company may still want to register as a VAT vendor as it will be able to claim input VAT on the invoices it pays.

An interesting development is the announcement in the 2013 Budget Review of the proposal to require all foreign businesses supplying e-books, music and other digital goods and services in South Africa to register as VAT vendors.⁷⁰ This proposal may be difficult to implement and enforce. Further, it is submitted that unless a special dispensation is provided for their application to be a VAT vendor, they will also be required to register as external companies in terms of the Companies Act. It is also likely that the nature and pattern of their businesses are such that the major content providers with a significant customer base in South Africa, albeit online customers, will have met the requirement of registering as an

⁶⁵ Section 7(1)(a) of the VAT Act.

⁶⁶ Section 23(1)(a) of the VAT Act.

⁶⁷ Section 23(2)(a) of the VAT Act.

⁶⁸ Section 23(2)(b) of the VAT Act.

⁶⁹ Section 23(2A)(b) of the Companies Act.

⁷⁰ National Treasury "Budget Review 2013" (2013) 59. Available online at <http://www.treasury.gov.za/documents/national%20budget/2013/review/Prelims%202013.pdf>. Accessed on 20 June 2013.

external company as such a company would already be continually engaging in business in South Africa as envisaged in section 23(2)(b) of the Companies Act.

2.3.5 **Registration of foreign company as an employer for purposes of the Income Tax Act**

If it is necessary to withhold employees' tax from the remuneration of any employees of a foreign company rendering services in South Africa, the foreign company may appoint a representative employer⁷¹ that will act as its agent with the authority to withhold the employees' tax and pay the remuneration to the employee.⁷² The representative agent can be an accounting firm running the payroll of the foreign company in South Africa. The agent will usually have the responsibility of meeting all the compliance obligations of the foreign company in terms of the Income Tax Act. The foreign company thus need not register as an employer in South Africa for the purposes of the Income Tax Act.

2.3.6 **Tax position for the employee of the foreign company**

If the employee of the foreign employer is a South African resident, then the employee is subject to normal tax⁷³ on his/her income received on a worldwide basis (unless section 10(1)(o)(ii) exemption on income earned outside South Africa applies).

If the employee of the foreign employer is not a South African resident and is resident in a country with a double tax agreement with South Africa, then article 15 of the OECD MTC provides that South Africa does not have taxing rights on the employment income received by the employee in respect of services rendered in South Africa if the employee was not in South Africa for more than 183 days in any twelve month period, the remuneration was paid by a non-resident employer, and the remuneration is not borne by a permanent establishment in South Africa.

2.3.7 **Consequences of not registering as an external company or not maintaining a registered address in South Africa**

A foreign company that does not register as an external company when it is required to do so, may be subject to a compliance notice issued by the

⁷¹ An example of this is a company which offers payroll services in South Africa.

⁷² Paragraph (3) of the definition of "representative employer" read with paragraph 2(1)(b) of the Fourth Schedule.

⁷³ As defined in section 1.

Commission requiring the company to register within 20 business days or otherwise to cease carrying on business or activities in South Africa.⁷⁴ It is submitted that the repercussions of not registering as an external company in terms of the Companies Act may not be serious enough to motivate foreign companies to register as external companies, given the necessity of maintaining a registered office in South Africa on registration and the risk of this creating a permanent establishment of the foreign company in South Africa and the resulting taxability of business profits in South Africa of any income attributable to that permanent establishment.

2.4 **Domesticated companies in terms of the Companies Act and whether it is a tax resident in South Africa**

The South African tax system is a residence-based or world-wide based system. A South African tax resident is subject to tax on its worldwide gross income, whereas a non-resident is only subject to tax on income arising from a South African source.

A South African tax resident is a person (other than a natural person) which is a company incorporated, established or formed in South Africa, or which has its place of effective management in South Africa. A foreign company can thus be deemed to be a resident in South Africa if it has its place of effective management in South Africa.⁷⁵

There is no difference in the rate of taxation on the taxable income of a South African resident company and a non-resident company. Both types of companies are subject to tax at 28%.

The Companies Act provides for a foreign company that is registered in a foreign jurisdiction to transfer its registration to South Africa. Once the registration of the foreign company is transferred, the foreign company exists as a company in terms of the Companies Act as if it had been originally so incorporated and registered in terms of this statute.⁷⁶

A company which is registered in South Africa is automatically a tax resident in South Africa unless a place of effective management tie-breaker clause in an applicable double tax agreement provides otherwise. Therefore, a foreign company which is

⁷⁴ Section 23(6) of the Companies Act.

⁷⁵ A foreign company can also elect to be a "headquarter company" as set out in section 9I. A headquarter company must meet the "asset test" and "income test" set out in section 9I(2). The headquarter company regime has favourable holding company features such as no withholding taxes on dividends, relaxation of exchange control requirements on repatriation of offshore dividends received, no thin capitalisation requirements, and no deeming of income from its "control foreign companies."

⁷⁶ Section 13(5) of the Companies Act.

registered in another jurisdiction will automatically become a tax resident in South Africa (if it is not already) on transferring its registration to South Africa in terms of section 15(4) of the Companies Act. This brings all its assets into the South African tax net with a deemed disposal and acquisition at market value of its assets on the day it becomes a resident.⁷⁷ Should it cease to be a resident in the future, this triggers capital gains exit taxes on the company.⁷⁸ Given such unfavourable tax implications on becoming and ceasing to be tax resident, one questions the reason why a foreign company would choose to be a domesticated company in terms of the Companies Act.

The answer is in the requirements on the foreign company before it may transfer its registration to South Africa. A foreign company may only transfer its registration to South Africa if all the following requirements are met:⁷⁹

- 2.4.1 the law of the jurisdiction in which it was registered permits the transfer and the foreign company has met all requirements in that jurisdiction for the transfer;
- 2.4.2 the transfer must be approved by "special resolution" of its shareholders; the whole or greater part of its assets and undertaking are within South Africa, other than assets and undertaking of any subsidiary that is incorporated outside South Africa;
- 2.4.3 the majority of its shareholders are resident in South Africa;
- 2.4.4 the majority of its directors are or will be South African citizens; and
- 2.4.5 immediately following the transfer of registration, the company will satisfy the solvency and liquidity test and will no longer be registered in another jurisdiction.

Given the above requirements, the foreign company is likely to have its place of effective management in South Africa (if the citizens are based in South Africa) and most of its assets within the South African tax net already. Therefore, it would most likely already be a South African tax resident and transferring its registration from another jurisdiction is unlikely to result in more tax inefficiencies.

However, despite meeting the above requirements, a foreign company may not transfer its registration to South Africa if it is permitted to issue bearer shares, is in liquidation or a receiver or manager has been appointed in relation to its property, is engaged in

⁷⁷ Paragraph 12(1) and (2)(a) of the Eighth Schedule.

⁷⁸ Section 9H(3). See discussion of these exit taxes by Ger "SARS overreacts after SCA decision on exit taxes" *TAXtalk* (2012) 22.

⁷⁹ Section 13(6) of the Companies Act.

business rescue or an application has been lodged for the company to be declared insolvent.⁸⁰

The transfer of registration of a foreign company to South Africa and it becoming a domesticated company should be distinguished from the process where a company incorporated in terms of the Companies Act transfers its registration to another jurisdiction and deregisters its registration in South Africa.

A company may apply to be deregistered upon transfer of its registration to a foreign company if the shareholders of the company have adopted a special resolution approving such an application and transfer of registration and the company has satisfied the prescribed requirements for doing so, which include the satisfactory evidence that the company satisfies the requirements to register in the foreign jurisdiction.⁸¹

If the company ceases to be a tax resident in South Africa on it deregistering from South Africa, then the capital gains exit taxes in terms of section 9H will be triggered. It will be deemed to have distributed a dividend *in specie* for which it would have to be liable for dividends tax. However, if the place of effective management of the company has been outside South Africa (which may be a reason for it deregistering from South Africa in the first place), then the company may already have ceased to be tax resident in South Africa before its deregistration.

Given the tax risks involved in domesticated companies and deregistering a company as a result of it being registered in another jurisdiction, it is submitted that these measures should be adopted only as a last resort, for instance, if such companies held valuable assets which cannot be transferred easily to another entity.

2.5 **Non-profit companies and public benefit organisations**

In terms of the Companies Act, a non-profit company is incorporated for a public benefit or other specified object⁸² and the income and property of this company is not usually distributable to its incorporators, members, directors, officers or persons related to any of them.⁸³

Although the attributes of the categories of companies set out in the Companies Act (and the common law as well as any other relevant statute) lend themselves towards a

⁸⁰ Section 13(7) of the Companies Act.

⁸¹ Section 82(5) of the Companies Act read with regulation 40(8).

⁸² As required by item 1(1) of Schedule 1 of the Companies Act.

⁸³ Definition of "non-profit company" in section 1 of the Companies Act.

particular treatment in these tax statutes, further requirements will need to be met in a relevant tax statute before qualifying for a more advantageous tax regime.

A non-profit company in the Companies Act will thus further need to meet the requirements in section 30 to be a "public benefit organization" (or section 30A to be a "recreational club" or section 30B to be an "association" which is established to promote the common interests of persons carrying on any particular kind of business, profession or occupation). A non-profit company will also need to meet the requirements of the VAT Act on "welfare organization" before it can apply to be a VAT vendor.

Therefore, incorporating a non-profit company in terms of the Companies Act is the first step towards achieving tax exempt status. The other requirements of the Income Tax Act will still need to be met.

3. Securities (shares)

3.1 Preliminary

The Companies Act defines "securities" as any shares, debentures or other instruments, irrespective of their form or title, issued or authorised to be issued by a profit company.⁸⁴ The discussion on "securities" in this dissertation covers shares in 3 below, and instruments other than shares (i.e. debt instruments) in 4 below.

A "share" is defined in the Companies Act as "*one of the units into which proprietary interest in a profit company is divided*".⁸⁵ The definition of "share" in the Income Tax Act,⁸⁶ which was amended with effect from 1 January 2013 to bring it closer to the meaning of "share" as defined in the Companies Act, now reads as follows: a "share" means, "*in relation to any company, any unit into which the proprietary interest in that company is divided.*" It is not an exact alignment but should be close enough that the definitions in both these statutes do not result in any conceptual difficulties arising as a result of any differences.

It is submitted that the amendment to the definition of "shares" in the Income Tax Act is a step in the right direction as a "share" is a legal construct arising in the context of the share capital of companies and is thus relevant to the manner of all things relevant to this, for instance, distributions, share repurchases, and classes of shares. Thus, the

⁸⁴ Section 1 of the Companies Act.

⁸⁵ Section 1 of the Companies Act.

⁸⁶ Section 1(1).

Income Tax Act as a taxing statute, in seeking to "tax" the economic gain enjoyed by a shareholder, should, as much as possible, use concepts and terminology used in the Companies Act. The process of drafting and interpreting both statutes should not be the other around, with the Companies Act taking the lead from the Income Tax Act as this would end any effort of creating simplicity in the creation and maintenance of companies.⁸⁷

Unfortunately, concepts which are fundamental to company law are used in the Income Tax Act in much more complex forms, to the extent that a similar concept in the Companies Act is but a starting point. Often the complexity is inadvertent and a result of efforts to curb avoidance schemes or arrangements. This dissertation will discuss the differences between the two statutes on the following sub-topics relating to shares:

- 3.1.1 classes of shares, focusing on the difference between ordinary and preference shares on the one hand, and equity and non-equity shares on the other, and the relevance of the classification when applying the anti-avoidance sections of section 8E on hybrid equity instruments, and section 8EA on third-party backed shares;⁸⁸
- 3.1.2 the flexibility of the board to determine what is "adequate" consideration and the newly introduced value mismatch provisions in the Income Tax Act;⁸⁹
- 3.1.3 the wide definition of "consideration" in the Companies Act and the practical issues with determining "contributed tax capital" for the purposes of the Income Tax Act;⁹⁰
- 3.1.4 the issue of shares for future services, future benefits or future payment in terms of section 40(5) of the Companies Act and tax implications arising from this.⁹¹

3.2 **Classes of shares**

3.2.1 **Nature and classes of shares in terms of company law**

Shares represent the proprietary rights that a person holds in a company.⁹² A share gives the holder a proportionate part of the assets of the company, whether

⁸⁷ This is listed as one of the purposes of the Companies Act in section 7(b)(ii).

⁸⁸ See 3.2 below.

⁸⁹ See 3.3 below.

⁹⁰ See 3.4 below.

⁹¹ See 3.5 below.

⁹² FHI Cassim, MF Cassim, R Cassim, Jooste, Shev, Yeats *Contemporary Company Law* (2012) 213.

by way of dividend or distribution of assets in winding up.⁹³ They are rights of action which give their owner a certain interest in the company, its assets and its dividend.⁹⁴

All shares in a class should have preferences, rights, limitations and other terms that are identical to those of other shares in the same class.⁹⁵ It is however, possible for a company to have classes of shares with differing preferences, rights, limitations and other terms. The Memorandum of Incorporation of a company must set out the classes of shares and with respect to each class of shares, the distinguishing designation and preferences, rights, limitations and other terms associated with that class.⁹⁶

The division of classes of shares may be made on the basis of, amongst others, dividend rights, participation in a distribution on liquidation, voting rights, redemption rights and convertible rights. From a company law perspective, a company has unlimited freedom to create the capital structure it requires and to structure the rights of its shareholders in a variety of ways.⁹⁷ The two most common classes of shares in company law (and in the Memorandum of Incorporation of companies) are ordinary shares and preference shares.

Ordinary shares are shares with rights to participate fully in the dividends distributed and in the return of capital on liquidation of a company. Preference shares are shares with preferential rights on the dividends distributed and in the return of capital on liquidation relative to the rights of the ordinary shareholders. Where a company has ordinary and preference shares in issue, ordinary shareholders have no preferred rights and the preference shareholders have preferred rights over the ordinary shareholders.

In terms of company law, preference shareholders usually have a preferential right to a dividend. However, this is still subject to the company meeting the requirements of the Companies Act for making a distribution in terms of section 46 and the company declaring the distribution in terms of the Companies Act, Memorandum of Incorporation and rules of the company. Preference

⁹³ *Bradbury v English Sewing Cotton Co Ltd* [1923] AC 744 (HL) at 746, as referred to in FHI Cassim, MF Cassim, R Cassim, Jooste, Shev, Yeats *Contemporary Company Law* (2012) 213.

⁹⁴ *Randfontein Estates Ltd v The Master* 1909 TS 978 at 981-2 followed in *De Leef Family Trust and Others v Commissioner for Inland Revenue* 1993 (3) SA 345 (A) at 288, as referred to FHI Cassim, MF Cassim, R Cassim, Jooste, Shev, Yeats *Contemporary Company Law* (2012) 214.

⁹⁵ Section 37(1) of the Companies Act.

⁹⁶ Section 36(1)(a) and (b), but subject to (d).

⁹⁷ FHI Cassim, MF Cassim, R Cassim, Jooste, Shev, Yeats *Contemporary Company Law* (2012) 216.

shareholders do not usually have the right to participate in surplus profits unless the preference share terms expressly provide that they do, in which case they will be referred to as the participating preference shareholders. Therefore, unless expressly provided in the preference share terms, the preference shareholders have the right to participate in profits of the company up to the fixed percentage dividend to which they are entitled.

Preference shares can also be cumulative, which give the holder a prior right to both current and arrear preference dividends. The general presumption is that unless the preference share terms state otherwise, preference shares are *prima facie* cumulative.⁹⁸ Where dividends must first be declared before they can be claimed, cumulative preference shares do not have preferential rights on cumulative but undeclared dividends. However, this may be changed in the preference share terms which give cumulative preference shareholders the right to be paid arrear dividends before capital is repaid to ordinary shareholders.⁹⁹

In terms of the Companies Act, both ordinary and preference shares can be redeemable, although it is more common for preference shares to be redeemable. Importantly, despite similarities between a redeemable share and debt, such a share is not debt.¹⁰⁰ In *Choice Holdings Ltd v Yabeng Investment Holding Co Ltd*,¹⁰¹ the court held that "*in the event of the redemption of a preference share, the company, of course, pays its shareholders the sum concerned and in this sense there is, throughout the duration of the shareholdership, a vinculum juris between shareholder and company which may ripen into an enforceable debt*", but "*this fact cannot render a shareholder, including a shareholder of preference shares, a prospective or contingent creditor within the meaning of the Companies Act.*"¹⁰²

3.2.2 "Equity shares" in terms of the Income Tax Act

An "equity share" is defined in section 1(1) "*as any share in a company, excluding any share that, neither as respects dividends nor as respects returns of*

⁹⁸ Cassim, MF Cassim, R Cassim, Jooste, Shev, Yeats *Contemporary Company Law* (2012) 217.

⁹⁹ *Ibid.*

¹⁰⁰ See *Durban Add-Ventures Ltd v Premier, KwaZulu-Natal (No 1)* 2001 (1) SA 384 (N), as referred to in Cassim, MF Cassim, R Cassim, Jooste, Shev, Yeats *Contemporary Company Law* (2012) 220.

¹⁰¹ 2001 (3) SA 1350 (W), as referred to in FHI Cassim, MF Cassim, R Cassim, Jooste, Shev, Yeats *Contemporary Company Law* (2012) 220.

¹⁰² *Ibid.*

capital, carries any right to participate beyond a specified amount in a distribution."¹⁰³

At first blush, it appears as if an ordinary share in terms of company law would be an equity share and a preference share would not be an equity share. However, the distinction and implications for these types of shares are more nuanced.

A share which has an unlimited right to participate in dividends or an unlimited right to participate in returns of capital is an equity share. Given that an ordinary share in a company usually grants its holder residual rights in dividends and returns of capital, it is likely that an ordinary share would be treated as an equity share in terms of the Income Tax Act. However, a preference share could be considered an equity share if the preference share terms provide for one of the following - an unlimited right to participate in dividends or an unlimited right to participate in returns of capital. From the definition of "equity share" in the Income Tax Act, it is not necessary for a preference share to have both these characteristics to be classified as an "equity share" for tax purposes. The usage of "*neither .. nor ..*" in the definition means that a share must have both a limited right to dividends and a limited right to returns of capital before it is excluded from being an equity share. The classification of shares in terms of company law and the name of the share used are not conclusive in determining the classification of the share for tax purposes and it is imperative that the terms of the share concerned be considered further.

3.2.3 **Hybrid equity instruments in terms of section 8E**

Dividends earned by a taxpayer are largely exempt from normal tax.¹⁰⁴ As an anti-avoidance measure, section 8E provides that any dividend or foreign dividend received by or accrued to a person in respect of a "hybrid equity instrument" must be deemed to be an amount of income from the perspective of the recipient.¹⁰⁵ This means that the recipient will not be able to deduct the dividend earned as exempt income in terms of section 10(1)(k). There is disparity in the treatment of dividends arising from hybrid equity instruments as despite the dividend being taxed in the hands of the recipient, the dividends distributed will still not be deductible by the company making the distribution.

¹⁰³ Section 1(1).

¹⁰⁴ Section 10(1)(k).

¹⁰⁵ Section 8E(2).

The definition of "hybrid equity instrument" in section 8E provides for features of three different types of shares that would be considered to be "hybrid equity instruments":

- 3.2.3.1 paragraph (a) of the definition provides for features of "any share, other than an equity share";
- 3.2.3.2 paragraph (b) of the definition provides for features of "any share, other than a share contemplated in (a)"; and
- 3.2.3.3 paragraph (c) of the definition provides for features of "any preference share";

which would result in these shares being classified as a "hybrid equity instrument".

In considering whether the shares of a company, say Co X, fall within the ambit of being hybrid equity instruments, the first port of call is to consider whether the shares of Co X are "equity shares".

If these shares are "equity shares", then it will be necessary to apply the features in paragraph (b) to the features of the shares (which are equity shares). It is submitted that since paragraph (a) deals with shares other than equity shares, and paragraph (b) deals with shares other than a share contemplated in paragraph (a), then paragraph (b) must then deal with equity shares. A share can only be classified in terms of the Income Tax Act, as an equity share or not an equity share.

If the features of the (equity) shares of Co X do not have the features as set out in paragraph (b), then it will only be necessary to consider the features in paragraph (c) if the amount of any dividend or foreign dividend in respect of these shares is based on or determined with reference to a specified rate of interest or time value of money. This is because the shares could still be classified as "preference shares" in terms of the definition of "equity shares" in section 8E, which refers to the definition of "preference shares" in section 8EA.¹⁰⁶

If the dividend in respect of the (equity) shares in Co X is determined annually by the board as is usually the case for ordinary shares, then these (equity) shares

¹⁰⁶ Paragraph (b) of the definition of "preference shares" in section 8EA provides for the features of "equity shares" which would cause such shares to be classified as "preference shares" for purposes of this section.

are not hybrid equity instruments and there is no need to consider paragraph (c) at all.

Paragraph (a) of the definition of "hybrid equity instrument" in section 8E and the features listed appear to be those of redeemable preference shares.¹⁰⁷ If the shares in Co X are not equity shares, then it will be necessary to consider whether any of the features listed in paragraph (a) of the definition apply to them. In addition, if the shares are not equity shares, these shares would automatically be "preference shares" as defined in section 8E read with the definition in section 8EA, and it will also be necessary to consider if the features in paragraph (c) apply to them.

3.2.4 **Third-party backed shares in terms of section 8EA**

Continuing with our analysis of the shares of Co X, if the shares are not "equity shares", these shares would be considered "preference shares" as defined in section 8EA. It would be further necessary to consider whether the features of these shares would cause these shares to fall within the definition of "third-party backed shares". However, it will only be necessary to consider the features of "third-party backed shares" in relation to the shares of Co X shares which are equity shares if the yield on these shares is based on a specified rate of interest or time value of money.

3.3 **Issue of shares for "adequate consideration"**

3.3.1 **Authority to issue shares for adequate consideration**

Unlike the Companies Act 1973, the Companies Act empowers the board of a company generally to issue shares,¹⁰⁸ but only within the classes, and to the extent, that the shares have been authorised by or in terms of the company's Memorandum of Incorporation.¹⁰⁹ The board of a company may issue authorised shares for adequate consideration, as determined by the board of directors.¹¹⁰ The board must determine the consideration and terms for the issue of the shares before the issue.¹¹¹ The adequacy of the consideration as determined by the board cannot be challenged on any basis other than in terms of a breach of

¹⁰⁷ Davis, Olivier, Urquhart, Engels, Roeleveld, Wessels *Juta's Income Tax* Loose-leaf 8E-4.

¹⁰⁸ The exceptions when special resolutions are required are set out in section 41 of the Companies Act, which include the issue of shares to directors or persons related to the company.

¹⁰⁹ Section 38(1) of the Companies Act.

¹¹⁰ Section 40(1) of the Companies Act.

¹¹¹ Section 40(2) of the Companies Act.

the standards of directors conduct¹¹² and the personal liability of the director as a result of this breach.¹¹³

The Companies Act defines "consideration" broadly to mean:

"anything of value given and accepted in exchange for any property, service, act, omission or forbearance or any other thing of value, including -

(a) any money, property, negotiable instrument, securities, investment credit facility, token or ticket;

(b) any labour, barter or similar exchange of one thing for another; or

*(c) any other thing, undertaking, promise, agreement or assurance, irrespective of its apparent or intrinsic value, or whether it is transferred directly or indirectly."*¹¹⁴

The wide definition of consideration for the issue of shares thus includes the issue of shares for an asset, for services rendered and even includes an undertaking or agreement presumably made by the shareholder to the company. The board must thus simply be satisfied that the consideration for the shares, whether financial or otherwise, is adequate.

Unlike company statutes in other jurisdictions such as the Companies Act in New Zealand,¹¹⁵ the Companies Act does not impose any obligation on the board to value any non-financial consideration and to pass a resolution that it is satisfied that the consideration is adequate and fair and reasonable to the company and to the rest of the shareholders. The courts have also been reluctant to inquire closely in the value of the consideration for shares unless it is glaringly inadequate or there was evidence of fraud or of an absence of any *bona fide* valuation of the consideration.¹¹⁶

From the above, it appears as if the board of directors is given the flexibility and the discretion to determine what it considers to be adequate consideration for the

¹¹² As set out in section 76 of the Companies Act.

¹¹³ Section 77(2) of the Companies Act.

¹¹⁴ Section 1 of the Companies Act.

¹¹⁵ The safeguards in section 47 of the New Zealand Companies Act, No 105 of 1993 include the obligation on the board to determine the present cash value of the consideration and to resolve that this value is not less than the amount to be credited for the issue of the shares and that the value is fair and reasonable to the company and to all existing shareholders.

¹¹⁶ *Ooregum Gold Mining Co of India v Roper and Wallroth* [1892] AC 125 (HL) 136 to 7, as referred to in FHI Cassim, MF Cassim, R Cassim, R Jooste, J Shev, J Yeats *Contemporary Company Law* (2012) 226.

issue of shares in the company. There is no additional requirement on the exercise of the board's discretion even for issue of shares for assets or non-pecuniary consideration.

The above flexibility to directors to determine the adequacy of consideration for the issue of shares should be considered in light of the new value mismatch provisions introduced in the Income Tax Act by the Taxation Laws Amendment Act 22 of 2012.¹¹⁷

The purpose of the value mismatch amendments in the Income Tax Act is to target schemes with uneven exchanges when shares are issued that enable value to be transferred to or from the company for the issue of the company's shares without triggering the appropriate tax due either to the company or to the shareholder.

3.3.2 **Section 24BA - issue of shares for assets of unequal value to the shares**

Section 24BA was introduced to deal with value mismatches when shares are issued for assets. Importantly, section 24BA applies¹¹⁸ where the consideration for the issue of shares is different to an arm's length consideration before taking into any account any other transaction, operation, scheme, agreement or understanding that directly or indirectly affects that consideration.

Section 24BA provides that where the market value of the asset disposed of by the taxpayer exceeds the market value of the shares issued, the issuing company will be subject to a capital gains tax on the difference.¹¹⁹ The difference will also reduce the base cost of the shares for the shareholder or tax cost if the shares are held as trading stock.¹²⁰

Where the market value of the shares exceed the market value of the assets, the difference is deemed to give rise to a deemed dividend distribution *in specie* with the company being liable for the 15% dividends tax.¹²¹ The base cost or tax cost

¹¹⁷ The amendments introduced include the repeal of value-shifting rules in the Eighth Schedule.

¹¹⁸ Subject to section 24BA(4), which is that this section does not apply when the company and the shareholder disposing of the asset form part of the same group of companies.

¹¹⁹ Section 24BA(3)(a). This section overrides paragraph 11(2)(b) of the Eighth Schedule which provides that the issue of shares is not a disposal.

¹²⁰ Section 24BA(3)(a)(ii). The base cost or the tax cost of the shares for the shareholder is the market value of the asset, reduced by the difference in value between the asset and the shares as required in terms of this section. The base cost or tax cost of the asset to the company is the market value of the shares immediately after the acquisition of the asset (section 40CA(1)).

¹²¹ Section 24BA(3)(b).

of the shares for the shareholder will not be adjusted in this instance, and will be the market value of the assets disposed.¹²²

The application of section 24BA to the issue of shares in exchange for assets to correct value mismatches can thus be detrimental to both the company issuing the shares and the shareholder disposing of the "mismatched" asset.

Importantly, section 24BA does not apply where the company and the shareholder disposing of the asset to the company form part of the same group of companies.¹²³ The special rules in Chapter II Part III, which will be referred to in this dissertation as the "corporate rules",¹²⁴ generally take precedence over all other provisions in the Income Tax Act except for, amongst others, sections 24B(2) and 24BA.¹²⁵ As most of the corporate rules apply between companies in the same group of companies,¹²⁶ section 24BA should thus not apply in the majority of transactions relying on the rollover relief in the corporate rules.

3.3.3 **Section 24B - shares acquired in exchange for shares issued**

Where the asset concerned are shares in another company, then section 24B takes precedence over section 24BA.¹²⁷ The application of section 24B(2) can be explained using the following example. Section 24B(2) provides that where Co X is issued shares in Co Y directly or indirectly in exchange for the issue of shares in Co X (or a connected person to Co X), then the base cost or tax cost of the Co Y shares in the hands of Co X is deemed to be nil. Section 24B(2) is then further qualified by section 24B(2A), 24B(2B) and 24B(2C), which take precedence over section 24B(2).

¹²² Paragraph 11(1)(a) read with paragraph 6.1.1.5 of the SARS "Comprehensive Guide to Capital Gains Tax" (Issue 4). Available at <http://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20-%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax%20-%20External%20Guide.pdf>. Accessed on 10 August 2012. The base cost or tax cost of the asset to the company will still be the market value of the shares immediately after the acquisition of the asset (section 40CA(1)).

¹²³ Section 24BA(4). This section uses the definition of "group of company" as the term is defined in section 1 and not the narrower definition in section 41.

¹²⁴ The corporate rules provide rollover relief in specified transactions for income tax and capital gains tax consequences for trading stock, capital assets and allowance assets transferred.

¹²⁵ Section 41(2).

¹²⁶ As defined in section 41(1).

¹²⁷ Section 24BA(3).

3.3.4 **Section 40CA - base cost or tax cost of asset acquired in exchange for shares**

If section 24B does not apply, section 40CA(1) provides that the base cost or tax cost of an asset acquired in exchange for shares issued by a company to be the market value of the shares issued immediately after the acquisition. If the asset is acquired in exchange for debt issued by the company, the base cost or tax cost of the asset acquired is equal to that amount of debt.

3.4 **Whether value of "consideration" for the Companies Act is the value used for "contributed tax capital" for tax purposes**

The wide definition of "consideration" in the Companies Act gives rise to a number of issues. The discussion in this paragraph will focus on one of the issues, being the value of the consideration for the issue of shares accepted for Companies Act purposes and whether this value is also the value of the consideration accepted for the purposes of "contributed tax capital" in the Income Tax Act.

The definition of "consideration" in the Companies Act is wide and includes pecuniary and non-pecuniary consideration as long as it is "anything of value". The wide definition gives rise to a number of problems. The root of the problems lies in the adaptation of a more comprehensive definition of "consideration" in the South African Consumer Protection Act 68 of 2008 to the definition used in the Companies Act.¹²⁸ Although definitions can be adapted from other statutes, here the adaptation of "consideration" in the Companies Act is problematic as it contains elements which may not be appropriate in a company law context.¹²⁹

The term "consideration" when used as a noun and not as a verb¹³⁰ is only used in the context of consideration received or paid in the issue or acquisition of securities in the Companies Act.¹³¹ Therefore, it is submitted that the preamble of the definition of "consideration" which refers to "anything of value given and accepted in exchange for any property, service, act, omission or forbearance or any other thing of value" (our emphasis) obfuscates rather than clarifies what is acceptable as consideration in the context in which the term is used in the Companies Act, which is the *quid pro quo* for

¹²⁸ Indeed, the Canadian lawyer who drafted the Consumer Protection Act was commissioned by the Department of Trade and Industry to draft the Companies Act.

¹²⁹ Delpont and Vorster *Henochsberg on the Companies Act* (2011) 21.

¹³⁰ For instance, the term is used as a verb in section 152 of the Companies Act "consideration of business rescue plan".

¹³¹ See, for instance, section 40 of the Companies Act.

the issue of or exchange for securities.¹³² Although the emphasized words may be relevant in casting the widest possible net for consumer protection legislation, they are irrelevant in company law, and even less relevant to a taxing statute.

The specific inclusions in paragraphs (a) to (c) also add to the lack of clarity, with paragraph (a) being the clearest and paragraph (c) the most unclear. Paragraph (c) refers to "*any other thing, undertaking, promise, agreement or assurance, irrespective of its apparent or intrinsic value, or whether it is transferred directly or indirectly.*" (Our emphasis.) The Oxford Concise English Dictionary defines "apparent" as "readily visible or perceivable" and "intrinsic" as "inherent, essential or belonging naturally". Therefore, paragraph (c) can be interpreted to mean any other thing regardless of its obvious or natural value. This suggests that there is another value to the "thing" in addition to its apparent or intrinsic value. Which value then should be taken into account as the value of the consideration for the issue of shares - the apparent or intrinsic value or the "other value"?

As mentioned in 3.3.1 above, there is no further requirement for the board of directors to value and disclose to the existing shareholders such value of any non-pecuniary consideration received for the issue of the shares in the company. There is, however, a requirement that a company's annual financial statements must show the company's assets, liabilities and equity, as well as its income and expenses, and any other prescribed information.¹³³ In addition, where a company's annual financial statements are to be audited, and securities have been issued to a director, prescribed officer or related person, the statements must include the consideration received by the company for such issue.¹³⁴ Notably, a company is required to enter in its securities register every transfer of any certificated securities, amongst others, the value of any consideration still to be received by the company on each share or interest, in the case of a transfer of securities contemplated in section 40(5) and (6) of the Companies Act.¹³⁵ There is no requirement in terms of the Companies Act to enter in the securities register the value of the consideration received, although in practice this is usually done.

It is submitted that although it is not a strict requirement on the board to do so in terms of the requirements to issue shares in the Companies Act, it is probably necessary for

¹³² In contrast, see the clearer description of "consideration" in the New Zealand Companies Act, No 105 of 1993, which provides in section 46 that the "*consideration for which a share is issued may take any form and may be cash, promissory notes, contracts of future services, real or personal property, or other securities of the company*".

¹³³ Section 29(1)(c) of the Companies Act.

¹³⁴ Section 30(4)(d) of the Companies Act.

¹³⁵ This is discussed in 3.5 below.

the board to value any non-pecuniary consideration received on the issue of shares at the time of issue in order for the company to meet its obligations to prepare accounting records and financial statements. In fact, it is submitted that it would be prudent and necessary for the company to do so if only to pre-empt any potential challenge by SARS that the value mismatch provisions discussed in 3.3 above applied to the issue of shares.

The definition of "contributed tax capital" in the Income Tax Act includes an amount equal to the sum of the consideration received by or accrued to that company for the issue of shares of that class on or after January 2011 reduced by any amount transferred for the benefit of the holder of shares of that class on or after 1 January 2011.¹³⁶ The Income Tax Act does not define "consideration". Existing jurisprudence on "amount"¹³⁷ and the use of the phrase "equal to the sum of" is clear indication that contributed tax capital can include pecuniary and non-pecuniary amounts, and it is submitted, correctly so. If non-pecuniary amounts are acceptable in the Companies Act, they should equally be acceptable in the corresponding taxing statute, being the Income Tax Act.

The share capital of a company recorded in its financial statements was the starting point to determine whether an amount is subject to secondary tax on capital.¹³⁸ The share capital and share premium (in terms of the Companies Act 1973 where it was possible to issue shares at par value) largely represented the paid up capital of a company and distributions to a shareholder out of the share capital and share premium of a company were not subject to secondary tax on companies (or the current dividends tax), but were considered to be returns of capital potentially subject to capital gains tax.¹³⁹

It is submitted that the starting point to determine the consideration received by or accrued to a company for the issue of shares would still be the value recorded in the company's financial statements as "share capital". At the time of a specific issue, the share capital of a company from that issue should be equal to its "contributed tax

¹³⁶ Section 1.

¹³⁷ See for instance, jurisprudence on "total amount in cash or otherwise" in the context of the "gross income" definition, including seminal cases such as *Commissioner for Inland Revenue v Delfos* (1933) 6 SATC 92, *Lace Proprietary Mines Ltd v Commissioner for Inland Revenue* (1938) 9 SATC 349 and *Commissioner for Inland Revenue v Butcher Brothers (Pty) Ltd* (1945) 13 SATC 21.

¹³⁸ Sections 64B and 64C, which have been replaced by the new dividends tax regime in Chapter 2 Part VIII of the Income Tax Act.

¹³⁹ Paragraphs 76 and 76A of the Eighth Schedule.

capital" as both should be the amounts received by or accrued to the company.¹⁴⁰ However, going forward the value of the "contributed tax capital" of a company may differ from the value of its "share capital". A key reason for this is the proviso to the definition of "contributed tax capital" which provides that the amounts transferred to a shareholder must not exceed an amount that bears to the total contributed tax capital attributable to that class of shares immediately before the transfer the same ratio as the number of shares of that class held by the shareholder bears to the total number of shares of that class.¹⁴¹ Disproportionate transfers would thus result in a different amount left as "share capital" to "contributed tax capital". It may thus be necessary for companies to maintain different records of their share capital for accounting and dividends tax purposes.

3.5 Issue of shares in terms of sections 40(5) and 40(6) of the Companies Act

3.5.1 The issue of shares for "delayed" consideration

When a company has received the consideration for the issue of shares that is approved by the board, the shares are considered to be fully paid, and the company must issue the shares and register the name of the holder in its securities register.¹⁴² However, where the subscription price is an instrument such that the value of the consideration cannot be realised by the company until a date after the date of issue, or is in the form of an agreement for future services, future benefits or future payment by the subscriber, the company is regarded as having received the consideration at any time only to the extent that the value of the consideration has been realised by the company or the subscriber has fulfilled its obligations in terms of the agreement.¹⁴³

Regardless of the time that the consideration is received, the company must issue the shares immediately and "*cause the issued shares to be transferred to a third party, to be held in trust and later transferred to the subscribing party in accordance with a trust agreement.*"¹⁴⁴

The voting rights and appraisal rights on the shares held in trust may not be exercised by the subscriber, and pre-emptive rights may only be exercised and

¹⁴⁰ There may potentially still be differences due to the "accrual concept", however, this should be a timing difference only.

¹⁴¹ Ger "Capital punishment: How the new concept of 'contributed tax capital' will affect companies and their shareholders" *De Rebus* (May 2011) 55.

¹⁴² Section 40(4) of the Companies Act.

¹⁴³ Section 40(5)(a) of the Companies Act.

¹⁴⁴ Section 40(5)(b) of the Companies Act.

distributions must be paid or credited to the extent that the instrument becomes negotiable or the subscriber has fulfilled the obligations in terms of the agreement. Further, distributions may also be credited against remaining value of future services, payment or benefit still to be received by the company. Shares may not be transferred by or at the direction of the subscriber unless the company has expressly consented to in advance and must be transferred to the subscriber when the instrument has become negotiable and when all obligations of the subscriber have been met.¹⁴⁵ There is also the possibility that the issued shares held in trust are to be returned to the company and cancelled on demand if the instrument is dishonoured after becoming negotiable or if the subscriber has not met its obligations in terms of the agreement.¹⁴⁶

The possibility of the issue of shares contemplated above give rise to a myriad of interpretational questions and tax issues, and also subject to a fair amount of discussion and debate. A key interpretational question is whether section 40(5)(b)(ii) of the Companies Act requires the creation of "trust" as defined in the Trust Property Control Act 57 of 1988 and registration of that trust with the Master in terms of the latter statute or whether this section contemplates a contractual arrangement similar to an escrow or safe-keeping arrangement which does not need to be so registered.

Senior counsel view was obtained on this question. His view is that the arrangement contemplated in section 40(5)(b) of the Companies Act does not prescribe that a trust in terms of the Trust Property Control Act 57 of 1988 be established, whether trust in a wide sense or narrow sense. The arrangement contemplates that the owner of the shares is the subscriber of the shares in issue. Despite the use of the terms "transferred to a third party", ownership of the shares remain with the subscriber and are only "transferred to a third party" to be held in trust, similar to an *escrow* account. The purpose of the procedural and documentary requirements set out in sections 40(5) and 40(6) is to protect the company and all its other existing shareholders by ensuring that the issued shares are held in trust by a third party (and not at the disposal of the subscriber) until such time that the instrument can be valued and the agreed obligations have been met. The trust agreement must provide for the transfer of the issued shares

¹⁴⁵ Section 40(6)(a) to (d) of the Companies Act.

¹⁴⁶ Section 40(6)(d)(iv) of the Companies Act. This is subject to the 40 business days grace period provided in section 40(7)(b).

to a third party and for a corresponding transfer back to the subscriber at a specified point in the future.¹⁴⁷

3.5.2 **Scope of section 24BA - value mismatch provision for shares issued for shares**

The issue of shares for delayed consideration contemplates the following different broad categories of consideration - an instrument, an agreement for future benefit, an agreement for future payment and an agreement for future services.

The value mismatch provision in section 24BA provides for the issue of shares for assets, as defined in paragraph 1 of the Eighth Schedule. "Asset" is defined to include:

"(a) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and

(b) a right or interest of whatever nature to or in such property."

Due to the wide definition of "asset" above, it is submitted that the issue of shares for the instrument which value is yet to be realised, an agreement for future benefit and future services will fall within the ambit of section 24BA. An instrument falls squarely within the definition of "asset" and it is clear that an issue of shares for such asset could trigger section 24BA as the shares would have been issued for consideration which constitutes an "asset".

"Asset" is defined to include incorporeal property, which could include in the present context, personal rights held by the company enforceable against the subscriber in terms of the agreement. In this sense, the personal rights held by the company against the shareholder for future services and which are received as consideration for the issue of shares constitute an "asset".

As "asset" excludes any currency, the issue of shares for future payment could thus fall outside the ambit of section 24BA, unless the view is also taken that the issue of shares in terms of an agreement for future payment also provides the company with personal rights against the subscriber for such payment. These

¹⁴⁷ Opinion from senior counsel was obtained in March 2013.

personal rights are the "asset" acquired as consideration for the issue of shares, and thus section 24BA would also apply to such issues.

The dissertation continues the discussion below on the basis that the delayed consideration contemplated in section 40(5) of the Companies Act fall within the ambit "asset" in section 24BA and as a result, any value mismatch between the consideration exchanged for the shares at the time of issue of the shares by the company, could result in the tax triggers in section 24BA, unless the group exemption in section 24BA(4) applies.

3.5.3 **Valuation of the delayed consideration at time of issue**

As discussed in 3.4 above, the value of the delayed consideration will need to be quantified by the company for the purpose of recording the value of its share capital in its accounting records and financial statements. In addition, there is also a requirement on the company to record in its securities register the name of the shareholder and the value of the consideration still to be received by the company.¹⁴⁸

The value of the instrument cannot be realised until after the date of issue. Despite this, it is submitted that it is likely that the value of the instrument can be quantified at the time of issue or at worse, estimated based on underlying assumptions. The quantification of future payment and in most cases, future services, should not pose significant practical difficulties. The quantification of future benefits, unless such benefit is in monetary terms, may however pose some practical but not insurmountable difficulties. Again, the valuation of the future benefits should be estimated at the time of issue because it is required in terms of entry in the securities register, and also, more importantly, to prevent any tax triggers in the value mismatch provision of section 24BA.

3.5.4 **Dividends received by subscriber during period that shares are held in trust**

Any dividends distributed by the company to the subscriber in respect of the shares held in trust must be paid and credited to the subscriber to the extent that the instrument has become negotiable or obligations fulfilled. Such dividends must be paid or credited by the company or may be set off against the remaining not yet received value of the subscription price.¹⁴⁹

¹⁴⁸ Section 51(5)(d) of the Companies Act.

¹⁴⁹ Section 40(6)(c) of the Companies Act.

Any dividends received by the subscriber are exempt income but subject to dividends tax at 15% or lower rate in terms of any applicable double tax agreement, unless the subscriber is exempt from dividends tax.¹⁵⁰

3.5.5 If the shares are issued as consideration for future services by an employee, what value should be included as the subscriber's gross income and when?

If the subscriber is an employee of the company, and the company has issued these shares to him / her by virtue of his or her employment, the value of the shares would be included in the employee's gross income unless section 8C applies. Section 8C applies to delay the inclusion of any gain or loss of restricted equity instruments until the vesting of such instruments. The definition of "restricted equity instrument" is defined as an equity instrument which, amongst others, is subject to any restriction (other than a restriction imposed by legislation) that prevents the taxpayer from freely disposing of that equity instrument at market value.¹⁵¹

Section 40(5)(b)(ii) read with sections 50(5)(d)(i) and 40(5)(d)(iii) of the Companies Act provide that the shares are to be held in trust (and therefore not freely transferable by the subscribing employee) unless the company has given its express advance consent for the transfer or until the instrument has become negotiable and all obligations have been met.¹⁵²

As restrictions imposed by legislation does not result in "equity instruments"¹⁵³ being classified as "restricted equity instruments",¹⁵⁴ there is a possibility that the market value of the shares¹⁵⁵ at the time of issue be included as part of the subscriber's remuneration in the year of issue with corresponding employee's tax withholding obligations on the company.¹⁵⁶

Therefore, in light of the uncertainty, the share incentive scheme should be structured to provide for the subscribing taxpayer to be subject to other

¹⁵⁰ Exemption from dividends tax is provided in section 64F.

¹⁵¹ Section 8C(7).

¹⁵² It is submitted that "and" at the end of section 40(6)(d)(iii) should read "or" in order for section 40(6) to make sense.

¹⁵³ The definition of "equity instrument" in section 8C(7) includes shares in a company.

¹⁵⁴ This includes the possibility that any requirement on the employee to be in a required period of employment to perform such future services, which is common in most share incentive schemes.

¹⁵⁵ The amount to be included is the "total amount, in cash or otherwise" as defined in the "gross income" definition in section 1. Therefore, the value to be included should be the market value of the shares at the time of issue, and on the basis that the subscribing employee did not pay any consideration for the shares.

¹⁵⁶ Paragraph 2(a) of the Seventh Schedule of the Income Tax Act.

restrictions in addition to the ones set out in section 40(5) of the Companies Act which would result in the shares being classified as a "restricted equity instrument".

From the perspective of the company, the contributed tax capital of the company is an amount equal to the sum of the consideration received by or accrued to the company for the issue of the shares of that class.¹⁵⁷ It is submitted that as the company does not have an unconditional entitlement to the consideration, the sum of the consideration should only be included as part of the contributed tax capital of the company as and when the value of the shares are realised or obligations are fulfilled by the subscriber.

In addition, despite conflicting case law, it is submitted that the company should be entitled to a deduction for the value of the future services as and when such services are rendered, as the company would have incurred such expenditure in the production of income in terms of section 11(a) and 23(g).

3.5.6

If the shares are issued as consideration for future services by an independent contractor, what value should be included as the subscriber's gross income and when?

Although the shares are issued and ownership is in the hands of the independent contractor, it is submitted that there is no accrual of the shares at the time of issue to the contractor as the contractor does not have an unconditional entitlement to the shares until its obligations in terms of the agreement are met and the shares must be "transferred" to it in terms of section 40(6)(d)(iii) of the Companies Act. The shares will be held in *escrow* for safe-keeping until such obligations are met. As such, the value of the shares to be included in the gross income of the contractor as part of amounts received in respect of services rendered should only be included as and when it performs these obligations.

From the perspective of the company, the discussion above in 3.5.6 on the company's contributed tax capital and deduction remain valid for the issue of shares for future services rendered by independent contractors.

¹⁵⁷ Paragraph (b)(ii) of the definition of "contributed tax capital" in section 1.

4. Securities (debt instruments)

4.1 Preliminary

As mentioned above, section 1 of the Companies Act defines "securities" as "*any shares, debentures or other instruments, irrespective of their form ...*". The Companies Act does not define "debentures" and there is no indication of the nature of "other instruments", although section 1 of the Securities Services Act 36 of 2004 with its extensive definition of "securities" may give an indication of the variety of instruments which may be issued by companies and also instruments which may be traded on an exchange. Chapter 2 Part D in the Companies Act which deals with the capitalisation of companies provides for the authorisation and issue of shares, securities other than shares, and options. Section 43 of the Companies Act which deals with the issue of securities other than shares contains a definition of "debt instruments". "Debt instruments" is defined to include any securities other than shares but does not include promissory notes and loans.¹⁵⁸ There is no definition of options in the Companies Act although section 42(1) provides for a company to issue options for the allotment or subscription of authorised shares or other securities of the company.

The significant tax issues in this area surround the issue of hybrid securities, instruments which have the characteristics of both a share and a debt, as well as the common feature of making the holder a creditor of the company.¹⁵⁹

This dissertation had discussed the anti-avoidance provisions of hybrid equity instruments in section 8E and third-party backed shares in section 8EA in 3.2.3 and 3.2.4 above. This paragraph will thus discuss the tax implications of hybrid debt instruments in section 8F and proposed new section 8FA.

A company issuing "debt instruments" in terms of section 43 of the Companies Act should thus consider whether the debt instrument would be a "hybrid debt instrument" in terms of section 8F. The recharacterisation rules for hybrid debt instruments in section 8F provide that no deduction on the "interest" paid or payable by the issuing company shall be allowed by the issuing company. The interest received by the holder of the instrument, i.e. the "lender", would still be subject to normal tax.

4.2 Hybrid debt instruments in section 8F

Currently, a "hybrid debt instrument" is defined as an instrument where:

¹⁵⁸ Section 43(1) of the Companies Act.

¹⁵⁹ See FHI Cassim, MF Cassim, R Cassim, Jooste, Shev, Yeats *Contemporary Company Law* (2012) 231.

"(a) that instrument is at the option of the issuer convertible into or exchangeable for any share in that issuer or any connected person in relation to that issuer within three years from the date of issue of that instrument;

(b) the issuer in relation to that instrument is entitled to repay that instrument in whole or in part within three years from the date of issue of that instrument by the issue of shares by the issuer or any connected person in relation to the issuer to the holder of the instrument;

(c) the issuer in relation to that instrument is entitled to repay that instrument in whole or in part within three years from the date of issue of that instrument and is entitled at the time of that repayment to require the holder of that instrument to subscribe for or acquire shares in the issuer or any connected person in relation to the issuer; or

(d) that instrument, other than a listed instrument issued by a listed company, is at the option of the holder convertible into or exchangeable for any share in the issuer or any connected person in relation to the issuer within three years from the date of issue and it is determined on the date of issue that the value of that share at the time of conversion or exchange is likely to exceed the value of the instrument by at least 20 per cent."

National Treasury has issued a request for public comment proposed amendments to limit against excessive interest deductions.¹⁶⁰ The proposed amendments include amendments to section 8F and introduction of a new section 8FA. Broadly, the amendments to "hybrid debt instruments" will focus on two sets of rules, the rules relating to the nature of the instrument (referred to as the "corpus"), and another set of rules relating to the yield of the instrument.¹⁶¹

The anti-avoidance rules on the instrument will focus on debt-labelled instruments which have features which indicate that redemption of the instrument for cash is unlikely within a reasonable period (i.e. 30 years) or have features that enable a conversion of the debt instrument to shares. These features will be tested on a continuous basis and not only on the issue of the instrument.¹⁶²

¹⁶⁰ National Treasury "Request for public comment for incorporation into forthcoming 2013 Tax Laws Amendment Bill: Proposed limitations against excessive interest tax deductions" (2013). Available at <http://www.treasury.gov.za/public%20comments/TLAB%202013/>. Accessed on 20 June 2013.

¹⁶¹ Annexure C Paragraph IIIA National Treasury "Request for public comment for incorporation into forthcoming 2013 Tax Laws Amendment Bill: Proposed limitations against excessive interest tax deductions" (2013). Available at <http://www.treasury.gov.za/public%20comments/TLAB%202013/>. Accessed on 20 June 2013.

¹⁶² *Ibid.*

The anti-avoidance rules on the yield of the instrument are the requirement that the yield of the instrument must be based on the time value of money principles or a specified rate of interest. The timing of payment must not be affected by the solvency of the company.¹⁶³

If a debt instrument is classified as a "hybrid debt instrument" in terms of the rules on the instrument, the stated interest of the instrument will be treated as dividend by the issuing company (i.e. borrower) and no "interest" deduction will be possible. The yield may also potentially be subject to dividends tax and the interest accrual and incurral rules in section 24J will no longer apply.

If a debt instrument is classified as a "hybrid debt instrument" in terms of the yield of the instrument, the stated interest will be treated as dividend declared by the issuing company as well as dividends in the hands of the recipient and could be subject to dividends tax. The issuing company will also not be able to claim the "interest" paid as a deduction. The interest accrual and incurral rules in section 24J will also no longer apply.

The anti-hybrid rules are subject to three exemptions - debt owed to resident individuals, debt forming part of regulated bank capital and regulated insurer capital.

These new rules are proposed to come into effect on 1 January 2014.

5. Corporate finance

5.1 Preliminary

Chapter 8 in *Contemporary Company Law*¹⁶⁴ on corporate finance discusses distributions, repurchases (buy-backs), acquisition by a company of shares in its holding company (indirect repurchases), financial assistance for the acquisition of securities, financial assistance to directors *et al*, and shareholders' pre-emption rights. This dissertation will focus its analysis on corporate finance on the tax issues of distributions, repurchases (buy-backs) and acquisition by a company of shares in its holding company (indirect repurchases).

5.2 Distributions in terms of the Companies Act

The Companies Act 2008 defines "distribution" to mean

¹⁶³ *Ibid.*

¹⁶⁴ FHI Cassim, MF Cassim, R Cassim, Jooste, Shev, Yeats *Contemporary Company Law* (2012) 262.

"... a direct or indirect -

(a) transfer by a company of money or other property of the company, other than its own shares, to or for the benefit of one or more holders of any of the shares, or to the holder of a beneficial interest in any such shares, of that company or of another company within the same group of companies, whether-

(i) in the form of a dividend;

(ii) as a payment in lieu of a capitalisation share, as contemplated in section 47;

(iii) as consideration for the acquisition-

(aa) by the company of any of its shares, as contemplated in section 48; or

(bb) by any company within the same group of companies, of any shares of a company within that group of companies; or

(iv) otherwise in respect of any of the shares of that company or of another company within the same group of companies, subject to section 164(19);

(b) incurrance of a debt or other obligation by a company for the benefit of one or more holders of any of the shares of that company or of another company within the same group of companies; or

(c) forgiveness or waiver by a company of a debt or other obligation owed to the company by one or more holders of any of the shares of that company or of another company within the same group of companies;

but does not include any such action taken upon the final liquidation of the company.¹⁶⁵

In addition, a company must not make any proposed distribution unless the distribution is in terms of (i) an existing legal obligation of the company or court order; or (ii) the

¹⁶⁵ Section 1 of the Companies Act.

board has authorised the distribution by resolution and the board has acknowledged that the distribution will meet the requirements of the solvency and liquidity test.¹⁶⁶

The definition of "distribution" in section 1 of the Companies Act provides for three main methods by which distributions can be made, the first being a transfer of money or property; the second, the incurrance of an obligation; and the third, the forgiveness or waiver of an obligation.¹⁶⁷

The meaning of "distribution" in the Companies Act is wider than the meaning of the concept in the Income Tax Act, with the latter concept being largely around dividend payments to shareholders which are subject to dividends tax, and returns of capital to shareholders (prior to disposal of the shares by the shareholder), which are subject to capital gains tax. It is thus possible for a distribution in terms of the Companies Act to result in a variety of tax implications (not limited to dividends tax and capital gains tax on returns of capital), depending on the nature of the distribution, method of payment and recipient of the distribution. The tax implications are discussed in more detail below.

5.3 Taxation of dividends and returns of capital in the Income Tax Act

Before turning to a discussion of the tax implications of the possible methods of distribution in terms of the Companies Act, it is useful to set out a broad discussion of how amounts transferred to shareholders in respect of any shares held in a company are treated in terms of the Income Tax Act.

Generally, amounts distributed by companies that fall within the definition of "dividend" as defined in section 1 are subject to dividends tax unless the shareholder is exempt from dividends tax.¹⁶⁸ The liability for dividends tax falls on the beneficial owner of the dividend for dividends which are not distributions of assets *in specie*, and on the resident company, for distributions of asset *in specie*.¹⁶⁹ Amounts distributed which are not dividends would be subject to capital gains tax.¹⁷⁰ Dividends (and foreign dividends) received by a shareholder are included in its gross income,¹⁷¹ with most dividends

¹⁶⁶ Section 46(1) of the Companies Act. The test as set out in section 4 of the Companies Act.

¹⁶⁷ Van der Linde "The regulation of distributions to shareholders in the Companies Act 2008" 2009 *Tydskrif vir die Suid-Afrikaanse Reg* 485.

¹⁶⁸ Section 64E.

¹⁶⁹ Section 64EA(a) and (b).

¹⁷⁰ Part XI of the Eighth Schedule.

¹⁷¹ Paragraph (k) of the "gross income" definition in section 1.

received from resident companies being exempt from normal tax¹⁷² and foreign dividends (as defined in section 10B) qualifying for participation exemption.¹⁷³

The capital gains tax implications for distributions which are funded from reduction of contributed tax capital (before disposal of the shares themselves by the shareholder) are set out in paragraph 76, 76A and 76B of the Eighth Schedule. These implications have varied from first, a reduction of base cost of the relevant shares to, second, a deemed part disposal and finally, to a revised base cost reduction provision.¹⁷⁴

This dissertation will now discuss the tax implications of the three methods by which a distribution can be made in terms of the Companies Act.

5.4 **Transfer of money or other property other than its own shares**¹⁷⁵

The first method by which a distribution can take place in terms of the Companies Act is by way of a direct or indirect transfer of money or other property, other than the company's own shares. The first method then lists five specific examples, which in light of the generality of the last example, indicates that this list is meant to be an exhaustive list.¹⁷⁶ Before turning to a discussion of the tax implications of these different examples, it is necessary to discuss the tax implications of two issues, i.e. the possibility of distributions which are not proportionate to all shareholders in a class, and transfers of money or other property.

5.4.1 **Distributions which are not proportionate to shareholding**

Henochsberg is of the view that it is possible for distributions in terms of the Companies Act be made to one or some shareholders in a class and that a distribution when it is made need not be made to all shareholders in a particular class.¹⁷⁷ However, there is doubt whether this is still good law as section 37(1) of the Companies Act provides for the equality of all shares in a particular class.¹⁷⁸

An example when disproportionate distributions may occur is when dividends are

¹⁷² Section 10(1)(k)(i), except for provisos (aa) to (hh) in this section which are not exempt from normal tax.

¹⁷³ Section 10B(2) provides for participation exemption of 10%.

¹⁷⁴ Bester and Beckett "The tax consequences of a share repurchase" September / October 2012 *The Taxpayer* 165.

¹⁷⁵ Paragraph (a) of the definition of "distribution" in section 1 of the Companies Act.

¹⁷⁶ Van der Linde "The regulation of distributions to shareholders in the Companies Act 2008" 2009 *Tydskrif vir die Suid-Afrikaanse Reg* 486.

¹⁷⁷ Delpont and Vorster *Henochsberg on the Companies Act* (2011) 23.

¹⁷⁸ As above. Section 37(1) of the Companies Act provides that all of the shares of any particular class authorised by a company have preferences, rights, limitations and other terms that are identical to those of other shares of the same class. See further discussion on possibility of selective repurchases in 5.4.6 below.

calculated as a percentage of issue price of no-par value shares instead of merely in respect of the share.¹⁷⁹

The company making disproportionate amounts of dividend payments should specify whether the amounts paid are dividends, as defined in the Income Tax Act, or whether the amounts result in a reduction of contributed tax capital. Where amounts result in a reduction of contributed tax capital, the proviso to the definition of "dividend" is important, i.e. that amounts transferred to a shareholder must not exceed an amount that bears to the total contributed tax capital attributable to that class of shares immediately before the transfer, the same ratio as the number of shares of that class held by the shareholder bears to the total number of shares of that class.¹⁸⁰

5.4.2 **Transfer of money or other property of the company**

A distribution in terms of the Companies Act can take the form of cash or other property. If the distribution is a "dividend" as defined in the Income Tax Act (i.e. does not result in a reduction of the company's contributed tax capital), then the shareholder will be subject to dividends tax¹⁸¹ unless the shareholder is exempt from dividends tax in terms of section 64F. The dividends tax will be withheld by the company or a regulated intermediary.¹⁸²

A transfer of other property which is a dividend in terms of the Income Tax Act is a distribution *in specie*. The resident company making the distribution of asset *in specie* is liable for the dividends tax.¹⁸³ Where the asset *in specie* is a listed financial instrument, the value of the asset for purposes of withholding dividends tax on the distribution is the ruling price of the financial instrument at close of business on the last business day before the date that the dividend is deemed to be paid.¹⁸⁴ The value of all other assets distributed which are not listed financial instruments is equal to the market value of the asset on the date that the dividend is deemed to be paid.¹⁸⁵

¹⁷⁹ Delpont and Vorster *Henochsberg on the Companies Act* (2011) 24.

¹⁸⁰ See further discussion in footnote 208 above.

¹⁸¹ Section 64EA(a).

¹⁸² Section 64G and 64H.

¹⁸³ Section 64EA(b).

¹⁸⁴ Section 64E(3)(a).

¹⁸⁵ Section 64E(3)(b).

As mentioned above, there are five specific examples in the definition of "distribution" in the Companies Act as "transfers of money or other property" and this dissertation will now discuss the tax implications of each one below.

5.4.3 **Distribution in the form of a dividend**

Unlike the New Zealand Companies Act,¹⁸⁶ the South African Companies Act does not define the concept of "dividend". The narrow meaning of a dividend is a proportionate payment to a class of shareholders from the profits of a company.¹⁸⁷

From a dividends tax perspective, it is recommended that the board specify whether a distribution of dividend is made out of the profits of the company or out of the contributed tax capital of the company.¹⁸⁸ The former would thus give rise to dividends tax and the latter, to potential capital gains tax implications.

5.4.4 **Distribution as payment in lieu of capitalisation shares**

The issue of capitalisation shares is correctly excluded from being distribution in the Companies Act - "... *transfer by a company of money or other property of the company, other than its own shares, ...* " (Our emphasis.) This is because a distribution of a company's own shares are not regarded as property transferred by it.¹⁸⁹ A payment in lieu of capitalisation shares, however, is a distribution in terms of the Companies Act and would need to comply with the requirements in terms of section 47 of this statute, including the requirement on the company to meet the solvency and liquidity test upon completion of the distribution on the assumption that every shareholder would elect to receive cash in lieu of capitalisation shares.¹⁹⁰

The definition of "dividend" in the Income Tax Act also excludes the transfer of shares in a company. Similarly, the payment in lieu of capitalisation shares would not be excluded and be subject to dividends tax (unless the shareholder is exempt in terms of section 64F), if the amount does not reduce the contributed tax capital of the company.

¹⁸⁶ Section 53(1) of the New Zealand Companies Act, No 105 of 1993.

¹⁸⁷ Van der Linde "The regulation of distributions to shareholders in the Companies Act 2008" 2009 *Tydskrif vir die Suid-Afrikaanse Reg* 487.

¹⁸⁸ See paragraph (b)(bb) of the definition of "contributed tax capital" in section 1(1).

¹⁸⁹ Van der Linde "The regulation of distributions to shareholders in the Companies Act 2008" 2009 *Tydskrif vir die Suid-Afrikaanse Reg* 487.

¹⁹⁰ Section 47(2)(a) of the Companies Act.

This dissertation now considers the tax implications of each of the five specific examples given for distributions made as transfers of money or other property.

5.4.5 **Distribution as consideration for the acquisition of a company's own shares**

The definition of "distribution" in the Companies Act differentiates between acquisition by the company of its own shares¹⁹¹ and acquisition by a company of any shares within the same group of companies.¹⁹² First, a discussion on the acquisition of a company of its own shares in this paragraph 5.4.5, and then a discussion on the acquisition of a company of shares in another company in the same group in paragraph 5.4.6.

The Companies Act draws a distinction between a redemption of shares and a repurchase of shares (or share buybacks). A redemption of shares is a repurchase of shares in accordance with the terms and conditions of those shares. The redemption of shares is thus an event which is contemplated at the time the shareholder subscribes for the redeemable shares. The date and value of redemption may also be set out as a term of subscription. The terms and conditions of a redeemable share may be contained in a company's Memorandum of Incorporation, in the subscription agreement or issue document.

Blackman¹⁹³ observes that the distinction:

"... thus turns on whether the company takes back its shares in accordance with rights attaching to the shares themselves (redemptions), or in accordance with a separate contract entered into between it and the shareholders concerned (repurchases or buy-backs)."

A share redemption is thus a share which is issued where the redemption is a term of the share, for instance, a redeemable preference share. In fact, it may be possible to say that a share redemption can only take place in terms of a redeemable share, whether such share is the more common redeemable preference share or the less common redeemable ordinary share.

On the issue of whether and how dividends tax or capital gains tax applies on the transfer of money or other property for the distribution, a share repurchase and

¹⁹¹ Paragraph (a)(iii)(aa) of the definition of "distribution" in the Companies Act.

¹⁹² Paragraph (a)(iii)(bb) of the definition of "distribution" in the Companies Act.

¹⁹³ Blackman, Jooste & Everingham *Commentary on the Companies Act* Looseleaf (2003) at 5-61.

share redemption will not result in different tax implications. Both these forms of distribution will result in the same tax implications on this issue alone.¹⁹⁴

The tax implications for a share repurchase or share redemption depend first on the nature of the consideration, i.e. whether the share repurchase is a dividend or a return of capital, and second, on whether the shares are held on capital account or not.¹⁹⁵

If the amount paid by the company to the shareholder is a dividend, the full amount paid will be subject to dividends tax unless the shareholder is exempt from dividends tax in terms of section 64F. If the amount paid by the company to the shareholder results in a reduction of the contributed tax capital of the shares and thus a return of capital, the share repurchase will give rise to capital gains tax consequences in terms of Paragraphs 76, 76A or 76B of the Eighth Schedule.

The definition of "dividend" excludes a general share repurchase by a listed company.¹⁹⁶ A general share repurchase is treated as if sold to a third party. Therefore, the implications will depend on whether the shares were held on capital or revenue account. If the shares are held on capital account, the full amount paid by the company (which is excluded from being treated as a dividend) will be proceeds for the disposal with the initial subscription or acquisition cost of the shares to the shareholder as the base cost of the shares. If the shares are held on revenue account, the full amount paid by the company will be treated as amount received on disposal of trading stock, with the initial subscription or acquisition cost as the cost of the stock.

If the share repurchase is not a general share repurchase above and results in a mix of a return of capital and a dividend, the pro-rated distribution from the contributed tax capital amount of the company will constitute proceeds for purposes of the disposal for the shareholder but not the portion of the repurchase consideration which constitutes dividend as defined.¹⁹⁷ If the amount which constitutes proceeds in the repurchase consideration is less than the base cost of

¹⁹⁴ However, in addition to considering whether dividends tax or capital gains tax would apply, a share redemption of a redeemable share should also consider the application of section 8E and 8EA and whether the redeemable share is a hybrid equity instrument or third-party backed share. See further our discussion in paragraph 3 above.

¹⁹⁵ Bester and Beckett "The tax consequences of a share repurchase" September / October 2012 *The Taxpayer* 166.

¹⁹⁶ Paragraph (iii) of the definition of "dividend" in terms of the Income Tax Act, which excludes general share purchase as contemplated in subparagraph (b) of paragraph 5.67(B) of the JSE Limited Listings Requirements, where that acquisition complies with any applicable requirements prescribed by paragraphs 5.68 and 5.72 to 5.84 of section 5 of the JSE Limited Listings Requirements.

¹⁹⁷ Paragraph 35(3)(a) of the Eighth Schedule provides that proceeds received by a shareholder must be reduced by any amount of the proceeds that was included in the shareholder's gross income. Dividends are included in a shareholder's gross income in terms of paragraph (k) of the definition of "gross income" in section 1.

the shares repurchased, this results in a capital loss for the shareholder. Although argued and decided in the context of a share redemption, it is submitted that the principles in *ITC 1859*,¹⁹⁸ are equally applicable in a share repurchase. In this case, the court held that there is no disposal to a connected person in a share redemption. Therefore, the anti-avoidance "clogged-loss" rule in paragraph 39 of the Eighth Schedule does not apply. Further, the dividends and redemption premium received by the shareholder is not a recovery as envisaged in paragraph 20(3) of the Eighth Schedule.¹⁹⁹

Where the shareholder of the repurchased shares (resulting in a capital loss) is a resident company, there is a further obstacle towards recognition of the capital loss in the share repurchase. Paragraph 19(1)(a) of the Eighth Schedule provides that any capital loss which is less than any exempt dividends and which results from a disposal of the share by the shareholder from a share repurchase or as part of the liquidation, winding-up or deregistration of that company must be disregarded. An "exempt dividend" is defined as a dividend which is exempt from dividends tax and normal tax.²⁰⁰ Any dividend distribution paid to a resident company is exempt from dividends tax and normal tax. Therefore, any capital loss arising from the share repurchase²⁰¹ can only be claimed by the company as a capital gains tax loss if it exceeds the sum of any pre-disposal dividends up to 18 months prior to the repurchase and the dividends portion of the repurchase consideration itself.²⁰²

Distributions made to individuals are subject to dividends tax, therefore, not exempt dividends. Such individuals would thus not be limited in terms of paragraph 19 from claiming a capital gains tax loss should a repurchase result in a capital loss.

A share repurchase can also be a pro rata offer to all shareholders or a selective offer to some shareholders.²⁰³ The tax issues arising from a selective repurchase

¹⁹⁸ (2012) 74 SATC 213.

¹⁹⁹ *ITC 1859* 74 SATC 213. Williams "Capital gains tax consequences of redemption of redeemable shares". Available online at <http://www.thesait.org.za/news/news.asp?id=87400>. Accessed on 1 June 2013.

²⁰⁰ Paragraph 19(3)(b) of the Eighth Schedule.

²⁰¹ The capital loss on the share repurchase is the difference between the contributed tax capital portion of the consideration which is less than the base cost of the shares.

²⁰² B&B 168.

²⁰³ See Van der Linde "Share repurchases and the protection of shareholders" 2010 *Tydskrif vir die Suid-Afrikaanse Reg* 288 on page 303 where she agrees with the interpretation that the presumption of equality within a class of shares in section 37(1) should be interpreted to refer to the predetermined class rights and not to subsequent equal treatment of all shareholders in a class in transactions such as repurchases. Share repurchases are only decided at a later stage. She argues that this interpretation is supported by the ordinary meaning of "terms" as something that has already been agreed upon and also the generality of the repurchase power given to companies.

offer are similar to the tax issues which arise from disproportionate transfers of money or other property in respect of shares in a company.²⁰⁴

5.4.6 **Distribution as consideration for the acquisition of shares by a company of shares in another company in the same group**

Although the acquisition of shares in another company in the same group is a distribution in terms of the Companies Act, it is not a dividend or a return of capital in terms of the Income Tax Act. A "dividend" is defined in the Income Tax Act as any amount transferred by a company in respect of any shares in that company, whether as distribution made by the company or as consideration for the acquisition of any share in that company. A "return of capital" is also defined with reference to a transfer resulting in a reduction of contributed tax capital of the company, whether the amount is transferred by way of a distribution made by or as consideration for the acquisition of any share in that company.²⁰⁵

The nature of this "distribution" will thus be more in the nature of a sale of shares rather than a share repurchase.

Unless the acquisition of shares in another company in the same group²⁰⁶ takes place in terms of the corporate rules,²⁰⁷ the acquisition will be a disposal for the shareholder selling the shares with the resulting tax consequences depending on whether the shares were held on capital or revenue account.²⁰⁸ The tax consequences will be the same for the seller, even if the subject matter of the sale is shares in the holding company of the purchaser. In this regard, although section 48 of the Companies Act provides for the requirements of a share repurchase by a company of its own shares and of shares in its holding company (for instance, to be held as treasury shares), there is no need to draw this distinction for tax as the tax implications will be the same regardless.

²⁰⁴ See discussion in 5.4.1 above.

²⁰⁵ These distributions in terms of the Companies Act are not regulated in terms of section 48 of the Companies Act on "company or subsidiary acquiring company's shares" unless the subsidiary is acquiring shares in its holding company.

²⁰⁶ As defined in section 1 of the Companies Act, this is defined to be the holding company and all its subsidiaries.

²⁰⁷ For instance, in terms of section 42 asset-for-share transaction, or section 45 intra-group transaction.

²⁰⁸ See our discussion in 5.3 above.

5.4.7 **Transfers otherwise in respect of shares**²⁰⁹

A conversion of shares is not expressly regarded as a distribution in terms of the Companies Act. However, it could be regarded as a distribution in terms of the Companies Act, for instance, in terms of paragraph (a)(iv) or (b) of the definition of "distribution".²¹⁰

From a tax perspective, if the conversion of shares to debt instruments is fixed up front with the details pertaining to the shares replicated and carried over to the debt instrument on conversion, it is possible that there is no disposal. However, should the option to convert be left at the discretion of the shareholder or company, the rights of the shares cannot be said to be acquired up front because the right of conversion is either subject to a suspensive condition or did not exist at the time the shares were acquired. In this instance, a disposal is triggered at the time of conversion. Paragraph 13(1)(a)(v) provides that the time of disposal is the date of conversion.²¹¹

Notably, the conversion of shares into debt instruments falls outside the ambit of "hybrid equity instruments", "hybrid debt instruments" and "third-party backed shares".²¹²

The definition of "distribution" in the Companies Act on transfers otherwise in respect of any shares of that company or of another company in the same group is subject to section 164(19) of the Companies Act. Section 164(19) provides that the making of a demand, tendering of shares and payment by a company to a shareholder in terms of the appraisal remedy in section 164 is not a distribution or a share repurchase in terms of section 48.

5.5 **Incurrence of debt or obligation by company for shareholder of the company or another company in same group**

Debt or other obligation incurred by a company for the benefit of a shareholder of the company or for the benefit of a shareholder of another company in the same group of

²⁰⁹ Van der Linde "The regulation of distributions to shareholders in the Companies Act 2008" 2009 *Tydskrif vir die Suid-Afrikaanse Reg* 488.

²¹⁰ Van der Linde "The regulation of distributions to shareholders in the Companies Act 2008" 2009 *Tydskrif vir die Suid-Afrikaanse Reg* 489.

²¹¹ See paragraph 6.1.1.2.4 of SARS "Comprehensive Guide to Capital Gains Tax" (Issue 4) 68. Available at <http://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20-20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax%20-%20External%20Guide.pdf>. Accessed on 10 August 2012. Although this view is held for the conversion of convertible preference shares to convertible ordinary shares, it is submitted that these principles would also apply to the situation where convertible shares are converted to debt instruments.

²¹² See discussion above at 3.2.3 above.

companies is considered a distribution in terms of the Companies Act and would need to meet with, amongst others, the solvency and liquidity test.²¹³

From a tax perspective, debt incurred by a company for a shareholder of the company could have been a deemed dividend in terms of the repealed secondary tax on companies regime.²¹⁴ There is, however, no express inclusion in the current dividends tax regime that the incurrance of a debt or other obligation by a company for its shareholder could be considered a dividend and be subject to dividends tax. The definition of "dividend" in section 1 of the Income Tax Act provides "*for an amount transferred or applied by a company that is a resident for the benefit or on behalf of any person in respect of any share in that company, ...*". (Our emphasis.)

It is submitted that as a general principle, unless the debt or obligation is incurred by the company in respect of the share held by the shareholder,²¹⁵ the transaction should not be considered to be a dividend and give rise to dividends tax. Section 64E(4), however, provides that any amount owed to a company by resident individuals who are connected persons in relation to the company is deemed to be a dividend. The amount of the "dividend" is the greater of the difference between the official rate of interest²¹⁶ and the interest payable on the debt or nil.²¹⁷ The dividend that is deemed to be paid is also deemed to consist of a distribution *in specie*,²¹⁸ which means that the company is liable for the dividends tax.²¹⁹

From a tax perspective, debt or other obligation incurred by the company for a shareholder of another company within the same group of companies falls outside the definition of "dividend" and is thus not subject to dividends tax as it should not be incurred by a company in respect of any share in that company.

²¹³ As set out in section 4 of the Companies Act.

²¹⁴ Section 64C(b) or (g).

²¹⁵ Support for this view can be found in Van der Linde "The regulation of distributions to shareholders in the Companies Act 2008" 2009 *Tydskrif vir die Suid-Afrikaanse Reg* 490. She argues that a qualification can probably be read into the definition of paragraph (b) of the definition of "distribution" in the Companies Act that the incurrance of debt or obligation would be considered to be a distribution only if incurred in respect of shares or by reason of the shareholding. Comparable definitions in the American Bar Association "Model Business Corporation Act" and the New Zealand Companies Act, No 105 of 1993 contain such qualifications. Likewise, in the Income Tax Act, the definition of "dividend" does contain such express qualification in the words "*in respect of any share in that company*". Therefore, it is submitted that incurrance of debt by the company for a shareholder is not a dividend unless such debt is incurred in respect of the share held by the shareholder.

²¹⁶ As defined in paragraph 1 of the Seventh Schedule, which essentially is the repurchase rate plus 100 basis points, i.e. 6% at the current rate.

²¹⁷ Section 64E(4)(b)(ii).

²¹⁸ Section 64E(4)(b)(i).

²¹⁹ Section 64EA(b).

Where the debt or other obligation is incurred by the company and remains a debt or other obligation which is owed by the shareholder to the company or to another company in the same group (i.e. the repayment of the debt has not been waived by the company), no other significant tax implications should arise from the incurrence. Where the debt or other obligation is incurred by the company, and the company waives the repayment of the debt or obligation, this gives rise to other significant tax implications which will be discussed further in 5.6 below.

5.6 **Forgiveness or waiver of debt or obligation owed to company by shareholder of company or another company in same group**

As with the incurrence of debt or other obligation, the similar view is held that the forgiveness or waiver of debt should only be considered a distribution in terms of the Companies Act if it has been made in respect of shares or by reason of shareholding.²²⁰

It is submitted that the forgiveness or waiver of debt or obligation should not be considered a dividend at all and thus not be subject to dividends tax, regardless if the debt is owed by a shareholder to the company or by the shareholder to another company in the same group. There are specific provisions in the Income Tax Act which deal with tax implications arising from the forgiveness or waiver of debt and these would apply in this situation.

The Taxation Laws Amendment Act 22 of 2012 introduced a new uniform debt relief system. The new system recognises that the tax system was acting as an impediment to the recovery of companies in financial distress. The new system thus addresses debt reductions or cancellations for less than full consideration (i.e. debt relief) as a result of the debtor's inability to pay. This system provides for rules relating to ordinary revenue (i.e. section 19) and rules relating to capital gain (i.e. paragraph 12A).²²¹

5.6.1 **The ordinary revenue rules**²²²

The ordinary revenue rules in section 19 do not apply where the debt reduction or cancellation is a bequest in terms of a deceased estate, a donation or arises from

²²⁰ See Van der Linde "The regulation of distributions to shareholders in the Companies Act 2008" 2009 *Tydskrif vir die Suid-Afrikaanse Reg* 490.

²²¹ National Treasury "Explanatory Memorandum of the Taxation Laws Amendment Bill, 2012" (2012) 44. Available online at <http://www.treasury.gov.za/legislation/bills/2012/Final%20EM%202012%20TLAB.pdf>. Accessed on 18 August 2012.

²²² These rules apply to debt which is also referred to as "ordinary" debt relief in National Treasury "Explanatory Memorandum of the Taxation Laws Amendment Bill, 2012" (2012) 49. Available online at <http://www.treasury.gov.za/legislation/bills/2012/Final%20EM%202012%20TLAB.pdf>. Accessed on 18 August 2012.

an employer-employee relationship.²²³ Section 19 applies when debt owed by a person is reduced and the debt was used to finance deductible expenditure or allowances.²²⁴

If the debt reduced or cancelled was used to acquire trading stock which is not yet disposed of by the debtor at the time the debt is reduced or cancelled, the cost of the trading stock will be reduced by the amount of the reduction or cancellation of the debt.²²⁵ If the cost of the trading stock has been reduced to nil, any remaining amount of debt reduced or cancelled will be recouped or recovered to the debtor's income in terms of section 8(4)(a) in the year of assessment that the reduction or cancellation takes place.²²⁶

If the amount of debt reduced or cancelled is used to finance deductible expenses or allowances (other than trading stock that is held at the time the debt is reduced), or acquisitions of allowance assets, the amount reduced or cancelled will be deemed to have been recovered or recouped. The expenses and allowances previously claimed will thus be deemed to be recouped.²²⁷

If the amount of debt reduced or cancelled was used in the acquisition, creation or improvement of an allowance asset, the amount reduced will be deemed to be a recoupment of the deductions previously granted under the Income Tax Act in respect of the asset.²²⁸

If the ordinary debt was used to finance an allowance asset, the reduction amount will be deemed to be a recoupment of the deductions previously granted under the Income Tax Act in respect of that asset.

5.6.2 **The capital gain rules**²²⁹

Paragraph 12A of the Eighth Schedule provides for the capital gains tax consequences arising from the reduction or cancellation of debt. As with the ordinary revenue rules, the capital gain rules do not apply where the reduction or

²²³ Section 19(8).

²²⁴ Section 19(2).

²²⁵ Section 19(3).

²²⁶ Section 19(4).

²²⁷ Section 19(5).

²²⁸ Section 19(6).

²²⁹ These rules also apply to debt which is referred to as "capital" debt in National Treasury "Explanatory Memorandum of the Taxation Laws Amendment Bill, 2012" (2012) 47. Available online at <http://www.treasury.gov.za/legislation/bills/2012/Final%20EM%202012%20TLAB.pdf>. Accessed on 18 August 2012.

cancellation of debt is as a result of a bequest from a deceased estate, a donation or employment relationship.²³⁰

In addition, the capital gain rules also do not apply when the lender and borrower are in the same group of companies as defined in section 41, unless the debt reduction or cancellation is part of a tax avoidance scheme.²³¹ These rules also do not apply where the debt reduction or cancellation is in the course of the liquidation, winding-up, deregistration or final termination of the borrower company and the lender is a connected person in relation to the company, but only up to the limit of the paragraph 20 expenditure incurred by the lender in respect of the debt recovered or cancelled. There are also important provisos which largely relate to the debt reduction being part of an avoidance scheme and the time limit within which the company must take steps to liquidate, wind-up, deregister or finally terminate its existence.²³²

Paragraph 12A rules apply when the net amount of debt reduced is used directly or indirectly to finance any expenditure in respect of which no deduction or allowance has been granted or for an allowance asset.²³³

If the amount of debt reduced is used to finance expenditure in respect of an asset still held at the time of the debt reduction, the base cost of the asset will be reduced by the reduction amount.²³⁴ If the base cost of the asset has been reduced to nil, any remaining reduction amount will reduce any assessed capital loss of the borrower.²³⁵

5.7 **Distributions exclude any action taken upon final liquidation of the company**

The definition of "distributions" in the Companies Act expressly excludes liquidation distributions.²³⁶ The reason for this exclusion is because liquidation distributions are only made to shareholders after the creditors have been paid. Thus, this removes the

²³⁰ Paragraph 12A(6)(a) to (c) of the Eighth Schedule.

²³¹ Paragraph 12A(6)(d) of the Eighth Schedule.

²³² Paragraph 12A(6)(e) of the Eighth Schedule.

²³³ Paragraph 12A(2) of the Eighth Schedule.

²³⁴ Paragraph 12A(3) of the Eighth Schedule.

²³⁵ Paragraph 12A(4) of the Eighth Schedule.

²³⁶ See concluding words of the definition in section 1 of the Companies Act.

need for creditor protection by way of requiring the company to meet the solvency and liquidity test before making such liquidation distributions.²³⁷

From a tax perspective, a liquidation distribution will not avoid dividends tax and capital gains tax implications (if funded from a reduction of contributed tax capital) implications for the shareholder. In addition, a liquidation distribution of assets will also not avoid income tax implications if deductible expenses or allowances were previously claimed on the assets, or if such assets were trading stock. A liquidation distribution of the assets will also have capital gains tax implications if such assets were held as capital assets. However, there will be rollover relief for the income tax and capital gains tax implications for a liquidation distribution of assets if the liquidation distribution meets the requirements of section 47 of the corporate rules.

6. Conclusion

6.1 Conceptual differences between the Companies Act and Income Tax Act

Although the Income Tax Act has historically recognised concepts which are fundamental to company law (such as share capital and dividends), there are now significant conceptual differences between modern company law as set out in the Companies Act and the Income Tax Act. The Income Tax Act has developed its own concepts based on company law concepts which serve as a starting point. Therefore, although the Companies Act may have treated a transaction in a specified manner, it has become necessary to consider the tax implications of the transaction, regardless of its treatment in terms of the Companies Act. This has given rise to conceptual and practical difficulties, a few of which is noted below.

6.2 Types of companies in terms of the Companies Act

The Companies Act provides for two broad categories of companies - profit and non-profit companies. Within the category of profit companies, there are four further types of companies - private companies, public companies, state-owned companies and personal liability companies. A public company in terms of the Companies Act will not necessarily be recognised as a public company.

An external company is a foreign company which conducts business or non-profit activities in South Africa and as such is required to register with the Commission within 20 business days after it first begins to conduct business or non-profit activities. The foreign company a foreign company must be regarded as conducting business, or non-

²³⁷ Van der Linde "The regulation of distributions to shareholders in the Companies Act 2008" 2009 *Tydskrif vir die Suid-Afrikaanse Reg* 484.

profit activities in South Africa if the company "*is a party to one or more employment contracts within the Republic*". The meaning of the quoted phrase is unclear. Regardless, a foreign company registering as an external company must have an office in South Africa. A physical office and an employee may result in a factual scenario where the foreign company is carrying out business through a permanent establishment in South Africa. South Africa has taxing rights on the profits attributable to that permanent establishment. However, it is possible to minimise the risk of the foreign company establishing a foreign establishment in South Africa by contracting with a South African service provider or having the employee employed by a South African affiliate on secondment.

A foreign company meeting the criteria for registration as an external company in South Africa will still need to meet the requirements of registration as set out in the VAT Act, including meeting the taxable supply threshold requirement of ZAR 1 million for 12 months for a compulsory registration.

A foreign company can appoint a payroll administrator as its agent in South Africa, and the administrator will thus be a representative employer and fulfil any compliance obligations of the foreign company in terms of the Fourth Schedule.

If there is an applicable double tax agreement between South Africa and the company in which the foreign company is resident, article 15 of the double tax agreement may provide relief to the employee of the foreign company who is rendering services in South Africa. South Africa would not have taxing rights on the employee's remuneration if the employment income received by the employee in respect of services rendered in South Africa if the employee was not in South Africa for more than 183 days in any twelve month period, the remuneration was paid by the foreign company and the remuneration is not borne by a permanent establishment in South Africa.

The repercussions of not registering as an external company in terms of the Companies Act may not be serious enough to motivate foreign companies to do so, given the necessity of maintaining a registered office in South Africa on registration and the risk of this creating a permanent establishment of the foreign company in South Africa.

6.3 Securities (shares)

Company law provides for ordinary shares and preference shares. Preference shareholders hold preferential rights on dividends distributed and in the return of capital on liquidation relative to the ordinary shareholders.

A share which has an unlimited right to participate in dividends or an unlimited right to participate in returns of capital is an equity share. A preference share need not have both features to be considered an "equity share". It will be considered an "equity share" if it has one of the features. The classification of shares in terms of company law and the name of the share used are not conclusive in determining the classification of the share for tax purposes and the terms of the share must be considered further. Further, the features of the shares will need to be tested against the definition of "hybrid equity instrument" in section 8E and "third-party backed share" in section 8EA. If the shares meet the anti-avoidance tests in these sections, dividends declared by the company issuing the shares will be treated as interest in the hands of the shareholder but still be treated as dividends from the perspective of the issuing company.

"Consideration" in the Companies Act is defined widely and includes pecuniary and non-pecuniary amounts. The board of a company may issue authorised shares for adequate consideration, as determined by the board. There is no express requirement on the board to value non-pecuniary consideration received by a company for an issue of shares. The flexibility and discretion of the board to determine what constitutes adequate consideration should be considered against the new value mismatch provisions introduced in section 24BA. Section 24BA does not apply in a group of companies context and takes precedence over the corporate rules. When the market value of the asset forming the consideration is greater than the market value of issued shares, the issuing company will be subject to capital gains tax on the difference, and the difference will also reduce the base cost (if held as capital asset) or tax cost (if held as trading stock) of the shares in the hands of the shareholder. When the market value of the issued shares exceeds the market value of the asset forming part of the consideration, the difference is deemed to give rise to a deemed dividend *in specie* with the company being liable for the 15% dividends tax.

The issue of shares for "delayed consideration" with the issued shares to be transferred to a third party to be held in trust and later transferred to the subscribing party in accordance with a trust agreement in terms of section 40(5)(b) of the Companies Act should not be interpreted to mean that a trust in terms of the Trust Property Control Act 57 of 1988 is to be established. It is submitted that section 24BA

could apply to the issue of shares for "delayed consideration" in terms of section 40(5)(b) of the Companies Act. Therefore, it is recommended that the "delayed consideration" is valued to the extent possible at the time of the issue of the shares to anticipate any future challenges that the value of the shares issued did not equate the consideration received for the shares.

6.4 **Securities (debt instruments)**

A company issuing "debt instruments" should consider whether such instruments meet the test of being a "hybrid debt instrument" in terms of section 8F. If the debt instrument has the anti-avoidance features in this instrument, any interest paid or payable on the instrument by the issuing company can be deducted by this company. The interest received by the holder of the instrument, i.e. the lender, would still be subject to normal tax.

6.5 **Corporate finance**

Distributions made in terms of the Companies Act are not necessarily dividends in terms of the Income Tax Act which are subject to dividends tax. The board will need to make an election as to whether a distribution will be funded out of reserves or out of contributed tax capital. Distributions which are funded out of reserves will be subject to dividends tax and distributions which are funded out of contributed tax capital will have capital gains tax implications in terms of paragraph 76, 76A or 76B of the Eighth Schedule, which implications have varied from reduction of base cost, deemed part disposal and revised base cost reduction.

A share repurchase which is funded out of reserves should not be treated as a disposal between connected persons. Therefore, the anti-avoidance rule in paragraph 39 of the Eighth Schedule does not apply. Further, the dividends and redemption premium received by the shareholder is not a recovery as envisaged in paragraph 20(3) of the Eighth Schedule. However, any capital loss arising from the share repurchase can only be claimed by the company as a capital gains tax loss if it exceeds the sum of any pre-disposal dividends up to 18 months prior to the repurchase and the dividends portion of the repurchase consideration itself due to the limitation set out in paragraph 19(1)(a) of the Eighth Schedule.

A distribution in terms of the Companies Act includes the incurrence of debt or obligation by the company for the shareholder of the company or another company in the same group. The incurrence of the debt is, however, not a dividends tax which is subject to dividends tax. It is also not a return of capital which gives rise to capital gains

tax implications for the shareholder. The incurrence of the debt may give rise to other tax implications. Where the debt or other obligation incurred by the company remain as a debt or other obligation owed to the company, i.e. the repayment of the face value of the debt has not been reduced by the company, no other significant tax implications arise. Where some or part of the face value of the debt is reduced by the company, the new uniform debt relief system should be considered. The new rules provide for ordinary revenue rules and capital gain rules. The new rules do not apply where the debt reduction is a bequest in terms of a deceased estate, a donation, or arises from an employer-employee relationship.

In terms of ordinary revenue rules, where the debt reduced was used to acquire trading stock which is not yet disposed, the cost of the trading stock will be reduced by the amount of the debt reduced. If the cost of the trading stock has been reduced to nil, any remaining amount of debt reduced will be recouped to the debtor's income in terms of section 8(4)(a) in the year of assessment that the reduction takes place. If the amount of debt reduced is used to finance deductible expenses or allowances (other than trading stock), the amount reduced will be a recoupment. If the amount of debt reduced was used to finance the acquisition of an allowance asset, the amount reduced will be a recoupment.

The capital gain rules do not apply when the lender and borrower are in the same group of companies as defined in section 41, unless the debt reduction is part of an avoidance scheme. The capital gain rules provide that when the net amount of debt reduced is used directly or indirectly to finance any expenditure in respect of which no deduction or allowance has been granted or for an allowance asset, the amount reduced will reduce the base cost of the asset. If the base cost has been reduced to nil, any remaining reduction amount will reduce any assessed capital loss of the borrower.

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