

**THE REACH AND IMPLICATION OF SECTION 45(4)(b) OF THE INCOME TAX  
ACT 58 OF 1962**

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## **THE REACH AND IMPLICATION OF SECTION 45(4)(b) OF THE INCOME TAX ACT 58 OF 1962**

Section 45 of the Income Tax Act<sup>1</sup> provides a mechanism whereby a company may dispose of its assets to another company and defer the tax consequences thereof, if both companies form part of the same group of companies.

Taxpayers seized the opportunity to manipulate the provisions of section 45 in order to enable a tax-free exit of their investments.<sup>2</sup> The South African Revenue Service responded to this by introducing certain anti-avoidance measures.<sup>3</sup> One of these anti-avoidance measures is the de-grouping charge in section 45(4)(b) of the Income Tax Act.

This study aims to provide a critical analysis of the mechanics of section 45, the intended purpose of section 45(4)(b), how legislation should be interpreted and ultimately how far the implications of section 45(4)(b) reach.

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<sup>1</sup> No 58 of 1962. Hereinafter all references to section 45 refers to section 45 of the Income Tax Act.

<sup>2</sup>National Treasury *Explanatory Memorandum on the Taxation Laws Amendment Bill 2008* 14. Hereinafter referred to the “Explanatory Memorandum 2008”.

<sup>3</sup> Explanatory Memorandum of the Revenue Laws Amendment Bill 2002 21. Louw “Section 45: The good, the Treasury, and the unknown” 2008 Without Prejudice June Vol 8 15.

## TABLE OF CONTENTS

<b>CHAPTER 1 - SCOPE AND PURPOSE OF DISSERTATION</b> .....	7
1.1 INTRODUCTION .....	7
1.2 SECTION 45 OF THE INCOME TAX ACT.....	8
1.3 INTERPRETATION OF LEGISLATION .....	11
1.4 RESEARCH QUESTION .....	12
1.5 EXPOSITION OF STUDY .....	12
1.5.1 History and Mechanics of Section 45 of the Income Tax Act.....	12
1.5.2 Interpretation of Statutes .....	12
1.5.3 De-Grouping Charge in Section 45(4)(b).....	12
1.5.4 Application.....	12
1.5.5 Conclusion and Recommendation.....	13
<b>CHAPTER 2 - HISTORY AND MECHANICS OF SECTION 45</b> .....	14
2.1 INTRODUCTION.....	14
2.2 DEFINITIONS.....	14
2.2.1. Company .....	14
2.2.2 Group of Companies.....	15
2.2.3 Intra-Group Transaction .....	17
2.2.4 Taxable Income of a Company.....	18
2.3 TAXES DEFERRED UNDER SECTION 45.....	18
2.3.1 Introduction.....	18
2.3.2 Capital Gains Tax .....	19
2.3.2.1 Disposal.....	19
2.3.2.2 Asset .....	19

2.3.2.4 Base cost .....	20
2.3.3 INCOME TAX.....	22
a) Trading stock .....	22
b) Allowance assets .....	24
c) Section 24C allowances.....	24
2.3.4 VALUE-ADDED TAX.....	25
2.3.5 SECURITIES TRANSFER TAX AND TRANSFER DUTY .....	26
2.4 CONCLUSION.....	27
<b>CHAPTER 3 - INTERPRETATION OF STATUTES.....</b>	<b>28</b>
3.1 INTRODUCTION.....	28
3.2 STATUTORY INTERPRETATION.....	28
3.3 LITERAL APPROACH.....	28
3.3.1 The Basic Mechanisms of the Literal Approach.....	28
3.3.2 Critique of the Literal Approach .....	30
3.4 PURPOSIVE APPROACH .....	31
3.5 TELEOLOGICAL APPROACH TO STATUTORY INTERPRETATION .....	32
3.6 A CONSTITUTIONAL ERA DAWNS .....	33
3.6.1 The Values and Principles Promoted by the Constitution.....	34
3.7 HOW HAS LEGISLATION BEEN INTERPRETED IN SOUTH AFRICA .....	36
3.8 CONCLUSION.....	38
<b>CHAPTER 4 - HISTORY AND MECHANICS OF THE DE-GROUPING</b>	
<b>CHARGE IN SECTION 45(4)(B).....</b>	<b>40</b>
4.1 INTRODUCTION.....	40
4.2 RATIONALE.....	40
4.2.1 Abuse of Section 45 in Relation to Tax- Free Cash-Outs .....	40
4.3 THE AMENDED SECTION 45(4)(B) .....	43
4.4 CONSEQUENCE OF A DE-GROUPING .....	44

4.4.1 Capital Assets .....	45
4.4.2 Allowance Assets .....	45
4.4.3 Trading Stock .....	46
4.5 CONCLUSION .....	46
<b>CHAPTER 5 - APPLICATION OF THE DE-GROUPING CHARGE IN SECTION 45(4)(B) .....</b>	<b>47</b>
5.1 INTRODUCTION .....	47
5.2 FICTIONAL SCENARIO OF A SECTION 45 TRANSACTION .....	47
5.2.1 Transaction .....	47
5.2.2 Requirement for a de-grouping in terms of section 45(4)(b).....	49
5.3 RATIONALE FOR THE ARGUMENT AGAINST DE-GROUPING.....	50
5.3.1 Requirements For a Section 45 Transaction .....	50
5.3.2 Interpretation of Legislation .....	51
5.3.2.1 International Law .....	51
5.3.2.2 Explanatory Memoranda .....	53
5.4 CONCLUSION .....	55
<b>CHAPTER 6 - CONCLUSION.....</b>	<b>56</b>
6.1 HOW FAR DOES THE DE-GROUPING CHARGE IN SECTION 45(4)(B) REACH .....	56
<b>BIBLIOGRAPHY .....</b>	<b>58</b>
ACTS, EXPLANATORY MEMORANDUM AND CONVENTIONS.....	58
BOOKS .....	58
CASE LAW .....	58
JOURNAL ARTICLES AND PUBLICATIONS .....	59
MEDIA STATEMENTS .....	60
THESIS.....	60

**ANNEXURE G**..... 61

**ANNEXURE M** ..... 62

# CHAPTER 1 - SCOPE AND PURPOSE OF DISSERTATION

## 1.1 Introduction

In 2001 South Africa adopted the capital gains tax regime.<sup>1</sup> In accordance with this regime the capital gain received or accrued on the disposal of assets will be included in a person's taxable income. The capital gain is equal to the amount received or accrued that exceeds the base cost<sup>2</sup> of the asset.<sup>3</sup> Consequently, capital gains tax is triggered upon a disposal<sup>4</sup> of an asset.

In the event that a group of companies would undertake a restructuring,<sup>5</sup> the disposal of assets may result in a significant amount of capital gains tax being triggered. In order to ensure that these types of transactions take place in a tax neutral manner, the corporate rules were introduced in 2001<sup>6</sup> and are governed by section 41 to 47 of the Income Tax Act No 58 of 1962 (hereinafter referred to as the "Income Tax Act").

The focus of this dissertation will be on section 45 of the Income Tax Act which is also referred to as "intra-group transactions" and more specifically the de-grouping charge in section 45(4)(b) of the Income Tax Act.

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<sup>1</sup> Taxation Laws Amendment Act 5 of 2001. This Act was promulgated on 20 June 2001.

<sup>2</sup> The base cost of an asset is determined in accordance with par 20 of the Eighth Schedule to the Act. In essence the base cost of an asset is the expenditure incurred in acquiring the asset as well as costs related to improving the asset or adding to it. (See *Haupt Notes on South African Income Tax (2015)* 723 for a further explanation on how to determine the base cost of an asset.)

<sup>3</sup> Par 1 of the Eighth Schedule to the Income Tax Act No 58 of 1962 defines an asset to include the following "...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 a right or interest of whatever nature in such property...".

<sup>4</sup> The term "disposal" is defined in Part III of the Eighth Schedule to the Income Tax Act No 58 of 1962 as "... any event, act or forbearance or operation of law which results in creation, variation, transfer or extinction of an asset...". The definition is quite lengthy and should be revisited per transaction as the definition makes provision for quite a few specific inclusions and exclusions.

<sup>5</sup> A restructuring in this instance means a change in the operational structure of a group of companies. This could mean introducing a new company or moving a business unit to either a new company within the group or a pre-existing company. As a result assets are disposed of and capital gains tax will be triggered.

<sup>6</sup> Explanatory Memorandum on the Revenues Law Amendment Bill 2002; Omar *Group taxation in South Africa – A contextual analysis* – Unpublished LLM 2009 41 -61 in which he argues that the corporate rules are akin to group tax systems which provide relief for inter-company transactions.

## 1.2 Section 45 of the Income Tax Act

Section 45 of the Income Tax Act provides a mechanism whereby a company may dispose of its assets to another company and defer the tax consequences of such a disposal. For the relief in section 45 of the Income Tax Act to apply the following requirements must be met:

- both companies must form part of the same group of companies<sup>7</sup> after the transaction; and
- the assets disposed of retain their nature upon transfer.<sup>8</sup>

The tax consequences that are deferred are collectively referred to as “roll-over relief”. The roll-over relief provided includes a deferral of income tax, capital gains tax and in certain circumstances may also provide a deferral in terms of securities transfer tax,<sup>9</sup> transfer duty<sup>10</sup> and value-added tax.<sup>11</sup>

The introduction of section 45, however opened the door to some innovative tax planning. Taxpayers seized the opportunity to manipulate their investments to enable a tax free exit.<sup>12</sup> These types of transactions are neither within the spirit of the legislation nor was it what was initially intended with the intra-group provisions.<sup>13</sup>

The South African Revenue Service (hereinafter referred to as “SARS”) responded to this by amending the legislation and introducing certain anti-avoidance measures.<sup>14</sup>

One of these anti-avoidance measures is the de-grouping charge in section 45(4)(b) of the Income Tax Act.

A ‘de-grouping’ event as envisaged in section 45(4)(b) of the Income Tax Act, will result in a reversal of the roll-over relief provided for in terms of section 45 of the Income Tax Act

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<sup>7</sup> The definition of “group of companies” as defined in s 41 is narrower than provided for in s 1 of the Income Tax Act. The s 41 definition excludes certain companies and shares and also determines that the companies within the group need to be South African resident companies.

<sup>8</sup> In this instance the nature of the assets refers to whether the asset is a capital asset, trading stock or an asset in terms of which allowances were deducted for tax purposes.

<sup>9</sup> S 8(1)(a) of the Securities Transfer Tax Act 25 of 2007.

<sup>10</sup> S 9(1)(l) of the Transfer Duty Act 40 of 1949.

<sup>11</sup> S 8(25) of the Value-Added Tax Act 89 of 1991.

<sup>12</sup> National Treasury *Explanatory Memorandum on the Taxation Laws Amendment Bill 2008* 14. Hereinafter referred to the “Explanatory Memorandum 2008”.

<sup>13</sup> National Treasury *Explanatory Memorandum of the Revenue Laws Amendment Bill 2002* 18.

<sup>14</sup> National Treasury *Explanatory Memorandum of the Revenue Laws Amendment Bill 2002* 21; Louw “Section 45: The good, the Treasury, and the unknown” June 2008 Without Prejudice Vol 8 15.

and as a result thereof adverse tax consequences will be triggered. Section 45(4)(b) will apply if one of the following events takes place:

- i) The transferee company cease to form part of *any* group of companies in relation to the transferor company, within a period of six years of the section 45 transaction; or
- ii) The transferee company ceases within a period of six years to form part of *any* group of companies in relation to a controlling group company in relation to the transferor company.

The de-grouping charge therefore, specifically deals with a time limit as well as maintaining a specific group structure i.e. it aims to keep the group of companies intact.

A group of companies in terms of section 1 of the Income Tax Act is<sup>15</sup> -

“...two or more companies in which one company (hereinafter referred to as the “controlling group company”) directly or indirectly holds shares in at least one other company (hereinafter referred to as the “controlled group company”), to the extent that -

- (a) at least 70 per cent of the equity shares in each controlled group company are directly held by the controlling group company, one or more other controlled group companies or any combination thereof; and
- (b) the controlling group company directly holds at least 70 per cent of the equity shares in at least one controlled group company;”

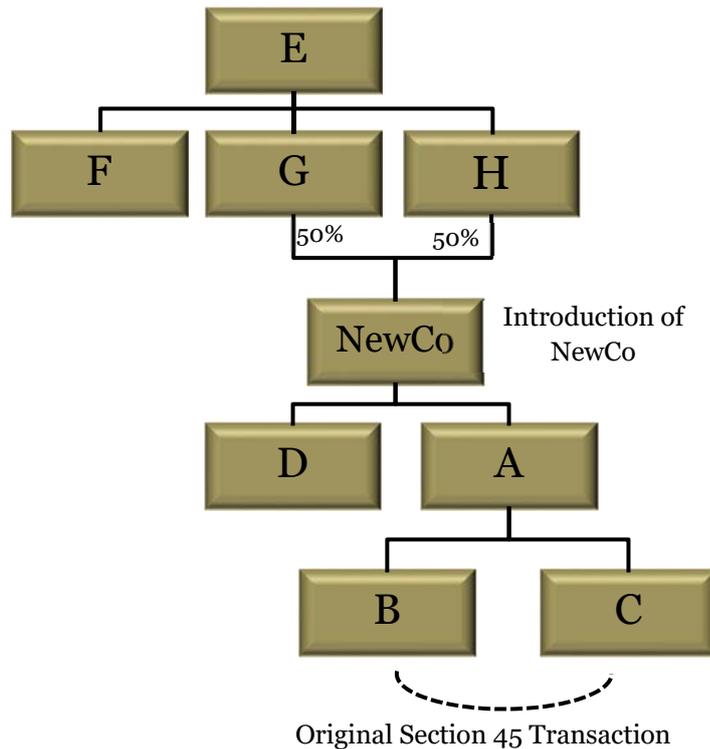
The above de-grouping charge and definition of group of companies could result in a very wide application especially regarding the use of the word “any” and “a” in section 45(4)(b) of the Income Tax Act.

Due to the wide application a de-grouping charge may be triggered in circumstances where the taxpayer is still operating within the spirit of the legislation i.e. the taxpayer has no intention of abusing section 45 yet triggers a de-grouping charge.

The diagram below illustrates potentially how far section 45(4)(b) of the Income Tax Act can reach:

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<sup>15</sup>This definition should be read together with s 41 of the Income Tax Act which in essence provides for certain companies to be excluded. This is discussed in more detail in Chapter 2 par 2.2.



\*All shareholding is 100%, unless otherwise indicated.

A group of companies,<sup>16</sup> as set out above, undertakes a section 45 transaction in terms of which the business of Company C<sup>17</sup> is transferred to Company B<sup>18</sup> in exchange for cash.<sup>19</sup> At the time of this transaction Company A owes 100% of the shares in Companies B and C and in turn Company H owes 100% of the shares in Company A.

Within six years of the original section 45 transaction, the needs of the group change and it is required that a new company<sup>20</sup> is interposed above Company A and D and as a subsidiary of Companies G and H.

If the NewCo is introduced within 6 years of the original section 45 transaction, a de-grouping event may occur, as Company H is no longer a controlling group company in

<sup>16</sup>As set out in s 41 of the Income Tax Act. For a comprehensive discussion of the group-of-companies definition as set out in s 41 of the Income Tax Act please refer to Chapter 2 par 2.2.

<sup>17</sup> Also referred to as the “transferor company”.

<sup>18</sup>Also referred to as the “transferee company”.

<sup>19</sup>Going forward this transaction will be referred to as the “original section 45 transaction”.

<sup>20</sup>In the diagram referred to as NewCo.

relation to Company A. This may happen despite the fact that the “group of companies” which was originally required for the section 45 transaction is still intact.

### 1.3 Interpretation of Legislation

This result illustrated in the diagram above seems to be illogical. A “de-grouping” will take place if the “group of companies” is restructured irrespective of whether the company(ies) party to the new restructure have been party to the original intra-group transaction.

The crisp question that needs to be asked is how the legislation should be interpreted. In this regard, there are two schools of thought: a literal approach or a purposive approach. A literal approach is where the ordinary grammatical meaning<sup>21</sup> of the words must be applied. This is referred to as the primary rule.<sup>22</sup> Prior to South Africa having a constitution a literal approach was preferred as it tended to favour the *fiscus* because arriving at a fair and equitable result was not required.<sup>23</sup>

However, since South Africa now has a Constitution<sup>24</sup> which is the supreme law of the Republic of South Africa all legislation needs to be interpreted to promote the spirit and objects of the Bill of Rights.<sup>25</sup> As a result thereof the argument in favour of the purposive approach has strengthened.<sup>26</sup> The purposive approach takes into consideration the context of the legislation.<sup>27</sup> In *Natal Joint Municipal Pension Fund v Endumeni Municipality*<sup>28</sup> Wallis J gives a dictum<sup>29</sup> in which he addresses the way that legislation should be interpreted going forward:

*“...the context and the language together with neither predominating over the other...”*

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<sup>21</sup>Du Plessis *Re-Interpretation of Statutes* (2011) 93.

<sup>22</sup>Goldswain “The purposive approach to fiscal legislation - the winds of change” 2008 *Meditari Accountancy Research* Vol 16 No 2 107.

<sup>23</sup>Goldswain *Meditari Accountancy Research* Vol 16 No 2 107.

<sup>24</sup>S 2 of the Constitution of the Republic of South Africa, 1996. Hereinafter referred to as the Constitution.

<sup>25</sup>S 39(2) of the Constitution. These values are set out in s 1 of the Constitution and include human dignity and equality.

<sup>26</sup>Goldswain *Meditari Accountancy Research* Vol 16 No 2 107.

<sup>27</sup>Botha *Statutory Interpretation— an introduction for students* (2012) 97. Botha also refers to this approach as the “text-in-context approach”, for this dissertation the term purposive approach will be used.

<sup>28</sup>2012 (4) SA 593 (SCA).

<sup>29</sup>At 602H-610C.

Taking the above into account it appears that statutory interpretation is a process that must be duly followed in order to determine how the legislation should be applied.

## **1.4 Research Question**

In order to determine how far the de-grouping charge in section 45(4)(b) reach and what the implications thereof may be, all aspects regarding section 45(4)(b) of legislation must be considered.

This study aims to provide a critical analysis of the mechanics of section 45, the intended purpose of the section 45(4)(b), how legislation should be interpreted and relevant case law.

These results will then be applied to a fictional scenario in order to determine how far the de-grouping charge actually reach if the legislation is interpreted with a purposive approach.

## **1.5 Exposition of Study**

### **1.5.1 History and Mechanics of Section 45 of the Income Tax Act**

Chapter 2 deals with the reasons for introducing section 45 to the Income Tax Act as well as how this section operates. This will serve as a precursor to Chapter 4 in which the de-grouping charge is discussed.

### **1.5.2 Interpretation of Statutes**

At the heart of this dissertation lies the question as to how legislation, specifically the de-grouping charge in section 45(4)(b) must be interpreted. In Chapter 3 a closer look is taken as to how legislation must be interpreted and what external materials may be considered.

### **1.5.3 De-grouping charge in Section 45(4)(b)**

Chapter 4 addresses the purpose of section 45(4)(b) and how it aims to address the abuse of section 45. Furthermore, section 45(4)(b) has undergone specific amendments. The purposes and effect of these amendments are discussed to determine whether it is effective in curbing the abuse of section 45.

### **1.5.4 Application**

With a greater understanding of how to interpret legislation as well as the mechanics of section 45 and the purpose behind the introduction of the de-grouping charge – we apply section 45(4)(b) to a fictional scenario in Chapter 5.

### **1.5.5 Conclusion and recommendation**

The research involving the mechanics of section 45, the purpose behind the introduction of section 45(4)(b) as well as the result of applying this section to a fictional scenario is summarised and a conclusion is reached as how this de-grouping charge should be applied in future.

## CHAPTER 2 - HISTORY AND MECHANICS OF SECTION 45

### 2.1 Introduction

Section 45 is found in Part III of Chapter II of the Income Tax Act<sup>1</sup> and is often referred to as the Corporate Rules.<sup>2</sup> The Corporate Rules were introduced in order to facilitate certain transactions between companies that form part of the same group of companies.<sup>3</sup> The following types of transactions are governed by the Corporate Rules: an “asset-for share” transaction, substitutive share-for-share transaction, amalgamation transaction, intra-group transactions, unbundling transactions and transaction relation to liquidation or winding-up and deregistration.<sup>4</sup> Typically, these transactions would not give rise to any economic benefit but would have been taxable were it not for the Corporate Rules.<sup>5</sup>

Section 45, the so-called “intra-group transaction”, governs transactions where an asset is disposed of between two companies that form part of the same group of companies.<sup>6</sup> The aim of these provisions is to defer<sup>7</sup> the tax consequences that would have occurred upon the disposal of the assets.

In order to understand the provisions of section 45 certain important definitions and concepts such as: company, group of companies, and how the taxable income of a company is determined must be considered.

Below each of these concepts will be discussed and set-out in terms of their application and interaction with section 45.

### 2.2 Definitions

#### 2.2.1. Company

A company is a separate legal entity and as such is treated separately from its shareholders for tax purposes.<sup>8</sup>

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<sup>1</sup>Hereinafter all references to s 45 will mean s 45 of the Income Tax Act, unless otherwise indicated.

<sup>2</sup>Haupt *Notes on South African Income Tax* (2015) 543.

<sup>3</sup>See discussion below in par 2.2.

<sup>4</sup>These transactions are governed by s 42, s 43, s 44, s 45, s 46 and s 47 of the Income Tax Act, respectively.

<sup>5</sup>Explanatory Memorandum to the Revenue Laws Amendment Bill, 2002 18; Stiglingh *et al Silke: South African Income Tax* (2015) 510.

<sup>6</sup>Stiglingh *et al* (2015) 543. For more detail on the definition of “intra-group transactions” see par 2.3 below.

<sup>7</sup>S 45(2) & (3) of the Income Tax Act.

<sup>8</sup>Stiglingh *et al* (2015) 495.

Section 19 defines a company for tax purposes to include the following:

- Any association, corporation or company (other than a close corporation) incorporated in the Republic of South Africa, including any body corporate formed under South African law;<sup>10</sup>
- Any association, corporation or company incorporated under a foreign law, including a body corporate formed under such law;<sup>11</sup>
- A co-operative;<sup>12</sup>
- An association<sup>13</sup> formed in the Republic of South Africa for the benefit of the public or a section of the public;<sup>14</sup>
- Any portfolio comprised of foreign investment schemes<sup>15</sup> or a portfolio of collective investment schemes in property Real Estate Investment Trust as defined in paragraph 13.1(x) of the JSE Limited Listing Requirements;<sup>16</sup> and
- Foreign partnerships are not regarded to be companies.<sup>17</sup>

### **2.2.2 Group of companies**

A group of companies is defined in the Income Tax Act in both section 1 and section 41. When applying section 45 one should read the definition of group of companies as defined in section 1 together with the definition of section 41.

The “group of companies” definition as set out in section 1:

“Means two or more companies in which one company (hereinafter referred to as the “controlling group company”) directly or indirectly holds shares in at least one other

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<sup>9</sup>Of the Income Tax Act.

<sup>10</sup>S 1 of the Income Tax Act, definition of “company” par (a). S13 of the Companies Act 71 of 2008 regulates the incorporation of companies. In order for a company to be incorporated under South African Law, a Memorandum of Incorporation must be completed and signed by the incorporators. The Memorandum of Incorporation together with a Notice of Incorporation and the prescribed fee must then be filed with the Companies and Intellectual Property Commission. See Cassim *Contemporary Company Law* (2012) 14.

<sup>11</sup>S 1 of the Income Tax Act, definition of “company” par (b).

<sup>12</sup>S 1 of the Income Tax Act, definition of “company” par (c).

<sup>13</sup>Other than a company or close corporation.

<sup>14</sup>S 1 of the Income Tax Act, definition of “company” par (d).

<sup>15</sup>S 1 of the Income Tax Act, definition of “company” par (e)(ii).

<sup>16</sup>S 1 of the Income Tax Act, definition of “company” par (e)(iii). In the JSE Listing Requirements a Real Estate Investment Scheme is defined in par 13.1 (x) as “...defined as an applicant issuer which receives a REIT status in terms of the Listings Requirements.” These listing requirements may be summarised as follow: A REIT must: own property worth at least 300 South African Rand; maintain its debt below 60% of its gross asset value; earn 75% of its income from rental or from property owned or investment income from indirect property ownership; have a committee in place to monitor risk; not enter into derivative instruments that are not in the ordinary course of business; and distribute at least 75% of its taxable earnings available for distribution to its investors each year.

<sup>17</sup>S 1 of the Income Tax Act, definition of “company”.

company (herein after referred to as the “controlled group company”), to the extent that–

- (a) at least 70 percent of the equity shares in each controlled group company are directly held by the controlling group company, one or more other controlled group companies or any combination thereof; and
- (b) the controlling group company directly holds at least 70 per cent of the equity shares in at least one controlled group company.”

From the above it can be deduced that in order to be regarded as a group of companies a parent company will need to hold, directly or indirectly 70% of the equity shares in a subsidiary company.

The definition in section 41 limits the application of the section 1 definition of group of companies, by excluding the following:

- a co-operative, a company formed for the benefit of the general public and a foreign collective investment scheme in participation bonds and securities;<sup>18</sup>
- a non-profit company as defined in section 1 of the Companies Act No. 71 of 2008;<sup>19</sup>
- a company that is subject to the exemptions in section 10 of the Income Tax Act by virtue of its status;<sup>20</sup>
- a company that is a public benefit organisation or recreational club as approved by the Commissioner in terms of section 30 or 30A;<sup>21</sup>
- a company that has been formed under foreign laws, unless that company has a permanent establishment in South Africa;<sup>22</sup>
- a company that has its place of effective management outside of South Africa;<sup>23</sup>
- any share that would have constituted an equity share, but for the provisions of this definition, unless that share is held as trading stock;<sup>24</sup>
- any person that is under a contractual obligation to sell or purchase the share or has an option to sell or purchase that share at its market value at the time of that sale or purchase.<sup>25</sup>

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<sup>18</sup>S 1 of the Income Tax Act “group of companies” definition par (i)(aa).

<sup>19</sup>S 1 of the Income Tax Act “group of companies” definition par (i)(bb).

<sup>20</sup>S 1 of the Income Tax Act “group of companies” definition par (i)(cc).

<sup>21</sup>S 1 of the Income Tax Act “group of companies” definition par (i)(dd).

<sup>22</sup>S 1 of the Income Tax Act “group of companies” definition par (i)(ee).

<sup>23</sup>S 1 of the Income Tax Act “group of companies” definition par (i)(ff).

<sup>24</sup>S 1 of the Income Tax Act “group of companies” definition par (ii)(aa).

<sup>25</sup>S 1 of the Income Tax Act “group of companies” definition par (ii)(bb).

The most notable exclusion from the above list is the exclusion of foreign companies unless that has a permanent establishment in South Africa.<sup>26</sup> This is due to the fact that groups of companies often span across country borders. Therefore, when contemplating an intra-group transaction caution should be given to ensure that the group of companies are South Africa tax resident or that a foreign company has a permanent establishment in South Africa.

In summary, section 1<sup>27</sup> provides the percentage of shareholding required to form a group, whilst the section 41 definition determines that certain companies must be excluded. Section 45 requires that the group of companies definition in section 1 must be read together with the group of companies definition in section 41 therefore, in its simplest form one may say that a section 45 transaction requires a South African group of companies.

### **2.2.3 Intra-group transaction**

Section 45 defines an intra-group transaction as follow:<sup>28</sup>

- The disposal of an asset from one company (transferor company) to another resident company (transferee company); and
  - Both companies form part of the same group of companies<sup>29</sup> at the end of the day of the transaction; and
  - As a result of the transaction the transferee company acquires that asset from the transferor company as a capital asset - if the transferor company held it as such; or
  - As trading stock if the transferor company held it as trading stock.<sup>30</sup>

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<sup>26</sup>According to Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development (17 July 2008) a permanent establishment is a “... fixed place of business through which the business of an enterprise is wholly or partly carried on.” This article then continues to provide for specific inclusions and exclusions. The definition of “permanent establishment” in S 1 of the Income Tax Act refers to the aforementioned definition and adds the following “...Providing that in determining whether a qualifying investor in relation to a partnership, trust or foreign partnership has a permanent establishment in the Republic, any act of that partnership, trust or foreign partnership in respect of any financial instrument must not be ascribed to that qualifying investor.” See Kluwer *International Tax Primer* (2002) 119 for further reading.

<sup>27</sup>Of the Income Tax Act.

<sup>28</sup>As defined in s 45(1)(a) of the Income Tax Act. For the sake of simplicity this dissertation will only address the definition as contained in par (a) of s 45(1).

<sup>29</sup>As defined in s 41 of the Income Tax Act. See discussion above in par 2.2.

<sup>30</sup>S 45(1)(a) of the Income Tax Act.

## 2.2.4 Taxable income of a company

It is important to understand how the taxable income of a company is calculated before the interpretation of the provisions of section 45 is discussed.<sup>31</sup> The provisions of section 45 may (depending on the nature of the transaction) influence the deductions, allowances, taxable capital gains and assessed losses of a company's taxable income.

The taxable income of a company may be determined as follow:<sup>32</sup>

<b>Taxable income</b>	
<b>Gross income</b>	Rxxx
<b>Less (exempt income)</b>	(xxx)
<b>Income</b>	<b>Rxxx</b>
<b><i>Less: Deductions and allowances</i></b>	(xxx)
<b><i>Less: Assessed loss</i></b>	(xxx)
<b>Add: Taxable capital gain</b>	xxx
<b>Add: amounts included in taxable income</b>	xxx
<b><i>Less: Deduction in terms of section 18A</i></b>	(xxx)
<b>Taxable income</b>	<b>Rxxx</b>

## 2.3 Taxes Deferred under Section 45

### 2.3.1 Introduction

Section 45 provides for assets to be disposed of in a tax neutral manner.<sup>33</sup> The taxes that could have arisen on the disposal of assets include capital gains tax, income tax, value-added tax, and securities transfer tax or transfer duty. Below a brief look is taken at the basic elements of these taxes and how section 45 provides relief.

<sup>31</sup>It is not the purpose of this dissertation to provide an in-depth analysis on the taxable income of a company and the specific components thereof. For further reading on this subject matter please see Haupt *Notes on South African Income Tax* (2015) 17.

<sup>32</sup>Adapted from Stigling *et al.* (2015) 6.

<sup>33</sup>These provisions of s 45(2)(a) and (b), s 45(3)(a) and (b) are structured in such a manner that the transferor and the transferee are deemed to be one and the same person with regard to any capital gain or loss, expenses incurred and allowances allowed or claimed. As such the tax on the disposal of the assets is deferred and the disposal is "tax neutral".

### 2.3.2 Capital gains tax

Capital gains tax<sup>34</sup> was introduced into the South African tax system in October of 2001.<sup>35</sup> The reasons for the introduction of CGT was to put South Africa on the same playing field as other countries, to provide for vertical and horizontal equity, to avoid taxpayers re-characterising income as capital,<sup>36</sup> economic efficiency, and broadening the tax base.<sup>37</sup>

The Eighth Schedule<sup>38</sup> determines the amount of CGT and section 26A imputes the capital gain into the taxable income of a person.<sup>39</sup> In order for CGT to arise there needs to be a disposal<sup>40</sup> of an asset, of which the proceeds exceed the base cost. A person's capital gain for a year of assessment is equal to the proceeds received, or accrued in terms of that disposal that exceeds the base cost of that asset.<sup>41</sup> Below the elements of CGT are discussed.<sup>42</sup>

#### 2.3.2.1 Disposal

A disposal is defined quite broadly in the Eight Schedule,<sup>43</sup> paragraph 11(1) reads as follow:

“...a disposal is any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset...”

Paragraph 11 then continues to list specific examples of disposals of which paragraph (a) is relevant for discussions in terms of section 45:

“the sale, donation, expropriation, conversion, grant, cession, exchange or any other alienation or transfer and ownership of an asset;”

The disposal of an asset may be summarised as an event that will result in a change of ownership of that asset.

#### 2.3.2.2 Asset

An asset is defined paragraph 1 of the Eighth Schedule to include:

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<sup>34</sup>Hereinafter referred to as “CGT”.

<sup>35</sup>South African Revenue Service: Draft Comprehensive Capital Gains Tax Guide Issue 5, 3. Hereinafter referred to as the “CGT-guide”.

<sup>36</sup>This was done in order to avoid income tax liability.

<sup>37</sup>Briefing by National Treasury's Tax Policy Chief Directorate to the Portfolio and Select Committees “Capital Gains Tax” 24 January 2001 [Online] [www.ftomasek.com/NationalTreasury.pdf](http://www.ftomasek.com/NationalTreasury.pdf) (accessed on 17 May 2015); CGT-guide 1-3.

<sup>38</sup>To the Income Tax Act, hereinafter referred to as the “Eighth Sch”.

<sup>39</sup>Refer to table above in par 2 4.

<sup>40</sup>This includes deemed disposal as set out in paragraph 12 of the Eighth Sch. It should further be noted that if the disposal is revenue in nature, then the normal principles in the Income Tax Act would apply and not those in the Eighth Sch.

<sup>41</sup>Par3(a) of the Eighth Sch.

<sup>42</sup>See Stiglingh *et al.* (2015) 912 where the elements are referred to as the “building blocks” of CGT.

<sup>43</sup> Par 11(1).

“... (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;

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

### **2.3.2.3 Proceeds**

Proceeds are defined in paragraph 35(1) of the Eighth Schedule:

“...the proceeds from the disposal of an asset by a person are equal to the amount received by or accrued to, or which is treated as having been received by, or accrued to or in favour of, that person in respect of that disposal, and includes –

- (a) the amount by which any debt owed by that person has been reduced or discharged; and
- (b) any amount received by or accrued to a lessee from the lessor of property for improvements effect to that property...”

Paragraph 35(3) of the Eighth Schedule further states that the following amounts will reduce the amount of proceeds:

- “...(a) any amount of the proceeds that must be or was included in the gross income of that person or that must be or was taken into account when determining the taxable income of that person before the inclusion of any taxable capital gain;<sup>44</sup>
- (b) any amount of the proceeds that has been repaid or has become repayable to the person to whom that asset was disposed of; or
- (c) any reduction, as a result of the cancellation, termination or variation of an agreement or due to the prescription or waiver of a claim or release from an obligation or any other event, of an accrued amount forming part of the proceeds of that disposal.”

### **2.3.2.4 Base cost**

The base cost of an asset is determined in terms of Part V of the Eighth Schedule and is equal to the expenditure incurred in acquiring the asset including the improvement cost and the

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<sup>44</sup>For example a recoupment.

direct cost in respect of the acquisition and disposal of an asset.<sup>45</sup> For purposes of determining base cost, it should be noted that a distinction is made between assets pre and post valuation date i.e. 1 October 2001.<sup>46</sup>

However, the base cost of an asset is reduced by any amount that has been allowed as a deduction<sup>47</sup> in determining the income tax of that person, and any amount that has reduced the expenditure incurred or become recoverable.<sup>48</sup>

The above concepts are illustrated in the following example: In year 1 Company Y acquires an asset of R1000. The asset depreciates with R100 every year. In year 3 the company sells the asset for R1200. The capital gain (if any) will be calculated as follows:

Base cost:	R1,000
Depreciation Year 1:	(100)
Depreciation Year 2:	(100)
Base Cost in Year 3:	<u>R 800</u>

$$\begin{aligned} \text{Capital gain} &= \text{Proceeds} - \text{base cost} \\ &= \text{R1,200} - \text{R800} \\ &= \text{R400} \end{aligned}$$

The taxable capital gain to be included in the taxable income of Company Y is 66.6% of the capital gain i.e. R400.<sup>49</sup>

Section 45(2)(a) provides for the following relief in terms of capital gains tax:

- (i) the transferor company (i.e. the company that disposes of the asset) will be deemed to have disposed of the asset for an amount equal to the base cost thereof. A capital gain<sup>50</sup> is equal to the amount by which the proceeds exceed the base cost.

<sup>45</sup>Stiglingh *et al.* (2015) 869. In terms of determining what constitutes “direct cost” par 20(1)(c)(i) – (ix) of the Eighth Schedule must be consulted. Furthermore, par 20(1)(h) of the Eighth Schedule provides a list of specific costs that may also be included in the base cost of an asset, these costs are also listed in an abbreviated format in Stiglingh *et al.* (2015) 888–889. Par 20(2) of the Eighth Schedule list costs that are specifically excluded for purposes of determining the base cost of an asset.

<sup>46</sup>Valuation date is defined in par 1 of the Eighth Sch as either 1 October 2001 (when CGT was introduced) or the date, on which a person ceases to be an exempt person, should the date occur after 1 October 2001. For purposes of this study we will work on the assumption that all assets’ are post valuation date assets. We note however, for completeness sake that pre-valuation date assets’ base cost is determined by the sum of the valuation date value of that asset and the expenditure allowable on or after the valuation date. For further reading how to determine the base cost of pre-valuation date assets see Stigling *et al.* (2015) 894 – 899.

<sup>47</sup>Par 3(a)(i) of the Eighth Sch.

<sup>48</sup>Par 3(b) of the Eighth Sch. The amount referred to here is typically the allowances allowed for depreciation for normal tax purposes.

<sup>49</sup>S 26A of the Income Tax Act read together with par 10 of the Eighth Sch.

<sup>50</sup>Par 3(a) of the Eighth Sch.

If the base cost is equal to the proceeds then no capital gain will arise upon disposal of the asset.

- (ii) The transferor company and the transferee company will be deemed to be one and the same person for purposes of determining a future capital gain or loss. The transferee company will be deemed to have incurred the expenditure<sup>51</sup> as the transferor company, as well as any valuation.<sup>52</sup> The transferee company therefore, has the same base cost in the transferred capital assets as the transferor company had.

### **2.3.3 Income tax**

Above it was illustrated how a capital gain was imputed into the taxable income of a company and how section 45 effects a capital gain upon a disposal of assets.

Below it will be illustrated how trading stock, which is revenue in nature will influence the taxable income of a company. In this regard, allowances and deductions also have an impact on the taxable income of a company. The effect of section 45 on these allowances and deductions will also be illustrated in this section

#### **a) Trading stock**

Haupt<sup>53</sup> defines trading stock as:

“..basically anything that is acquired or created for the purposes of sale or which will be incorporated in another asset which will be sold. It is therefore a revenue asset”.<sup>54</sup>

In section 1<sup>55</sup> the definition is more comprehensive and goes further to include:

- consumable stores and spare parts;
- anything produced, manufactured, constructed, assembled, purchased or in any other manner acquired by a taxpayer for purposes of manufacture, sale or exchange
- anything if the proceeds form part of the taxpayer’s gross income except –
  - proceeds from the disposal of capital assets by a mine;
  - proceeds from the disposal of a plantation<sup>56</sup>;

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<sup>51</sup>For purposes of the par 20 of the Eighth Sch i.e. base cost.

<sup>52</sup>As contemplated in par 29(4) of the Eighth Sch.

<sup>53</sup>Haupt (2015) 291.

<sup>54</sup>S 1 of the Income Tax Act, definition of “trading stock”.

<sup>55</sup>Of the Income Tax Act.

<sup>56</sup>As envisaged in par 14(1) of the First Schedule to the Income Tax Act.

- an amount received in terms of a key man policy.<sup>57</sup>

However, the definition specifically excludes the following:

- A foreign currency option contract; and
- A forward exchange contract<sup>58</sup>

The proceeds from the sale of trading stock will be included in the gross income of the taxpayer,<sup>59</sup> whilst expenses incurred to acquire trading stock will be allowed as a deduction.<sup>60</sup> The trading stock on hand at the end of the year needs to be “counted back” in order to balance the taxable income.

The amount allowed to be deducted from trading stock for purposes of determining taxable income may be illustrated as follow:

<b>Cost of Sales</b>	<b>Tax treatment</b>
<b>Opening stock (s 22(2))</b>	(R1,000)
<b>Purchases (s 11(a))</b>	(R900)
<b>Closing stock</b>	R400
<b>Total deduction from taxable income</b>	<b>(R1500)</b>

Section 45 provides that the transferor company must be deemed to have disposed of that trading stock for an amount equal to an amount that was incurred in terms of section 11(a) or section 22(1) and (2).<sup>61</sup> As such the transaction will be tax neutral because no profit would have been made on the sale.

For purposes of determining the taxable income of the transferee company<sup>62</sup> and the transferee company is deemed to be one and the same person. Therefore, the transferor company will be deemed to have acquired the trading stock on the same date and for the same amount as the transferor company for purposes of section 11(a) and section 22(1) and (2).

<sup>57</sup>S 1 of the Income Tax Act, definition of “gross income” par (n).

<sup>58</sup>Defined in s 24 of the Income Tax Act.

<sup>59</sup>Stiglingh *et al.* (2015) 690.

<sup>60</sup>S 11(a) of the Income Tax Act.

<sup>61</sup>S 45(2)(b)(i) of the Income Tax Act. The values referred to in s 22(1) and (2) are the opening closing stock and opening stock balances.

<sup>62</sup>S 45(2)(b)(ii) of the Income Tax Act.

### **b) Allowance assets<sup>63</sup>**

The disposal of allowance assets may give rise to certain recoupments. Section 45 provides for the tax neutral transfer of allowance assets.<sup>64</sup> The transferor company must not recover, recoup or include in its income any allowance that was allowed for that asset.

Going forward the transferee and the transferor company should be seen as one and the same person for purposes of determining:<sup>65</sup>

- the amount of allowances or deductions allowable for the transferee company; or
- the amount to be recovered recouped or included in the transferee companies' income.

Therefore, the transferee company will be allowed to treat the asset, for tax purposes, in the same manner as the transferor company would have been allowed to.

### **c) Section 24C allowances<sup>66</sup>**

An allowance in terms of section 24C of the Income Tax Act, allows the taxpayer, who received an amount of income in advance, to claim as a deduction expenditure that will be incurred in the future in order to fulfill obligations in terms of the contract. The purpose of this section is to try and match the income with the expenditure.<sup>67</sup>

Section 45 provides for the tax neutral transfer of contracts which would have qualified for section 24C allowances. Tax neutrality is achieved as follows:

- the transferor company must not include any allowance allowed in terms of section 24C in its income;<sup>68</sup>
- the transferee company is deemed to be one and the same person regarding the amount of any allowances which the transferor company may be entitled to and to

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<sup>63</sup>Payments that are of a capital nature are not deductible for tax purposes as it falls outside of the scope of the general deduction formula in 11(1)(a) and 23(g). Stiglingh *et al.* (2015) 224 indicates that if assets fulfil certain requirements in the Income Tax Act, such assets will be granted an allowance and may be written off for tax purposes

<sup>64</sup>S 45(3)(a)(i).

<sup>65</sup>S 45(3)(a)(ii)

<sup>66</sup>The difference between an s 24C allowance and a “normal” capital allowance (in (b) above) is that the s 24C allowance specifically relates to contracts in terms of which an amount of income has been received that will be used to fund future expenditure. Furthermore, in terms of s 45 of the Income Tax Act separate provisions are made for contracts that are to be transferred in terms of which a s 24C allowance was granted.

<sup>67</sup>Van den Berg “Section 24C allowance: income received in respect of gift vouchers & lay-by arrangements?” July 2013 EY Tax Alert 8.

<sup>68</sup>S 45(b)(i).

determine how much of that allowance must be included in income in respect of the section 24C future expenditure obligation.<sup>69</sup>

In essence the transferee company would continue in the same way as the transferor company would have and the transferor company is not allowed to claim the deduction in terms of section 24C, as such the disposal of the contract in terms of which a section 24C allowance was granted is tax neutral.

### **2.3.4 Value-Added Tax**

In terms of the Value-Added Tax Act<sup>70</sup> a supply by a vendor of goods or services in the course or furtherance of any enterprise carried on by a vendor will give rise to value-added tax.<sup>71</sup>

“Goods” is defined as follows:<sup>72</sup>

“‘goods’ means corporeal movable things, fixed property, any real right in any such thing or fixed property, and electricity, but excluding –

- (a) money;
- (b) any right under a mortgage bond or pledge of any such thing or fixed property; and
- (c) any stamp form or card which has a money and has been sold or issued by the State for the payment of any tax or duty levied under any Act of Parliament, except when subsequent to its original sale or issue it is disposed of or imported as a collector’s piece or investment article;”

The definition of “goods” includes a disposal of assets which will result in a value-added tax event. However, in terms of section 8(25) of the VAT Act, where the provisions of section 45 of the Act apply to a supply of goods or services, the vendors must be deemed to be one and the same person.<sup>73</sup> However, in order for the exemption to apply the following requirements must be met:

- Both the transferor and the transferee company must be registered for VAT;

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<sup>69</sup>S 45(b)(ii).

<sup>70</sup>No 89 of 1991. Herein after referred to as “the VAT Act”.

<sup>71</sup>S 7(1)(a) of the VAT Act. Value-Added Tax herein after referred to as “VAT”.

<sup>72</sup>S 1 of the VAT Act.

<sup>73</sup>If the vendors are deemed to be one and the same person, it will mean that the supply of goods will be a non-event for VAT purposes. See Stiglingh *et al.* (2015) 1078 for a discussion on the effect of s 8(25) of the VAT Act.

- the supply must consist of an enterprise or part of an enterprise which is capable of a separate operation; and
- the parties must agree in writing that the supply is a going concern.

The following requirements must be met for an enterprise to be considered to be a going concern:<sup>74</sup>

- the seller and the purchaser must agree in writing that the enterprise will be an income-earning activity;
- the assets which are required for carrying on such enterprise are disposed of by the seller to the purchaser; and
- the seller and purchaser agree in writing that the consideration for the supply of the enterprise is inclusive of tax at a zero rating.

Therefore, should the above criteria be met, the VAT Act will provide relief from VAT for transactions in terms of section 45.

### **2.3.5 Securities Transfer Tax and Transfer Duty**

The Securities Transfer Tax Act<sup>75</sup> levies a tax of 0.25% on the transfer of a security.<sup>76</sup> A security is defined<sup>77</sup> as any share or depository receipt in a company or any member's interest in a close corporation. However, the definition excludes the debt portion of a share linked to a debenture. A transfer<sup>78</sup> includes the sale, assignment, cession, disposal, cancellation or redemption of that security but excludes an event that does not result in a change of beneficial ownership, an issue of a security or a cancellation or redemption of a security if the company which issued the security is being wound up, liquidate or deregistered.

If the assets being transferred in terms of the section 45 transaction constitute shares in a company, the transaction will trigger STT. However, the STT Act<sup>79</sup> provides for an exemption if shares are transferred in terms of section 45 of the Income Tax Act.

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<sup>74</sup>Interpretation Note 57 read with s 11(1)(e) of the VAT Act.

<sup>75</sup>No 25 of 2007. Hereinafter referred to as “the STT Act”.

<sup>76</sup>S 2(1)(b) of the STT Act.

<sup>77</sup>S 1 of the STT Act.

<sup>78</sup>S 1 of the STT Act.

<sup>79</sup>S 8(1)(a)(iii) of the STT Act.

The public officers<sup>80</sup> of the relevant parties must make sworn affidavits or a solemn declaration that the sale of shares took place in terms of an intra-group transaction as defined in section 45<sup>81</sup> for the exemption to apply.

The Transfer Duty Act<sup>82</sup> imposes a tax on the transfer of property.<sup>83</sup> However, section 9(l)(ii) provides for an exemption if the transfer was done in terms of a section 45 transactions.<sup>84</sup>

## **2.4 Conclusion**

An intra-group transaction as envisioned in section 45<sup>85</sup> provides for a tax neutral manner in terms of which assets may be transferred in a group of companies as defined in section 41<sup>86</sup> of the Income Tax Act.

Tax neutrality is achieved as the transferor company steps into the shoes of the transferee company. Specifically a transfer in terms of section 45 will provide relief of capital gains taxes, disposal of trading stock, allowances and recoupments in terms of allowance assets and section 24C allowances, value-added tax<sup>87</sup> and relief from STT and Transfer Duty.

Section 45 is therefore, a useful tool to facilitate intra-group transaction on a tax neutral manner.

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<sup>80</sup>Of the respective companies.

<sup>81</sup>Of the Income Tax Act.

<sup>82</sup>No 40 of 1949. Hereinafter referred to as “the Transfer Duty Act”.

<sup>83</sup>S 2 of the Transfer Duty Act.

<sup>84</sup>As envisioned in the Income Tax Act.

<sup>85</sup>Of the Income Tax Act.

<sup>86</sup>Of the Income Tax Act.

<sup>87</sup>When all the requirements are met in terms of s 8(25) of the VAT Act.

## CHAPTER 3 - INTERPRETATION OF STATUTES

### 3.1 Introduction

The interpretation of legislation is not as simple as it may appear at first glance. Many cases have ended up in court as a result of legislation that was construed in different ways. Tax legislation is no exception and great care should be given when interpreting a section of the Income Tax Act.

In this Chapter, I will set out a brief history of the interpretation of legislation in South Africa and how the courts have progressed from a strict literal approach to a purposive approach and the influence of the Constitution<sup>1</sup> on the interpretation of legislation.

### 3.2 Statutory Interpretation

Statutory interpretation is the task of determining the most correct meaning of the legislation at hand and this is done by applying certain rules and principles.<sup>2</sup> The question has been asked whether the normal rules of statutory interpretation will find application when interpreting tax legislation.<sup>3</sup> This uncertainty has been laid to rest in *Glen Anil Development Corporation Ltd v SIR*<sup>4</sup> in which it was confirmed that fiscal legislation should be interpreted in the same manner as ordinary legislation.

The rules and principles applied to interpret legislation in South Africa will now be discussed below in order to sketch a picture of the development of statutory interpretation in South Africa.

### 3.3 Literal Approach

#### 3.3.1 The basic mechanisms of the literal approach

The strict literal approach - also referred to as the “text based approach” means that if there is no ambiguity in the legislation adherence must be given to the strict literal meaning of the

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<sup>1</sup> The Constitution of the Republic of South Africa 1996. Hereinafter referred to as the Constitution.

<sup>2</sup> Taljaard “*Geld die gewone reëls en beginsels van wetsuitleg by die uitleg van belastingwetgewing?*” unpublished MComm dissertation 2001 19; Botha *Statutory Interpretation – an introduction for students* (2012) 4.

<sup>3</sup> Van Niekerk “*Geld die gewone reëls van uitleg by belastingwette?*” 1971 THRHR 135. Goldswain “*The purposive approach to fiscal legislation - the winds of change*” 2008 *Meditari Accountancy Research* Vol 16 No 2 107.

<sup>4</sup> 37 SATC 319 at 334.

text. This strict literal meaning will then be seen as to have been the intention of the legislator.<sup>5</sup>

The literal approach has its roots in the English legal system and was incorporated into the South African legal system by a judgment of Lordship De Villiers.<sup>6</sup> The irony of this judgement is that the English Law at that time stipulated that the legal system of a concurred region (in this instance South Africa) must remain as is i.e. the concurred region must continue to apply its own legal system. South Africa's legal system at that time was the Roman-Dutch legal system which followed a purposive approach.<sup>7</sup>

The strict literal approach was entrenched in our law by the cases *CIR v Simpson*<sup>8</sup> and *CIR v Frankel*<sup>9</sup> in which the following *dictum* by Rowlatt J from the case of *Cape Brandy Syndicate v Inland Revenue Commissioners* was quoted with approval:<sup>10</sup>

“In a taxing Act one has to look merely at what is clearly said. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing to be implied. One can only look fairly at the language used.”

This *dictum* sums up the very narrow interpretation that is allowed under the so-called literal approach. However, should there be ambiguity in the text, the court is allowed to introduce other methods in order to avoid the absurdity.<sup>11</sup> The intention of the legislator then needs to be determined by making use of internal and external sources.<sup>12</sup>

Should the internal and external methods still not provide for any clarity the Roman Dutch common law presumptions may also be used. The Roman Dutch common law presumptions are:<sup>13</sup>

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<sup>5</sup> Botha 91.

<sup>6</sup> *De Villiers v Cape Divisional Council* 1875 Buch 50. See also Botha 92.

<sup>7</sup> Botha 92; Goldswain *Meditari Accountancy Research* Vol 16 No 2 107.

<sup>8</sup> 16 SATC 28.

<sup>9</sup> 16 SATC 251.

<sup>10</sup> 1921(1) K.B. 64 at 71; See also *Canadian Eagle Oil Company, Ltd. v The King*, 1946 A.C. 119 at 140 and Goldswain *Meditari Accountancy Research* Vol 16 No 2 107.

<sup>11</sup> *R v Venter* 1907 TS 910 914.

<sup>12</sup> Botha 92. Botha 115-123 further states that it should be noted that the internal and external sources are also used when applying the purposive approach; however these sources are then considered from the onset. Internal sources include the preamble to the legislation, the long title of the act, the definition section, purpose and interpretation clause, headings of sections, introductory paragraphs, punctuation and annexures. External sources that may be used are the Constitution, documents relating to commentary and debate of the drafting of the legislation and the circumstances under which the bill was drafted.

<sup>13</sup> Taljaard at 42 argues that as there is almost always an uncertainty regarding the interpretation, these presumptions may be used in most instances..

- the presumption against retrospective effect of legislation;<sup>14</sup>
- the presumption that legislation does not amend the law more than is required;<sup>15</sup>
- the presumption that the same word in the same Act will have the same meaning;<sup>16</sup>
- if more than one construction of the legislation is possible, the construction that is mores just and equitable must be followed;<sup>17</sup>
- no section is invalid or without a purpose;<sup>18</sup>
- *generalia specialibus non derogant* – where two acts are in conflict, it is the duty of the statutory interpreter to reconcile them;<sup>19</sup>
- *ejusdem generis* means that where general words follow a specific list of particular classes, persons or things, the general words will be construed as applicable only to the things of the same general nature of those listed before;<sup>20</sup> and
- *contra fiscum rule*<sup>21</sup> means where there is ambiguity the legislation must be interpreted in the least onerous way for the taxpayer.

### 3.3.2 Critique of the literal approach

The literal approach has received criticism over the years.<sup>22</sup> One of the main arguments against the literal approach is the fact that it presupposes that legislation is “easy” or “simple” to interpret.<sup>23</sup> The mere fact that a subject such as statutory interpretation exists and the various articles and books written on this subject proves otherwise.

Another argument is that if one may only use the secondary and tertiary rules of interpretation if the legislation is ambiguous, the courts do not have access to the full spectrum of aids that it should rightfully be able to use.<sup>24</sup>

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<sup>14</sup>*Jockey Club SA v Transvaal Racing Club* 1959 1 SA 441 A 451.

<sup>15</sup>*Gordon v Standard Merchant Bank Ltd* 1983 3 SA 68 A 94.

<sup>16</sup>*Minister of the Interior v Machadadorp Investments (Pty) Ltd* 1957 2 SA 395 (A) 404.

<sup>17</sup>*Durban City Council v Shell and BP Petroleum Refineries (Pty) Ltd* 1971 4 SA 446 (A) 456.

<sup>18</sup>Taljaard 39.

<sup>19</sup>*Cogmanskloof Besproeiingsraad v Land-en Landboubank van Suid-Afrika* 1990 (3) SA 126 (C).

<sup>20</sup>*Burton Construction (Pty) Ltd v Aviation Insurance Co* 1975 1 SA 135 T.

<sup>21</sup>*SIR v Raubenheimer* 1969 4 SA 314 (A) and *Estate Reynolds v CIR* 1937 AD 57.

<sup>22</sup>For a summary of the arguments see Botha 94-95 and Cowen “The interpretation of statutes and the concept of the “intention of the legislature” 1980 THRHR 374.

<sup>23</sup>Botha 95.

<sup>24</sup>Botha 95.

Furthermore, if attention is only paid to the words of the text two important aspects are ignored:<sup>25</sup>

- the fact that statutes operate in an on-going time-frame; and
- the statutes need to be harmonised with the legal system they form part of.

The ambiguity of the legislation is also dependent upon the subjective judgement of the court interpreting it and therefore opens the door for prejudice, as in essence the interpretation of the legislation is dependent on the views of the court.

The strict or literal approach does not always take into account justice, equity or fairness and as the legislature, judiciary and executive are now bound by virtue of section 8(1)<sup>26</sup> to promote the Bill of Rights in which these rights are entrenched, any interpretation that is not just, equitable or fair may be *prima facie* unconstitutional.<sup>27</sup> All legislation must be interpreted

### 3.4 Purposive Approach

The purposive approach shares certain characteristics with the methodology to ascertain the “intention of the legislature”.<sup>28</sup> The difference is however, that the purposive approach aims to ascertain the intention of the legislation from the onset, whilst the “intention of the legislature”<sup>29</sup> is only sought once ambiguity is apparent when following the literal approach.<sup>30</sup>

In the case of *Jaga v Dönges*<sup>31</sup> the court gave guidelines as to how the purposive approach should be applied in practice. These guidelines are considered to be the first real steps taken to move beyond the strict literal or “plain meaning” approach and are summarised below:<sup>32</sup>

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<sup>25</sup>Botha 96.

<sup>26</sup>Of the Constitution.

<sup>27</sup>Goldswain *Meditari Accountancy Research* Vol 16 No 2 119.

<sup>28</sup>Which is consistent with the literal approach.

<sup>29</sup>There is also critique on the “intention of the legislature”. See Wallis JA in *Natal Joint Municipal Pension Fund v Endumeni Municipality* 2012 (4) SA 593 (SCA) 17.

<sup>30</sup>Botha 92; Cowen 1980 *THRHR* 394.

<sup>31</sup>1950 (4) SA 653 (A).

<sup>32</sup>Botha 115 – 123; Cowen 394.

- the interpreter should from the onset take into account the wider contextual scene of the legislation including the “matter of the statute” and “its apparent scope and purpose”.<sup>33</sup> The Schreiner JA goes further in this matter and states that:<sup>34</sup>
  - “It is a wholesome rule of our law which requires a strict construction to be placed upon statutory provisions which interfere with elementary rights. And it should be applied not only in interpreting a doubtful parse, but in ascertaining the intent of the law as a whole.”
- the contextual scene must always be taken into consideration and the process of interpretation is not complete until this is done. This contextual scene may sometimes be more important than the language of the statute itself.<sup>35</sup>
- once the meaning of the text within the context is ascertained it should be applied irrespective of whether the interpreter is of the opinion that the legislator had envisioned a different outcome.<sup>36</sup>
- interpretation should not be limited to ambiguous language, corrective and drastic interpretation is also interpretation and operates in cases where the context operates with sufficient force in order to override even clear language pointing the other way.<sup>37</sup>

The purposive approach allows the court to amend the meaning of the text in order to fit the purpose of the legislation. As a result the role of the court is no longer just mechanical and as such the courts may exercise their inherent function to develop the law.<sup>38</sup>

### **3.5 Teleological approach to Statutory Interpretation**

The teleological approach has its roots in the Roman Dutch common law as the principles of this theory was promoted by Groot and Voet.<sup>39</sup> The interpretation was used in South Africa

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<sup>33</sup>Jaga v Dönges 1950 (4) SA 653 (A) 663 - 664.

<sup>34</sup>Jaga v Dönges 1950 (4) SA 653 (A) 664H.

<sup>35</sup>Jaga v Dönges 1950 (4) SA 653 (A) 662H.

<sup>36</sup>Botha 94.

<sup>37</sup>Jaga v Dönges 1950 (4) SA 653 (A) 663 F-G; Cowen 1980 *THRHR* 394.

<sup>38</sup>Botha 95.

<sup>39</sup>Taljaard 26. The teleological approach is a value based approach in terms of which legislation should be interpreted based on constitutional values. The teleological approach is therefore one aspect that must be considered when interpreting legislation in the context of the Constitution. This is confirmed by Botha 126.

in order to soften draconian legislation as a teleological approach requires that the legislation must be interpreted in a just and equitable fashion.<sup>40</sup>

The following quote in *Dadoo Ltd v Krugersdorp Municipal Council*<sup>41</sup> rightly shows the virtue of the teleological approach:

“It is a wholesome rule of our law which requires a strict construction to be placed on statutory provisions which interfere with elementary rights. And it should be applied not only in interpreting a doubtful phrase, but in ascertaining the law as a whole.”

These principles of fairness and equality are now entrenched in the Constitution in section 39(2) and therefore the principles of the teleological approach, which accords with the Constitutional values will always form part of the process of statutory interpretation.<sup>42</sup>

### **3.6 A Constitutional Era Dawns**

Before South Africa became a democracy and the enactment of the Constitution, South Africa followed the Westminster system of parliamentary sovereignty.<sup>43</sup>

Parliamentary sovereignty<sup>44</sup> in essence means that parliament is the highest power and is supreme over all other institutions.<sup>45</sup> As a result a court may not test the substance of a parliamentary Act to determine whether it is fair and/or equal.<sup>46</sup> In essence this means that parliament may pass laws that infringe on a person's rights and the courts may not review or declare the legislation invalid.

In contrast to parliamentary sovereignty South Africa now follows a system of constitutional supremacy. This means that the Constitution is the highest power and legislation may be tested by the courts to determine whether it aligns with the values and principles entrenched in the Constitution.<sup>47</sup>

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<sup>40</sup>Taljaard 26.

<sup>41</sup>1920 AD 530 at 552.

<sup>42</sup>See the discussion of the influence of the Constitution on statutory interpretation below in par 3.6.

<sup>43</sup>Goldswain *Meditari Accountancy Research* Vol 16 No 2 113.

<sup>44</sup>Also referred to as legislative supremacy.

<sup>45</sup>Such as the executive and judicial bodies.

<sup>46</sup>Botha 12; Goldswain *Meditari Accountancy Research* Vol 16 No 2 113.

<sup>47</sup>Botha 13.

In order to understand the effect of the Constitution on the interpretation of legislation, certain key aspects of the Constitution is discussed below.<sup>48</sup>

### **3.6.1 The values and principles promoted by the Constitution**

South Africa is a democratic state founded on the principles of dignity, equality and freedom.<sup>49</sup> The Bill of Rights<sup>50</sup> is the cornerstone of the democracy of South Africa and entrenches the rights of human dignity, equality and freedom in our Constitution.<sup>51</sup> The Constitution is the supreme law of the Republic of South Africa and any legislation inconsistent with the Constitution is invalid.<sup>52</sup>

The Bill of Rights applies to all law, the legislature, the executive, the judiciary and all organs of state as well as natural and juristic persons.<sup>53</sup> Legislation must be interpreted in such a way as to promote the spirit and objects of the Bill of Rights.<sup>54</sup>

Taking the above into account it is clear that when interpreting legislation the values entrenched in the Bill of Rights must be promoted and should in fact be the starting point, any interpretation inconsistent with that will be invalid.<sup>55</sup> Prior to the enactment of the Constitution, there was no responsibility upon the judiciary when interpreting legislation to ensure that it is equitable. Therefore, if the letter of the law resulted in an unequitable result it did not result in the legislation and interpretation thereof being unconstitutional and as such not valid.<sup>56</sup>

The Constitutional Court further emphasised the impact that the Constitution has on the interpretation of legislation: “The starting point in interpreting any legislation is the Constitution...”<sup>57</sup>

The effect of a system of constitutional supremacy may be summarised as follows:

“With the entrenchment of the Bill of Fundamental Rights and Freedoms in a supreme Constitution, however, the interpretive task frequently involves

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<sup>48</sup>These key aspects include what the object of the Bill of Rights and how the Bill of Rights should be interpreted.

<sup>49</sup>S 1 of the Constitution.

<sup>50</sup>Chapter 2 of the Constitution.

<sup>51</sup>S 7(1) of the Constitution.

<sup>52</sup>S 2 of the Constitution.

<sup>53</sup>S 7(2) of the Constitution.

<sup>54</sup>S 39(2) of the Constitution. The spirit and object of the Bill of Rights are set out in section 7 & 8 of the Constitution.

<sup>55</sup>Botha 99; Taljaard 2001 3.

<sup>56</sup>Goldswain *Meditari Accountancy Research* Vol 16 No 2 114.

<sup>57</sup>*Bato Star Fishing (Pty) Ltd v Minister of Environmental Affairs and Tourism* 2004 (4) SA 490 (CC) at 72.

making constitutional choices by balancing competing fundamental rights and freedoms. This can often only be done by reference to a system of values extraneous to the constitutional text itself, where these principles constitute the historical context in which the text was adapted and which helps to explain the meaning of the text. The Constitution makes it particularly imperative for courts to develop the entrenched fundamental rights in terms of a cohesive set of values, ideal to an open and democratic society. To this end common values of human rights protection the world over and foreign precedent may be instructive.”<sup>58</sup>

Therefore, due consideration should also be given as to how one interprets the Constitution as all other legislation will be tested against the values in the Bill of Rights.<sup>59</sup> The difference between the constitutional interpretation and statutory interpretation may be explained as follow:

“When interpreting the Constitution the aim is to ascertain the foundational values in the Constitution. Whereas as statutory interpretation is aimed at determining whether there is an interpretation of that legislation that conforms to the values and principles in the Bill of Rights.”<sup>60</sup>

Davis argues that when interpreting the Constitution a purposive approach should be followed.<sup>61</sup> It follows that the Constitution does not impact the legislation if the values in the Bill of Rights are upheld.<sup>62</sup> Specifically in relation to tax legislation this means that were taxes imposed are not legal and reasonable the courts may do away with the legislation or correct them in accordance with the Constitution. <sup>63</sup>

It is the view of Goldswain<sup>64</sup> that the Constitution has indeed bought upon a change for taxpayers as they now have a right of recourse in the event of an unjust or unfair interpretation of the legislation. It should however, be noted that some of the values of the Constitution was previously applied in case law by making use of the teleological approach.<sup>65</sup> As such even before we had a Constitution a value-based approach was incorporated into

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<sup>58</sup>*S v Makwanyane* 1995 (3) SA 391 (CC) at 498 H-I.

<sup>59</sup>Chapter 2 of the Constitution.

<sup>60</sup>*Matiso v Commanding Officer, Port Elizabeth Prison* 1994 4 (SA) 592 (SE) 597 G-H.

<sup>61</sup>Davis “*Democracy - its influence upon the process of constitutional interpretations*”<sup>10</sup> *South African Journal on Human Rights* 103 1994.

<sup>62</sup>Taljaard 6.

<sup>63</sup>Murphy “*The Constitutional Review of Taxation*” *Acta Juridica* 122 1995.

<sup>64</sup>Goldswain *Meditari Accountancy Research* Vol 16 No 2 107.

<sup>65</sup>See the discussion in par 5 above on the teleological approach.

our law by virtue of our Roman Dutch heritage. This value based approach, i.e. the teleological approach is entrenched in our Constitution and as such will always form part of the process of interpreting legislation.

### 3.7 How has Legislation been Interpreted in South Africa

In the case of *Bastian Financial Services v Hendrik Schoeman Primary School*<sup>66</sup> the court provides a condensed version of how legislation has been interpreted over the years. Van Heerden JA starts off by confirming the authority of the “golden rule” by quoting from *Manyasha v Minister of Law and Order*:<sup>67</sup>

“It is trite the primary rule in the construction of statutory provisions is to ascertain the intention of the Legislature ... One seeks to achieve this, in the first instance, by giving the words of the provision under consideration the ordinary grammatical meaning which their context dictates, unless to so would lead to an absurdity...”

He then continues to the dictum from *Jaga v Dönges*<sup>68</sup> in which the purposive approach was promoted and quoted by the Constitutional Court in *Bato Star Fishing (Pty) Ltd v Minister of Environmental Affairs & Others*<sup>69</sup> and uses the following quote from *Thoroughbred Breeders' Association v Price Waterhouse*<sup>70</sup> to support the fact that there is now a trend emerging in favour of the purposive approach:

“The days are long past when blinkered peering at an isolated provision in a statute was thought to be the only legitimate technique in interpreting it, if it seemed on the face of it to have a readily discernable meaning.”

Van Heerden JA also notes the *dictum* of *Dadoo Ltd and Others v Krugersdorp Municipal Council*<sup>71</sup> which proves that the object of the legislation has also been sought as means of interpretation.

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<sup>66</sup>2008 (5) SA 1 (SCA) at par 16 – 19.

<sup>67</sup>1999 (2) SA 170 (SCA) at 185 B-C.

<sup>68</sup>1950 (4) SA 653 (A).

<sup>69</sup>2004 (4) SA 490 (CC).

<sup>70</sup>2001 (4) SA 551 (SCA) para 12. See also *University of Cape Town v Cape Town Bar Council* 1986 (4) SA 903 (A) at 941D-E.

<sup>71</sup>1920 AD 530 at 543.

Van Heerden JA sets out the progress from the literal approach to the purposive approach, but he does not discuss that whilst there was a movement in favour of the purposive approach, certain judges still applied the literal approach,<sup>72</sup> nor does he discuss the influence of the Constitution.

After the enactment of the Constitution one would expect that when faced with the question of interpretation a purposive approach would *have* to be followed in order not to fall foul of the provisions of the Constitution.<sup>73</sup>

However in *Commissioner, SARS v Executor, Frith's Estate*<sup>74</sup> the court still chose to apply the literal approach as is evident from the quote below:

“The primary rule in construction of a statutory provision is (as is well-established) to ascertain the intention of the legislator and (as is equally well-established) one seeks to achieve this, in the first instance, by giving the words under consideration their ordinary grammatical meaning, unless to do so would lead to an absurdity so glaring that the Legislature could not have contemplated it.”

One can only question the judgement above as at that time the purposive approach has already been approved by the Constitutional Court.<sup>75</sup>

In a tax court case<sup>76</sup> of 2011 the court once again had to choose between applying the literal approach or the purposive approach –the court chose to make use of the literal approach in the absence of an ambiguity.<sup>77</sup>

It is therefore no surprise that in the recent case of *Natal Joint Municipal Pension Fund v Endumeni Municipality*<sup>78</sup> that Wallis JA decided to address the matter of interpretation once more. In his judgment he stated the following:<sup>79</sup>

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<sup>72</sup>The judiciary was inconsistent in their application of the purposive approach. Despite the fact that the *Dadoo Ltd and Others v Krugersdorp Municipal Council* was already delivered in 1920, the Appellate Division in *Public Carriers Association and others v Toll Road Concessionaries (Pty) Ltd and Others* (1990)(1)SA 925 (A) followed a strict literal approach.

<sup>73</sup>See discussion above as to why if a purposive approach is not followed, such an interpretation may be unconstitutional.

<sup>74</sup>2001 (2) SA 261 (SCA) 273.

<sup>75</sup>*S v Zuma* 1995 (SA) 642 (CC).

<sup>76</sup>*XYZ v CSARS* CASE 12895 2011.

<sup>77</sup>Van der Walt “*Purposive interpretation of tax statutes – back to the future?*” 2011 Tax Alert July.

<sup>78</sup>2012 (4) SA 593 (SCA) herein after referred to as the “Natal Pension Fund case”.

<sup>79</sup>2012 (4) SA 593 (SCA) at 15-16.

“The inevitable point of departure is the language of the provision itself, read in context and having regard to purpose of the provisions and the background to the preparation and production of the document.”

With this Wallis JA confirms that the approach to be followed is the second approach as was set out in the case of *Jaga v Dönges*<sup>80</sup> and that the context must be considered with the language from the onset with neither predominating over the other.

Wallis JA then proceeds to finally resolve the matter on the question of interpretation when he says:<sup>81</sup>

“This is the approach that courts in South Africa should now follow, without the need to cite authorities from an earlier era that are not necessarily consistent and frequently reflect an approach to interpretation that is no longer appropriate.”

### 3.8 Conclusion

South Africa has progressed<sup>82</sup> from favouring a strict literal approach to a purposive approach when interpreting legislation. The Constitution has played a role in this, as a strict literal approach may now be seen to be unconstitutional. However, prior to the Constitution certain judges applied a purposive approach<sup>83</sup> as is evident in the cases of *Jaga v Dönges*,<sup>84</sup> *Mjuqu v Johannesburg City Council*<sup>85</sup> and *University of Cape Town v Cape Bar Council*.<sup>86</sup> After the enactment of the Constitution certain judges still followed a literal approach.<sup>87</sup>

This leads to the conclusion that for many years no specific theory was followed and that in some cases the literal approach together with the “golden rule” was followed where other cases chose a purposive approach.

Taljaard<sup>88</sup> reaches the same conclusion: that there was no consistency from the courts in terms of which method should be applied for purposes of statutory interpretation.

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<sup>80</sup>1950 (4) SA 653 (A).

<sup>81</sup>2012 (4) SA 593 (SCA) at 15 -16.

<sup>82</sup>See Goldswain *Meditari Accountancy Research* Vol 16 No 2 107 who provides a thorough analysis and reaches similar conclusions then the ones reached in this chapter.

<sup>83</sup>This would have been in line with our Roman Dutch heritage.

<sup>84</sup>1950 (4) SA 653 (A).

<sup>85</sup>1973 (3) SA 421 (A).

<sup>86</sup>1986 (4) SA 903 (A).

<sup>87</sup>See the discussion above for an example of these cases.

<sup>88</sup>Taljaard 28.

This matter has now been resolved with the judgment of the *Natal Municipality* case where it is confirmed that a purposive approach should be adhered to where the context of the text is considered from the onset.

## **CHAPTER 4 - HISTORY AND MECHANICS OF THE DE-GROUPING CHARGE IN SECTION 45(4)(b)**

### **4.1 Introduction**

In the Chapter 2 the technicalities of section 45<sup>1</sup> have been discussed in order to illustrate how the section achieves its purposes of providing for a mechanism in terms of which companies may transfer assets on a tax neutral basis within a group of companies. In Chapter 3 the principles of statutory interpretation was addressed. With this knowledge consideration will be given to section 45(4)(b) of the Income Tax Act – an anti-avoidance provision established by the South African Revenue Service<sup>2</sup> to curb the abuse of section 45.<sup>3</sup>

### **4.2 Rationale**

#### **4.2.1 Abuse of section 45 in relation to tax- free cash-outs**

Section 45 has been used, *inter alia*, by taxpayers to facilitate transactions known as tax-free cash-outs.<sup>4</sup> A tax-free cash-out is a transaction whereby a company wishes to dispose of an asset to an independent third party purchaser, without the seller being subject to tax.<sup>5</sup>

In the Explanatory Memorandum on the Taxation Laws Amendment Bill<sup>6</sup> examples were given of these tax-free cash-outs. In order to better illustrate the workings of a tax-free cash-out, an example will be discussed below.<sup>7</sup>

Example of steps taken to effect a transaction that will result in a tax-free cash-out:

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<sup>1</sup> Of the Income Tax Act 58 of 1962. Hereinafter referred to as the “Income Tax Act”. All references hereinafter refers s 45 of the Income Tax Act.

<sup>2</sup> Hereinafter referred to as SARS.

<sup>3</sup> Other anti-avoidance measures include s 45(4)(B) and s 45(5). These sections will be triggered when (i) consideration received for the assets transferred leave the group or (ii) when the assets receive by virtue of s 45 are disposed of outside the group within a period of 18 months, respectively.

<sup>4</sup> National Treasury *National Explanatory Memorandum Taxation Laws Amendment Bill 2008* 14. Hereinafter referred to as “Explanatory Memorandum 2008”.

<sup>5</sup> Explanatory Memorandum 2008 14.

<sup>6</sup> 2008 14.

<sup>7</sup> Explanatory Memorandum 2008 14. See Explanatory Memorandum 2008 14-16 for more examples and more detailed commentary please see.

1. HoldCo<sup>8</sup> (i.e. the sellers) owns all the shares in OpCo.<sup>9</sup> OpCo has assets with a base cost of R200,000 and a market value of R1 million.
2. HoldCo incorporates NewCo<sup>10</sup> for nominal value.<sup>11</sup>
3. OpCo transfers all its assets to NewCo in exchange for R1 million.<sup>12</sup> Essentially, NewCo now has assets with a market value of R1 million but also has a loan liability of R1 million.
4. OpCo then distributes the R1 million to HoldCo as a dividend, leaving OpCo as an empty shell.
5. HoldCo then transfers all its shares in OpCo to NewCo in exchange for more shares in NewCo.
6. The independent third party then buys all the shares in NewCo from HoldCo for a nominal consideration. This means that the independent third party is now the holding company of NewCo and its wholly owned subsidiary OpCo.

If one ignores the general anti-avoidance rules the above transaction is tax neutral:<sup>13</sup>

- The transfer of the assets from OpCo to NewCo took place on a tax neutral basis by virtue of section 45.<sup>14</sup>
- The dividend declared from OpCo to HoldCo will be exempt from dividends tax as they are both South African resident companies.<sup>15</sup>
- The subscription of shares from HoldCo into NewCo will be for nominal value due to the fact that NewCo's market value decreased due to its newly incurred indebtedness.
- The above result also applies to the sale of the NewCo shares to the independent third party. The debt of NewCo will result in the shares having little or no net value and as such should not result in a capital gain.<sup>16</sup>

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<sup>8</sup> A company incorporated under South African law and serves as a holding company.

<sup>9</sup> OpCo is a company incorporated under South African law and serves as an operating company.

<sup>10</sup> A newly incorporated company, hereinafter referred to as "NewCo".

<sup>11</sup> HoldCo, OpCo and NewCo form a group of companies as defined in s 41 of the Income Tax Act. The nominal value refers to face value, at this point in time NewCo does not have any assets and as such HoldCo incorporated NewCo for a minimal amount.

<sup>12</sup> NewCo obtained the R1million from an independent bank.

<sup>13</sup> The anti-avoidance measures are found in s 80A-80L in the Income Tax Act.

<sup>14</sup> Of the Income Tax Act. For a more detailed analysis of the workings of s 45 please refer to Chapter 2.

<sup>15</sup> S 64G of the Income Tax Act.

<sup>16</sup> A step-by-step explanation of the tax implications is set out in Explanatory Memorandum 2008 14-15.

It should further be noted that at the time that taxpayers used section 45 to facilitate tax-free cash-outs similar to the transaction set out above, the relevant anti-avoidance provision read as follows:<sup>17</sup>

“Where a transferee company which has acquired an asset as contemplated in paragraph (a) ceases to form part of the same group of companies in relation to the transferor company contemplated in paragraph (a)(i) at any time before the disposal by the transferee company of that asset...”

Therefore, it was only required for the transferor and the transferee company to remain within the same group in order to avoid a de-grouping charge.<sup>18</sup> As such it was still quite easy to manipulate the relief provided for in section 45 in order to sell assets outside of the group of companies without suffering adverse tax consequences. SARS took cognisance of the fact that the anti-avoidance provisions as it read at the time failed to catch the scenario of a tax-free cash-out and that taxpayers were able to abuse the provisions of section 45.

In order to address the abuse of section 45 in relation to tax-free cash-outs the following two amendments were made:

- to limit the tax cost of intra-group notes issued in section 45 transactions to the lesser of the tax cost of the assets transferred or to the market value of the note issued;<sup>19</sup> and
- amending the de-grouping charge in section 45(4)(b).<sup>20</sup>

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<sup>17</sup> S 45(4)(b) of the Income Tax Act.

<sup>18</sup> In the example above it means that NewCo and OpCo should remain together as a group – hence the fact that both NewCo and OpCo were transferred to the independent third party in the above example.

<sup>19</sup> National Treasury released a media statement in 2008 (Media Statement: Taxation Laws Amendment Bills, 2008: Company Restructuring Measures 21 February 2008 3) the main issue that was addressed in this media statement was the asymmetry in terms of s 45 between the assets transferred and the consideration received in exchange. It was noted that group assets transferred retain a rollover tax cost whilst the consideration received in exchange obtains a market value. The remedy that was proposed in order to rectify the asymmetry was to limit the tax cost of intra-group notes issued in a s 45 transaction to the lesser of the tax cost of assets transferred or the market value of the note issued. The main focus of this dissertation is the de-grouping charge in s 45(4)(b) of the Income Tax Act, the limitation regarding the intra-group notes has merely been mentioned for completeness sake. Going forward we only the development of s 45(4)(b) of the Income Tax Act will be discussed.

<sup>20</sup> Explanatory Memorandum 2008 15.

### 4.3 The Amended Section 45(4)(b)

There are two ways in which a de-grouping can occur, namely:<sup>21</sup>

- 1) When a transferee company ceases to form part of any group of companies related to the transferor company; and
- 2) When a transferee company ceases to form part of a controlling group company in relation to the transferor company.

In order to introduce these two de-grouping requirements into section 45(4)(b), the section had to undergo substantial amendments. The first was in 2007<sup>22</sup> where a time limit was introduced as well as the word “any” in relation to group of companies:

“(b) Where a transferee company which has acquired an asset as contemplated in paragraph (a) ceases within a period of six years after the date of that acquisition to form part of *any group of companies* in relation to the transferor company contemplated in paragraph (a)(i) at any time before the disposal by the transferee company of that asset, that transferee company must—” (Own emphasis)

In 2008 section 45(4)(b) was again amended to read “...or *any* controlling group company in relation to the transferor company and transferee company...” (Own emphasis).<sup>23</sup>

A further change to section 45(4)(b) was then introduced,<sup>24</sup> to change the word “any” to “a” in respect of “controlling group company”. The amended wording then read as follow:

“*a* controlling group company in relation to the transferor company...”

The changing of “any” to “a” results in a substantial difference in the interpretation of this clause. I am of the view that the change of the word “any” to “a” results in a narrower interpretation of the phrase “controlling group company”. If the clause is applied with a narrower interpretation then it limits the de-grouping possibilities within a group of

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<sup>21</sup>S 45(4)(b).

<sup>22</sup>S 56(1) of the Revenue Laws Amendment Act 35 of 2007.

<sup>23</sup>By s 28 of the Taxation Laws Amendment Act 3 of 2008.

<sup>24</sup>Revenue Laws Amendment Act 60 of 2008.

companies. Ideally the de-grouping charge will then be limited to the group of companies that were involved in the section 45-transaction. This will support the purpose of the de-grouping charge as it will prevent manipulation of group structures to result in tax-free cash-outs, without being too stringent in terms of the limitation of the group.

Section 45(4)(b) now reads as follow:<sup>25</sup>

“(b) Where a transferee company contemplated in paragraph (a) of the definition of ‘intra-group transaction’ which has acquired an asset as contemplated in paragraph (a) ceases within a period of six years after the acquisition to form part of any group of companies in relation to the transferor company contemplated in paragraph (a)(i) or a controlling group company in relation to the transferor company, and the transferee company has not disposed of that asset-”

Understanding the development of this section is key to determine how far the de-grouping in section 45(4)(b) is intended to reach i.e. to a direct controlling group company or to an indirect controlling group company as well. This will be further addressed in the following chapter when the de-grouping charge is applied to a fictional scenario.

#### **4.4 Consequence of a De-Grouping**

Section 45(4)(b)(i)–(iii) sets out the tax consequences<sup>26</sup> in respect of capital assets, allowance asset and trading stock in the event of a de-grouping. A de-grouping will take place when the transferee company and the transferor company cease to form part of the same group of companies, or where the transferee company ceases to form part of the same group as any controlling group company of the transferor company. In order for the de-grouping section to be triggered the de-grouping has to take place within six years of the transfer of the assets and the assets were transferred in terms of a group of companies as envisaged in part (a) of the definition.<sup>27</sup>

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<sup>25</sup>For completeness sake it should be noted that Par (a) of s 45(4) of the Income Tax Act refers to a transferee company which acquired an asset in terms of a disposal by a transferor company by means of an intra-group transaction or in terms of subsequent disposals after an intra-group transaction for which no capital gain or loss was determined as a result of s 45 of the Income Tax Act. However, this section does not apply to any asset that constitutes trading stock that is regularly and continuously disposed of by the transferee company

<sup>26</sup>Refer to Haupt *Notes on South African Income Tax* (2015) 570 for further reading on the de-grouping charge.

<sup>27</sup>See Chapter 2 par 2 2 3 for a discussion on the definition of par (a) of intra-group transaction.

The effect of the de-grouping is that the transferee company will be liable for the tax of the deemed disposal for the assets, transferred in terms of section 45, that is still on hand at the time of the de-grouping.

#### **4.4.1 Capital assets**

The tax liability for the transferee company in relation to a capital asset that is still on hand at the time of the de-grouping and which was transferred in terms of an intra-group transaction is calculated by determining the following two amounts:<sup>28</sup>

- the value of the capital gain that was disregarded at the time of the transfer;<sup>29</sup>
- the value of the capital gain that would arise if the asset was sold for market value at the time of the de grouping.

The lesser of the above two amounts must be regarded as the capital gain which arose as a result of the de-grouping. This capital gain must be included in the taxpayer's taxable income.

Going forward the transferee company will have a base cost in that asset equal to the original base cost as well as the deemed capital gain that arose as a result of the de-grouping. Furthermore, in the event that a capital allowance may be claimed on the asset that extra amount on which the allowance will be calculated will be deemed to be 50% of the capital gain.<sup>30</sup>

#### **4.4.2 Allowance assets**

In respect of allowance assets (or mining assets) the tax liability for the de-grouping is calculated by determining the following two amounts:<sup>31</sup>

- determine the largest recoupment that was disregarded;<sup>32</sup>
- determine the proceeds of the disposal of a normal asset (or recoupment in the case of a mining asset) if the assets was disposed of at market value at the time of the de-grouping.

The larger of the abovementioned amounts must be added to the base cost of the asset. The transferee company may then claim capital allowances on the recoupment. In respect of the

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<sup>28</sup>S 45(b)(i); Haupt (2015) 570.

<sup>29</sup>If multiple intra-group transactions have taken place, the capital gain that must be used is the greatest capital gain that arose taking into account all the different intra-group transactions.

<sup>30</sup>S 45(b)(i).

<sup>31</sup>S 45(b)(ii); Haupt (2015) 570.

<sup>32</sup>In terms of s 45(3) of the Income Tax Act. If there were more than one disposal determine the largest disposal.

mining assets the recoupment may only be as an allowance just before the transferee sells the assets.

#### **4.4.3 Trading stock**

The tax liability for trading stock is similar to those of capital assets in the sense that “the lesser” amount is used to determine the tax due by the transferee company. The tax liability for the transferee company is calculated as follow:<sup>33</sup>

- the greatest taxable income that would have arisen if the trading stock was sold at the time of the transfer; and
- the taxable income at the time of the de-grouping.

The lesser of these two amounts will be included in the taxable income of the transferee company, and added to the cost of that stock. A de-grouping would not be triggered where the trading stock is regularly disposed of.

#### **4.5 Conclusion**

In the past taxpayers have abused section 45 to facilitate, *inter alia*, transactions that are known as tax-free cash-outs. The purpose of this transaction is to sell assets to an independent third party without suffering any tax consequences. The legislation at the time did not manage to catch this mischief and as a result thereof section 45 was amended during 2007 and 2008. The section now provides for anti-avoidance provisions that will be triggered when a transferee company ceases to form part of the same group of companies as the transferor company or any controlling group company in relation to the transferor company.

If a de-grouping occurs then the transferee company will be liable for the tax charge. In this regard, the Income Tax Act specifically makes provision for how the tax liability must be determined and differentiates between capital assets, allowance assets and trading stock.

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<sup>33</sup>S 45(4)(b)(iii) and see also Haupt (2015) 570-571.

## **CHAPTER 5 - APPLICATION OF THE DE-GROUPING CHARGE IN SECTION 45(4)(b)**

### **5.1 Introduction**

The de-grouping charge in section 45(4)(b)<sup>1</sup> is best illustrated when it is applied to a set of facts. In order to determine how far reaching the effect of the provisions of section 45(4)(b) could be and whether such an interpretation would make commercial sense and support the purpose of the section, a fictional scenario will be discussed.<sup>2</sup> Furthermore, I will argue that the legislation as it currently<sup>3</sup> stands should be interpreted with a narrow view regarding the qualifications around the de-grouping charge in order to avoid the result where a taxpayer is penalised without intending any mischief.

### **5.2 Fictional Scenario of a Section 45 Transaction**

#### **5.2.1 Transaction**

A group of companies<sup>4</sup>, as set out below, undertakes a section 45 transaction in terms of which the business of Company C<sup>5</sup> is transferred to Company B<sup>6</sup> in exchange for cash.<sup>7</sup>

At the time of this transaction Company A owes 100% of the shares in Companies B and C and in turn Company H owes 100% of the shares in Companies A and D.<sup>8</sup> Companies F, G and H are sister companies.<sup>9</sup>

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<sup>1</sup> Of the Income Tax Act.

<sup>2</sup> In the previous chapter the purpose of the s 45(4)(b) and the behavior of taxpayers it aims to change was discussed.

<sup>3</sup> As at July 2015.

<sup>4</sup> As set out in s 41 of the Income Tax Act. For a comprehensive discussion of the “group-of-companies” definition as set out in s 41 of the Income Tax Act, please refer to Chapter 3.

<sup>5</sup> Also referred to as the “transferor company”.

<sup>6</sup> Also referred to as the “transferee company”.

<sup>7</sup> Going forward this transaction will be referred to as the “original section 45 transaction”.

<sup>8</sup> Refer to diagram A.

<sup>9</sup> Company E holds 100% of the shares in Companies F, G and H and as such is the parent company.

Within six years of the original section 45 transaction the needs of the group change and it is required that a new company<sup>10</sup> is interposed above Company A and D, as a subsidiary of Companies G and H.<sup>11</sup>

If the NewCo is introduced within 6 years of the original section 45 transaction, a de-grouping event may occur, as Company H is no longer a controlling group company in relation to Company A. This may happen despite the fact that the “group of companies” which was originally required for the section 45 transaction is still intact.

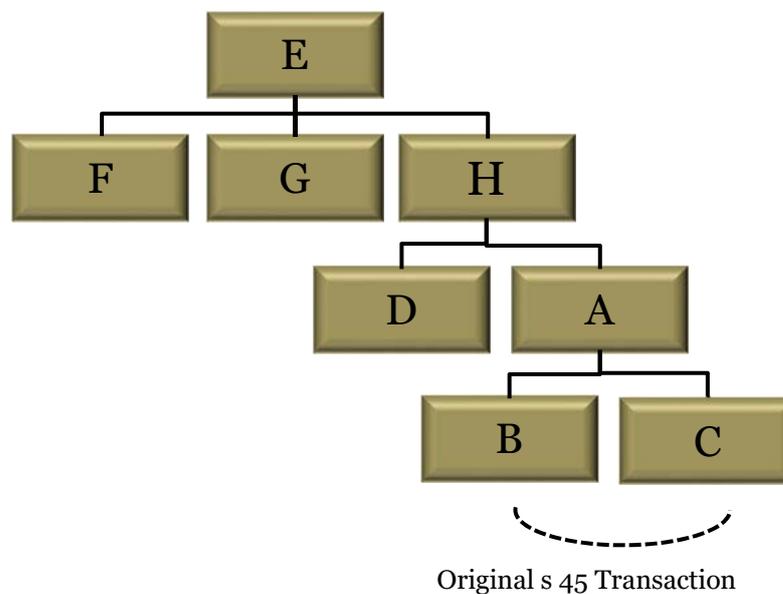


Diagram A<sup>12</sup>

<sup>10</sup> In the diagram referred to as NewCo.

<sup>11</sup>The group of companies may require the introduction of a new company for several reasons i.e. perhaps they want to introduce funding at that level, or perhaps they need to introduce Broad Based Black Economic Empowerment. The new company may be introduced by making use of s 42 of the Income Tax Act. S 42 of the Income Tax Act also forms part of the Corporate Rules and may be used by companies to obtain roll-over relief in circumstances where an asset is exchanged for the issue of shares. The “asset” may also be shares in a company. The shares issued in exchange for the asset must be equity shares as defined in the Income Tax Act. For a comprehensive discussion on s 42 please refer to Stiglingh *et al. Silke: South African Income Tax* (2015) 485; Haupt *Notes on South African Income Tax* (2015) 547. Croome *et al. Tax Law an Introduction* (2013) 431.

<sup>12</sup>All shareholding is 100%.

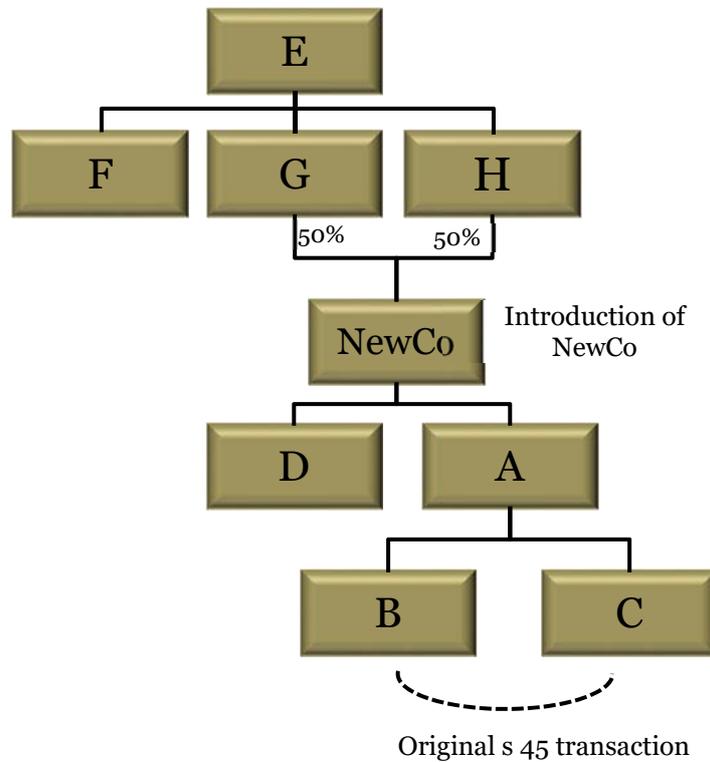


Diagram B<sup>13</sup>

### 5.2.2 Requirement for a de-grouping in terms of section 45(4)(b)

In terms of section 45, one of the following two requirements must be met in order for a de-grouping event to be triggered:<sup>14</sup>

- the first requirement is that the transferee company<sup>15</sup> ceases within a period of six years after the original section 45 transaction<sup>16</sup> to form part of *any group of companies* in relation to the transferor company<sup>17</sup>; or

<sup>13</sup>All shareholding is 100%, unless otherwise indicated.

<sup>14</sup> For an encompassing discussion of the de-grouping requirements please refer to Chapter 3.

<sup>15</sup> Company B.

<sup>16</sup> In terms of which Company C disposed of its business to Company B.

<sup>17</sup> Company C.

- the transferee company<sup>18</sup> ceases within a period of six years to form part of any group of companies in relation to a *controlling group* company of the transferor company.<sup>19</sup>

The introduction of NewCo would mean that Company H would no longer hold at least 70% of the shares of Company A<sup>20</sup> and as such would cease to be a controlling group company of the transferor company. However, Company A will still remain a controlling group company in relation to the transferor and the transferee company.

Taking the above in to account the de-grouping provisions in section 45(4)(b)<sup>21</sup> will be triggered by virtue of the fact that Company H would no longer be a controlling group company in terms of the transferor company and the transferee company. Applying this logic, it would mean that the transferee company would suffer the tax consequences that were deferred by virtue of the provisions of section 45.<sup>22</sup>

### **5.3 RATIONALE FOR THE ARGUMENT AGAINST DE-GROUPING**

#### **5.3.1 Requirements for a section 45 transaction**

The requirement for a transfer of assets from one company to another company to be regarded as a section 45 transaction is simply, that at the end of the day of that transaction the companies must form a group of companies as defined in section 41,<sup>23</sup> and that the assets required must retain its nature upon transfer.<sup>24</sup> Therefore, in order to effect the section 45 transaction, as in the example above, it was not a requirement that Company H formed part of the same group of companies as the transferor company and the transferee company; nor was it a requirement for Company H to be a “controlling group company” in relation to the transferor company.

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<sup>18</sup> Company B.

<sup>19</sup> Company C.

<sup>20</sup> Company H would also cease to hold 70% of shares in Company D, but for purposes of this example the change in shareholding for Company D is not relevant.

<sup>21</sup> Of the Income Tax Act.

<sup>22</sup> For a comprehensive discussion on the results of de-grouping in terms of section 45 of the Income Tax Act, please refer to Chapter 4.

<sup>23</sup> Of the Income Tax Act.

<sup>24</sup> S 45(1)(a)(i) and (ii) of the Income Tax Act.

The requirements for a section 45 transaction<sup>25</sup> are merely that the transferor company and the transferee company are in the same group of companies as Company A at the end of the day of that transaction and that the assets transferred retain its nature. As such there is a disconnect between the requirements for a section 45 transaction and the de-grouping charge.

### **5.3.2 Interpretation of legislation**

In Chapter 3 a brief summary was given on how the South African Court's interpret legislation. The decision in *Natal Joint Municipal Pension Fund v Endumeni Municipality*<sup>26</sup> confirms that a purposive approach must be followed when interpreting legislation and that from the outset the context and the language must be considered with neither predominating over the other.

When looking at the context surrounding section 45(4)(b) the following two aspects requires attention:

- international law<sup>27</sup>; and
- Explanatory Memoranda.<sup>28</sup>

#### **5.3.2.1 International Law**

In the English case of *Arab Bank plc v Merchantile Holdings Ltd*<sup>29</sup> the court had to determine whether it was illegal for a foreign subsidiary of an English company to give financial assistance for purposes of acquiring shares in its parent company. The court had to consider the amended section 151:<sup>30</sup>

“(1) ..., where a person is acquiring or is proposing to acquire shares in a company, it is not lawful for the company or *any of its subsidiaries* to give

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<sup>25</sup> As envisaged in s 45(1)(a) of the Income Tax Act.

<sup>26</sup> 2012 (4) SA 593 (SCA).

<sup>27</sup> S 233 of the Constitution of the Republic of South Africa, 1996 (hereinafter the Constitution) states that “...every court must prefer any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law.” Therefore, we need to consider international law to ensure that our interpretation of s 45(4)(b) is consistent with it.

<sup>28</sup> The Explanatory Memoranda provides the purpose of s 45(4)(b).

<sup>29</sup> [1994] 2 All ER 74.

<sup>30</sup> Companies Act 1985 an Act of Parliament of the United Kingdom of Great Britain and Northern Ireland (hereinafter referred to as the Companies Act). The amended legislation refers to s 151 in the Companies Act. It addresses the prohibition against granting of financial assistance by a subsidiary in order to obtain shares in the subsidiary's holding company.

financial assistance directly or indirectly for the purpose of that acquisition before or at the same time as the acquisition takes place ...” (own emphasis).

The literal interpretation of the above wording would broaden the ambit of the legislation in such a way that it would include companies other than United Kingdom domestic companies – for whom the legislation was intended. In light of this conundrum J Millet held as follows:<sup>31</sup>

“Read literally and with the assistance of the statutory definition of ‘subsidiary’, s 151 clearly purports to make it unlawful for a foreign subsidiary of an English parent company to give financial assistance for the purpose of the acquisition of shares of its parent company. The result, however, is to give the section an extra-territorial effect contrary to the general principles of private international law, for the capacity of a corporation, the regulation of its affairs, the maintenance of its capital and the protection of its creditors and shareholders are generally recognised to be matters for the law of the place of incorporation. *But there have been many cases in which the words of a statute have been given a more limited meaning than they are capable of bearing where there is a proper ground for concluding that this was the intention of Parliament...*”<sup>32</sup> (Own emphasis).

This judgement illustrates the fact that courts may apply a limited meaning to legislation if such an interpretation would give effect to the true purpose of the legislation i.e. the intention of Parliament.

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<sup>31</sup> *Arab Bank plc v Merchantile Holdings Ltd and another* [1994] 2 All ER 74 80.

<sup>32</sup> Some of these cases include *Drummond v Collins (Surveyor of Taxes)* [1915] AC 1011 at 1017; *Astor v Perry (Inspector of Taxes)*; *Duncan v Adamson (Inspector of Taxes)* [1935] All ER 713 at 723; *Collco Dealings Ltd v IRC* [1961] 1 All ER 762; *Re International Tin Council* [1987] 1 All ER 890 901-902.

Furthermore, if case law from Australia and the United Kingdom is considered, it is found that the courts recognise the principle of separate legal persons of the individual members of the group in the context of a “group of companies”.<sup>33</sup>

From the above international case law, it follows that when dealing with a group of companies, the group does not need to be looked at as a whole but the individual member companies of the group must be recognised. As such when dealing with the definition of a “group of companies” it does not mean that the entire group needs to be considered in all circumstances, but rather the individual members of the group as the case may require.

### **5.3.2.2 Explanatory Memoranda**

When considering the context in which section 45(4)(b) was introduced, the commentary in the relevant Explanatory Memoranda must be considered.<sup>34</sup> There is recent authority that one may take the Explanatory Memoranda into account when interpreting legislation.<sup>35</sup> This approach would be consistent with the ‘purposive’ approach now laid down by the courts as the basis for statutory interpretation.<sup>36</sup>

The Explanatory Memoranda assists with understanding the reasoning behind the amendments of section 45(4)(b).<sup>37</sup> The reason for these changes was to ensure that section 45 was not abused by taxpayers for purposes of tax-free cash-outs.<sup>38</sup>

The first change to section 45(4)(b) was to cater for a time limit, but effectively the following wording was also included:

“...to form part of *any* group of companies...” (Own emphasis)

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<sup>33</sup> *Salomon v A Salomon & Co Ltd* [1987] AC 22, *Adams v Cape Industries Plc* [1991] 1 All ER 929, *Walker v Wimborne* (1976) 3 ACLR 529 and *Industrial Equity Ltd v Blackburn* (1977) 137 CLR 567. This case law is in respect company law however, it is still relevant to us due to the fact that it deals with the application of “group of companies”.

<sup>34</sup> Explanatory Memoranda are issued by National Treasury in order to assist with the interpretation of the bill.

<sup>35</sup> *Minister of Health and Another No v New Clicks South Africa (Pty) Ltd and Others (Treatment Action Campaign and Another as AMICI CURIAE)* 2006 (2) SA 311 391.

<sup>36</sup> Refer to Chapter 2.

<sup>37</sup> For full detail on these amendments please refer to the previous chapter.

<sup>38</sup> National Treasury *National Explanatory Memorandum Taxation Laws Amendment Bill 2008* 14. Hereinafter referred to as “Explanatory Memorandum 2008”.

The Explanatory Memorandum<sup>39</sup> explained that the reason for the time limit was to ease the de-grouping charge and as such make it less stringent. However, no explanation was given as to why the word “any” was introduced. The only explanation that could be of assistance is the fact that the Explanatory Memorandum<sup>40</sup> stated that the purpose was that a de-grouping would be triggered if the transferor and the transferee company (previously involved in the section 45 transaction) were severed *from one another*. (Own emphasis).

Therefore, I submit that the word “any” should be read with a limited interpretation in order to avoid absurd results where for example, a change in shareholding further up the corporate structure could trigger a de-grouping lower down the corporate structure where the group of companies as were originally required for the section 45 transaction is still intact. This view is supported by looking at the context of the wording as well as taking guidance from international law.<sup>41</sup>

The second amendment related to the insertion of the word “any” in relation to “controlling group company”:<sup>42</sup>

“...or *any* controlling group company in relation to the transferor company and transferee company...”

A subsequent amendment took place that changed the word “any” to “a”:<sup>43</sup>

“...*a* controlling group company in relation to the transferor company...”

No specific reason for this change was given, however it supports the opinion that the section should be interpreted with a narrower view, which view is also supported by the Explanatory Memorandum.<sup>44</sup> This view is further supported by the fact that, no examples were given in the Explanatory Memorandum<sup>45</sup> of a de-grouping that would be triggered by a change of shareholding further up the corporate structure.

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<sup>39</sup>National Treasury *The Explanatory Memorandum to the Revenue Laws Amendment Bill 2007* 23. Hereinafter referred to as the “Explanatory Memorandum 2007”.

<sup>40</sup>Explanatory Memorandum 2007 23.

<sup>41</sup>S 233 of the Constitution.

<sup>42</sup>S 28 of the Taxation Laws Amendment Act 3 of 2008.

<sup>43</sup>Revenue Laws Amendment Act 60 of 2008 100.

<sup>44</sup>The Explanatory Memorandum 2007 23.

<sup>45</sup>The Explanatory Memorandum 2007.

## 5.4 Conclusion

The de-grouping charge in section 45 if interpreted literally, would result in de-grouping charges being triggered in scenarios that were never meant to be captured by the legislation.

I am of the view that this should not be the case and that when applying the purposive approach, which is also in line with international case law, the correct result in relation to the de-grouping charge would be achieved. A change in shareholding should therefore not result in a de-grouping charge in relation to a group of companies further down the corporate structure, as long as the companies involved in the original section 45 remains intact.

## CHAPTER 6 - CONCLUSION

### 6.1 HOW FAR DOES THE DE-GROUPING CHARGE IN SECTION 45(4)(b) REACH

The de-grouping charge in section 45(4)(b) on the face of it, appears to have far reaching consequences regarding the possibility of de-grouping.

In terms of section 45<sup>1</sup> one of the following two requirements must be met in order for a de-grouping event to be triggered:<sup>2</sup>

1. The first requirement is that the transferee company ceases within a period of six years after the original section 45 transaction to form part of *any group of companies* in relation to the transferor company; or
2. The transferee company ceases within a period of six years to form part of any group of companies in relation to *a controlling group* company of the transferor company.

As illustrated in Chapter 5, this will result in a de-grouping being triggered when there is a change in shareholding further up the corporate structure, irrespective of whether the shareholding change directly affects a company that was involved in the original section 45 transaction.<sup>3</sup>

However, when legislation is interpreted the literal interpretation of the words is only one component that needs to be considered, the other component is the context of the text. The context must be considered from the onset and not only when there is some form of ambiguity present.<sup>4</sup> If the context of the text is taken into consideration factors such as the purpose of the legislation and the judgements of international case law become relevant.<sup>5</sup>

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<sup>1</sup> Of the Income Tax Act.

<sup>2</sup> For a discussion of the de-grouping requirements please refer to Chapter 3.

<sup>3</sup> See s 45(1)(a) for the requirements for an s 45 transaction.

<sup>4</sup> *Natal Municipality v Endumeni Municipality* 2012(4) SA 593 (SCA). See also above, Chapter 3 for a discussion on statutory interpretation.

<sup>5</sup> See Chapter 4 and Chapter 5 regarding the application of the problem and how the relevant Explanatory Memoranda and international case law is of assistance in interpreting the legislation.

When considering the text and the context of section 45(4)(b) from the onset, I submit that the de-grouping charge as provided for in section 45(4)(b) should be interpreted as follow:

- 1) with a limited interpretation of the word “any” in relation to “any group of companies”; and
- 2) that “a controlling group company” should be interpreted with a narrow view so as not to make the group too broad for purposes of possible de-groupings.

Interpreting the legislation as such would make sense from a commercial perspective as it could never have been the intention for a de-grouping charge to be triggered in circumstances where it could not result in prohibiting any mischief. Furthermore, this view accords with what the purpose as stated in the Explanatory Memoranda and what is being advocated on an international level.<sup>6</sup>

I therefore, emphasise the importance of interpreting legislation with a diligent mindset that includes the proper consideration of the context of the legislation together with the text. If not, unintended consequences may result as is evident from section 45(4)(b).

It can therefore be argued that the de-grouping charge in section 45(4)(b) does in actual fact not reach beyond the initial group that was required to facilitate the section 45 transaction.

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<sup>6</sup> See Chapter 4 and 5 where the relevant Explanatory Memoranda and certain cases of the United Kingdom and Australia are discussed.

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# Annexure G



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Annexure G

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# Annexure M



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Co-supervisor (if applicable)

Date: .....13/10/2015.....

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