THE TAX IMPLICATIONS ASSOCIATED WITH SOME OF THE CHANGES MADE BY THE COMPANIES ACT 72 OF 2008 WITHIN SOUTH AFRICAN COMPANY LAW

MINI DISSERTATION (MND 803)

By

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Chapter 1 Introduction

1.1 Background

The Companies Act 71 of 2008,[1] which replaced the Companies Act 61 of 1973,[2] came into operation on 1 May 2011.[3] Historically, the Income Tax Act 58 of 1962[4] as well as other tax legislation have attempted to harmonise itself with South African Company legislation. The tax consequences associated with transactions performed under South African corporate law is, admittedly, an extremely important concept which warrants constant research. This is largely due to the wide-reaching financial implications that are associated with a particular transaction, not to mention the need for persons and companies to come to grips with outlying tax obligations and the major effect it may have.

1.2 Research question

The Companies Act is an exciting and challenging, but also a complex piece of legislation. The Companies Act introduces a variety of new legal concepts, underlying philosophies and changes to provisions of the Companies Act 1973. Given the novelty of this legislation, the tax implications of certain aspects may not always be clear. This dissertation will consider various provisions and concepts within the Companies Act and thereafter, analyse the tax implications associated with the concepts. The dissertation will also attempt to identify any conceptual or practical issues that may arise from the different legislation governing these concepts.

1.3 Objectives

As was mentioned earlier, the Companies Act is a relatively new piece of legislation which has introduced a variety of new concepts into South African Company law. As a result, these concepts may not have been analysed from a tax perspective. In order to give effect to the problem statement, the different chapters will firstly discuss and analyse the concepts as depicted in Company Law, and thereafter, systematically, discuss the various tax implications associated with each concept, specifically regulated by, *inter alia,* the Income Tax Act and the Value-Added Tax Act 89 of 1991.[5] The following concepts and provisions will be discussed throughout the dissertation:

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[1] Thereafter 'the Companies Act'.
[2] Thereafter 'the Companies Act 1973'.
[3] Proclamation by the president of the Republic of South Africa No. R. 32, 2011.
[4] Thereafter 'the Income Tax Act'.
[5] Thereafter 'the VAT Act'.

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- Chapter 2 discusses the types of companies recognised in terms of the Companies Act;[6]
- Chapter 3 analyses a handful of new provisions introduced by the Companies Act which may have hidden or concealed tax consequences, these are:[7] section 35(2) of the Companies Act (scrapping the nominal or par value rule); Section 164 of the Companies Act (appraisal rights); Section 37 of the Companies Act (classes of shares issued); and Section 40(5) of the Companies Act (sweat equity); and
- Chapter 4 focuses on the amalgamation and merger procedure under the Companies Act.[8]

1.4 Significance of the research

This research is significant as it attempts to shed some light on some of the tax consequences associated with the new provisions of the Companies Act. Given the newness of these provisions, relatively little consolidated material exists on the topic.

1.5 Limitations of Research

The applicability of this research is limited to the jurisdiction of South Africa in that the sources relied upon, unless otherwise indicated from the context, are of a South African nature. Furthermore, this dissertation does not involve statistical analysis or participation from the university, companies or participants.

1.6 Research methodology

This dissertation is qualitative in nature and will mostly make use of statutes as a point of reference. The statues used are considered to be the latest versions as of October 2015. The primary statutes used are the Companies Act and the Income Tax Act. Other statutes used include the Vat Act, Companies Act 1973, and the Securities Transfer Tax Act 25 of 2007.[9] This dissertation will also make use of other authority such as practise notes, interpretation notes, private binding rulings, text books, law journals and case law. My own opinion is also given in instances where a discussion is warranted or for purposes of clarity.

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[6] See Chapter 2.
[7] See Chapter 3.
[8] See Chapter 4.
[9] Thereafter, 'the Securities Transfer Tax Act'.

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Chapter 2 Types of companies recognised by the Companies Act 71 of 2008

2.1 Introduction

After much controversy and debate, the Companies Act has removed unnecessary difficulties that may arise when categorising the different types of companies that may be formed. The Companies Act suggests that all companies that are incorporated are either "profit" companies or "non-profit" companies, the latter being formed for a public benefit or an object related to social, cultural, communal or group activities.[10] There are no categories of non-profit companies, although it must have a board of directors and its name must end with the expression "NPC".[11] A profit company is defined as "a company incorporated for the purposes of financial gain for its shareholders".[12] There are four sub-categories of profit companies, namely- private, public, state-owned and personal liability companies.[13] Foreign companies, for purposes of this dissertation, is categorised by the Companies Act as external companies which do not conduct business or non-profit activities within the Republic of South Africa.[14]

Given the nature and purpose of the Companies Act,[15] one would suggest that taxing legislation, such as the Income Tax Act and VAT Act, would need to align itself with legislation such as the Companies Act. The reason for this would be to promote effective and efficient business practice, not to mention the importance of the interplay between the various legislation in dictating the rights and obligations of the particular parties involved. Therefore, it is no surprise that historically, the conceptual framework of the Income Tax Act has attempted to align itself with company legislation. For example, "share capital" as it was defined in the Companies Act 1973, was a concept which was relied upon in the Income Tax Act when determining the tax implications for particular distributions and returns of capital.[16] The Income Tax Act, as part of its goal to include various different types of entities, recognises

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[10] The non-profit company has effectively replaced the association which was incorporated under sec 21 of the Companies Act, 1973, more commonly known as the "section 21 company"

[11] Sec 11(3)(c)(v) of the Companies Act.

[12] Sec 1 of the Companies Act.

[13] Sec 8 of the Companies Act. A personal liability company is the modern substitute for the professional company formed under sec 53(b) of the Companies Act.

[14] Sec 23(2) of the Companies Act.

[15] The nature and purpose being to promote the development of the South African economy by encouraging entrepreneurship and enterprise efficiency, creating flexibility and simplicity in the formation and maintenance of companies, encouraging transparency and high standards of corporate governance as appropriate, given the significant role of enterprises within the social and economic life of the nation.

[16] Sec 1 of the Companies Act 1973. See also sec 72 of the Income Tax Act in order to illustrate how 'share capital', as defined in the companies Act, is relied upon in the Income Tax Act.

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several entities or organisations as companies which are not specifically regarded as such by the Companies Act. Consequently, this means that there are certain entities, such as close corporations, which are regarded as "companies" for purposes of income tax and value-added tax but are not recognised as such by the Companies Act.[17] Furthermore, the Income Tax Act also provides for specific tax treatment of entities that, as a result of their incorporation, have created specified attributes, i.e. recreational clubs[18] or small business corporations.[19]

This chapter will: consider the different types of companies contemplated in the Companies Act; identify the differences in classification of these companies when compared to the Income Tax Act and discuss the practical and conceptual implications which arise from these differences. It will also consider how these companies are incorporated and the possible tax consequences which may arise upon incorporation. It should however be made clear that although legislation may refer to a "company" as defined in the Companies Act, the Income Tax Act may still require the company to satisfy various other internal requirements before qualifying for a tax exemption or benefit. In this chapter, the following types of companies will be considered:

- public and private companies,
- foreign and external companies, and
- non-profit or public benefit companies.

2.2 Public and Private Companies

2.2.1 Introduction

As was alluded to earlier, the categorisation of companies found in the Companies Act 1973 has changed and has been replaced by a new categorisation introduced by the Companies Act.[20] For purposes of understanding, a 'company', according to the Companies Act, is defined as "a juristic person incorporated in terms of this Act, a domesticated company, or a juristic person that, immediately before the effective date-

a) was registered in terms of the-
    i. Companies Act 61 of 1973, other than as an external company as defined in the Act; or
    ii. Close Corporations Act 69 of 1984, if it has subsequently been converted in terms of schedule 2;
b) was in existence and recognised as an existing company in terms of the companies Act 61 of 1973; or

[17] This will become clearer at para 2.4 where non-profit companies are discussed in more detail.
[18] Sec 30A of the Income Tax Act.
[19] Sec 12E(4) of the Income Tax Act.
[20] Para 2.1 above.

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c) was deregistered in terms of the companies Act 61 of 1973, and has subsequently been registered in terms of this Act."[21]

A profit company, according to the Companies Act, is defined as a "company incorporated for the purpose of financial gain for its shareholders".[22] This is the same definition that was used in the Companies Act, 1973. The definition therefore envisages the principle that the primary duty of the director is to act in the best interest of the shareholding. This definition doesn't, however, suggest that a profit company is precluded from participating in a particular transaction that does not involve the production of income, i.e. profit companies may take part in charitable events and make donations. There are four categories of profit companies:[23]

1. Private companies;
2. Public companies;
3. State-owned companies; and
4. Personal liability companies

2.2.2 Private companies

Firstly, a private company is a profit company which is prohibited, according to the Memorandum of Incorporation ("MOI"), from offering any of its securities to the public and must restrict the transferability of its securities.[24] This is similar to the provisions contained in the Companies Act 1973, but has been widened to include securities other than shares.[25] This change may create unexpected consequences, i.e. a private company may no longer transfer or offer debt instruments to the public without first satisfying the requirements of the provisions governing public offerings and securities.[26] In order to comply with these requirements, most articles of association or MOI's of private companies incorporated under the Companies Act contain provisions which provide the directors with a discretionary right to refuse to register a transfer of its shares.[27] Secondly, the Companies Act 1973 also restricted the amount of shareholders of a private company to fifty. This too has been done away with by the Companies Act and consequently, a private company may have any number of shareholders.[28] Lastly, a private company's name must end with the expression

[21] Sec 1 of the Companies Act.
[22] Sec 1 of the Companies Act.
[23] For purposes of this dissertation, only public and private companies will be discussed under profit companies. The reason for this is that these companies create the majority of the entities formed in South Africa and will allow for a more thorough analysis of these two types of companies.
[24] Sec 8(2)(b) of the companies Act.
[25] Definition of 'securities' in sec 1 of the Companies Act. The other securities include debentures as well as shares.
[26] C Stein *The New Companies Act unlocked* (2011) 49. See also sec 99-110 of the Companies Act which outlines the various restrictions and requirements that specifically deal with public offerings and securities.
[27] As above.
[28] Stein (n 26 above) 49.

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'proprietary limited' or (Pty) Ltd.[29] A personal liability company[30] is regarded as a private company and must therefore meet the requirements of such.

2.2.3 Public companies

If a profit company cannot be categorised as a state-owned company, a personal liability company or a private company, it is deemed to be a public company by default.[31] There is no restriction placed on public companies with regards to the transferability of its securities. This means that a public company may freely transfer all securities to the public unless the MOI states otherwise. A state-owned company[32] is also regarded as a public company and has all the traits of such, but for the fact that it is state-owned. In other words, a state-owned company is considered a public company and may freely transfer securities but for the fact that it is a state-owned enterprise. Examples include: Eskom, Denel (Pty) Ltd and Brand South Africa.

2.2.4 Tax Implications

Typically, tax legislation does not differentiate between the categorisation of public and private companies, when considering normal tax implications. Consideration must however be given to section 38(1) of the Income Tax Act which states: "For the purposes of this Act a company shall in respect of each year of assessment be recognised as either a public or private company, and the Commissioner shall upon the request of any company inform that company whether it is recognised as a public company or as a private company". The above provision therefore suggests that the Income Tax Act requires the taxpayer to be recognised as either a public or private company at the end of each year of assessment. A private company, as classified by the Companies Act, will generally be recognised as such by the Income Tax Act, however, a public company in terms of the Companies Act, needs to first meet the internal requirements found in section 38(2)(a) of the Income Tax Act before being recognised as a public company.[33] This could lead to a situation, which was eluded upon earlier, where a public company fails to meet the internal requirements of the Income Tax Act and will subsequently be recognised as a private company for tax purposes.[34]

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[29] Sec 11(3)(c)(ii) of the Companies Act.

[30] This is a company whose MOI states that it is a personal liability company. This suggests that the directors have joint and several liabilities for the debts of the company.

[31] Sec 1 of the Companies Act.

[32] A new category of companies created by the Companies Act and includes entities that owned by or accountable to the national or provincial government, or to a municipality.

[33] Sec 38(2)(a) provides that 'the following companies shall, subject to the provisions of section thirty-nine, be recognized as public companies, namely any company of whose equity shares are publicly quoted by a stock exchange, provided the Commissioner is satisfied that the stock exchange is a *bona fide* stock exchange and that the rules for granting quotes for the purchase and sale of shares provide full protection of the interests of the public. Furthermore, the memorandum and articles of association of the company should contain no restrictions on the right to acquire or transfer any shares which could prevent members of the public from becoming shareholders in any class.

[34] Sec 38(3) of the Income Tax Act stipulates that all companies that are not recognised as a public company in terms of sec 38(1) are automatically recognised as private companies.

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So why is this classification important? The reason that the Income Tax Act requires a distinction is because some tax benefits are awarded to public companies, but not private companies. For example section 56(1)(n) of the Income Tax Act states that public companies are exempt from paying donations tax whilst private companies are still liable, except for the exemption found in section 56(1)(2)(n).[35] Another example which highlights this importance is found in paragraph 11C of the Fourth schedule to the Income Tax Act. The paragraph suggests, for purposes of anti-avoidance, that remuneration paid to the directors of a private company may be made on a deemed amount rather than an actual amount.

2.3 Foreign and external companies

2.3.1 Introduction

Although foreign and external companies are similar, a differentiation between the two should be made. Section 8 of the Companies Act does not include a foreign company as a separate type of company. However, a foreign company is defined in section 1 of the Companies Act as "an entity incorporated outside the Republic, irrespective of whether it is-

a) a profit, or non-profit, entity; or
b) carrying on business or non-profit activities, as the case may be, within the Republic".

Whereas an external company is defined in section 1 of the Companies Act as "a foreign company that is carrying on business, or non-profit activities, as the case may be, within the Republic, subject to section 23(2)."[36] Section 23(2)(a) of the Companies Act provides that a foreign company must be regarded as conducting business, or non-profit activities in South Africa if the company-

a) is a party to one or more employment contracts within the Republic; or
b) subject to subsection (2A), has engaged in a course of conduct, or in a course or pattern of activities over a period of at least six months, which would lead a person to reasonably believe that the company intended to continually engage in business or non-profit activities within the Republic.

Consequently, section 23(2A) of the Companies Act stipulates that a foreign company should not, in accordance with the above provisions, be regarded as conducting business or non-profit activities in South Africa solely on the basis that that company is or has engaged in any of the following activities:[37]

[35] Donations tax will not be payable if the donations made (by someone other than natural persons) during the year of assessment amounts to R10000 or less.
[36] Sec 23(2) prescribes the circumstances in which an foreign company is to be seen as conducting business, or non-profit activities, in the Republic and will therefore will be obligated to register as an external company.
[37] Sec 23(2A) of the Companies Act.

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

If consideration is given to the above provisions, it seems that once a foreign company has entered into one or more contract(s) of employment within the Republic, that foreign company is obligated to register as an external company. Alternatively, if the foreign company has not entered into a contract of employment but has carried out one or more of the activities listed in section 23(2A) of the Companies Act, that company will have to register as an external company. This is however dependant on the regularity and manner in which these activities are entered into and whether it would lead a person to reasonably conclude that the company intends to engage in business or non-profit activities in South Africa. What constitutes "one or more employment contracts within the Republic" is a question of interpretation and will have to be considered against the backdrop of each individual case. Brownell notes that the legislature intended to adopt a narrow interpretation which includes only employment contracts with services rendered between a foreign company (employer) and an employee based in South Africa, for example a South African national or permanent resident who is based in South Africa.[38]

2.3.2 Tax implications of a foreign company in South Africa

In terms of the Income Tax Act, when South Africa moved from a source basis of taxation in 2001 to a residency basis of taxation, the Companies Act introduced a definition of a resident into section 1. Accordingly, the definitions of 'domestic companies' and 'external companies' were removed.[39] In terms of section 1 of the Income Tax Act, a company will be considered a resident if it is incorporated, established or formed in the Republic or has its place of effective management in the Republic.[40] When comparing the aforementioned definition in the Income Tax Act to the definition of a foreign company in the Companies Act,[41] it is noticeable that a foreign company is explicitly incorporated outside the Republic and as such, will usually

[38] Brownell "What constitutes an employment contract within South Africa" - section 23(2) of the Companies Act 71 of 2008 April 2012 De Rebus 4.

[39] L Steenkamp "The Tax Treatment of foreign companies under the new Companies Act" November 2011 *Taxtalk Magazine* 27.

[40] Paragraph (b) of the definition of "resident" in sec 1 of the Income Tax Act.

[41] Sec 1 of the Companies Act.

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not qualify as a resident.[42] In light of the above, a foreign company is generally only subject to South African income tax from South African sourced income[43] namely income that is made and received in South Africa. Another important reason for this is to give effect to double tax treaties that South Africa has entered into with other countries and to ensure that double taxation does not take place to the disadvantage of taxpayers.[44]

The fundamental question that needs to be considered is: what will the tax implications be if the foreign (non-resident) company satisfies the guidelines in terms of sections 23(2)(a) and 23(2A) of the Companies Act? Consequently, this would place an obligation on the foreign company to register as an external company with the Companies and Intellectual Property Commission (CIPC) within 20 business days after starting to conduct such business and must, according to the Companies Act, maintain at least one registered office in South Africa? This question will be analysed below.

2.3.3 Tax implications of having to register as an external company

A foreign company which, according to sections 23(2)(a) and 23(2A) of the Companies Act, enters into an "employment contract within South Africa" or "carries on business in South Africa" should take cognisance of the following questions which may assist in determining the tax implications that may arise upon registration as an external company:[45]

1. Is there an audit requirement for external companies?
2. Will the external company be regarded as a resident for income tax purposes?
3. Will the external company in South Africa give rise to a permanent establishment of the foreign country in South Africa?
4. Will the foreign company need to register as a VAT vendor?
5. Will the employees of the foreign company be subject to normal tax in South Africa?
6. What are the consequences upon failure to register as an external company in terms of section 23(6) of the Companies Act?

2.3.4 Audit of External Companies

In the Companies Act 1973, section 2(2) stated that the Act applied in its entirety to external companies, unless it was provided otherwise. This position has significantly changed, as the definition of a company in section 1 of the Companies Act only includes companies incorporated in terms of the Companies Act and domesticated companies.[46] As such the only sections of the Companies Act that apply to external companies are section 23 (registration

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[42] A foreign company may however be regarded as a resident if its place of effective management is in South Africa. If this is the case, the foreign company will need to register as an external company and maintain at least one registered office. For a more detailed explanation see para 2.3.5.
[43] Sec 1 of the Income Tax Act.
[44] This is one of the primary goals of the OECD Model Tax Convention with respect to taxes on income and on capital.
[45] By virtue of this registration, the foreign company will need to maintain at least one registered office in South Africa.
[46] A domesticated company is a foreign company that has transferred its registration to South Africa.

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of external companies and registered office), section 32 (use of company name and registration number), section 33 (annual returns), section 115 (required approval for transactions) and section 159 (protection of whistle blowers) - none of which include an audit requirement.[47]

Although there is no provision specifically regulating and/or enforcing an audit requirement, there are conflicting views in this regard. One view agrees with this assertion and suggests that there is no requirement that an external company has to appoint an auditor for its operations in South Africa.[48] Section 30(2)(a) of the Companies Act doesn't explicitly refer to external companies, but does state that "the annual financial statements must- (a) be audited, in case of a public company…" Therefore, if the external company qualifies as a public company, it should be audited. If we consider the rest of section 30(2), read with regulations 26, 28 and 29, it prescribes that both profit and non-profit companies be audited or subject to independent review.[49] Since an external company can be incorporated as either a profit or non-profit, these companies may be subject to an audit or independent review.[50]

Furthermore, section 325 of the Companies Act 1973 provided that all external companies had to be audited by the appropriate personnel. In light of this, I am of the opinion that external companies should still be subject to an audit requirement or independent review, unless the company in question does not satisfy the requirements contained in the above regulations.[51]

2.3.5 Residency of the External Company

As was mentioned earlier,[52] South Africa moved from a source based taxation to a residency based taxation in 2001.[53] As a result of this shift, section 1 of the Income Tax Act now defines a juristic person as a resident if it is incorporated, established or formed in the Republic or if the place of effective management is located in the Republic.[54] The registration as an external company, in terms of the Companies Act, does not amount to incorporation, formation or establishment in terms of the Income Tax Act.[55] In light of the above, it should be noted that the registration or establishment of a branch could very well give rise to South African income tax on the profits of that branch (as a source within South Africa). This however does not mean that the foreign company will become a South African resident company.

[47] Steenkamp (n 39 above) 27.
[48] As above.
[49] Steenkamp (n 39 above) 27.
[50] This argument and viewpoint is held by a number of auditing firms in South Africa. These include: Ernst & Young's Talking Points: The Companies Act 2008 (as amended) and the company regulations 2011, PWC's Audit and Accounting requirements of the New Companies Act 2011 and Deloittes Companies Act to Audit or not to audit 2010.
[51] Regulations 26, 28 and 29 to the Companies Act.
[52] Para 2.3.2 above.
[53] Steenkamp (n 39 above) 27.
[54] Para b in definition of "resident" in sec 1 of the Income Tax Act.
[55] Steenkamp (n 39 above) 27.

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A foreign company can, however, be considered a resident if "its place of effective management" is in South Africa. The "place of effective management" is not defined in the Income Tax Act and as such, SARS has issued interpretation note 6 which denotes the place of effective management to be the:[56]

- place where regular, day- to- day management by directors or senior managers of the entity through the implementation of the policy and strategic decisions of its board of directors;
- place where the day-to-day management of the senior management or directors takes place or;
- place where the policy of the company is implemented.

Therefore, if SARS can prove that the external company is the place of effective management in accordance with the above, such a foreign company will be resident for tax purposes and will be taxed on worldwide income.

Along with interpretation note 6 and the OECD Model Tax Convention, *The Oceanic Trust Co Ltd NO v The Commissioner for the South African Revenue Service*[57] is one of the leading authorities in the determination of what "the place of effective management" means. *In casu*, the court accepted the taxpayer's reliance on a recent decision of the *England and Wales Court of Appeal in Commissioner for Her Majesty's Revenue and Customs v Smallwood and Anor*[58] in which it was held that the "place of effective management" of a trust (or other entities for that matter) is where the key management and commercial decisions that are necessary for the conduct of the entity's business are, in substance, made.[59]

2.3.6 Permanent establishment of the foreign company

A permanent establishment is defined as a fixed place of business through which the business of an enterprise is wholly or partially carried out.[60] This includes a place of management, a branch, an office, or a factory etc.[61] The presence of these things is, however, not considered conclusive proof that a permanent establishment does in fact exist. The need to identify a permanent establishment is of particular importance, when considering double tax

[56] It should be noted that these interpretation notes are not binding but offer a guideline to all stakeholders and will eventually replace the existing practise notes. See also the OECD model tax convention which describes the "place of effective management" as the place where key management and commercial decisions are made, which are necessary for the running of the undertaking.
[57] 74 SATC 127 (WCC).
[58] [2010] EWCA Civ 778.
[59] Para 50.
[60] Article 5(1) of the OECD Model Tax Convention.
[61] Article 5(2)(a), (b) (c) and (d) of the OECD Model Tax Convention.

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agreements[62] which the foreign country may have with South Africa.[63] It is in these instances that the provisions of the OECD Model Tax Convention[64] lend a hand in determining whether a permanent establishment has been created. It is important to realise that this Model is not legally binding, so even though the OECD recommends that member States[65] follow it, they are free to deviate from it in their bilateral tax treaties. Nonetheless, according to the OECD Model Tax Convention, a permanent establishment excludes:[66]

i. the use of facilities for storage, display or delivery of goods belonging to the foreign company;
ii. maintenance of stock for purposes set out in (i); or
iii. maintenance of a fixed place of business for purchasing, collecting information, or activities which of a preparatory or auxiliary nature etc.

Accordingly, if a person (other than an agent of independent status) has been given the authority to enter into agreements or negotiations on behalf of the foreign company in South Africa, and regularly exercises such authority, that person may in fact create a permanent establishment for the foreign company in South Africa.[67] On the contrary, a business who acts through a broker, general commission agent or any other agent of independent status shall not create a permanent establishment of the foreign company.[68] Likewise, a South African-based company, which is controlled by another foreign company, will not automatically create a permanent establishment of a foreign (holding) company.[69]

In light of the above, what does this mean if one were to give effect to section 23(2)(a) of the Companies Act, which provides that a foreign company - who is a party to an employment company - must register as an external company and consequently maintain a registered office within South Africa? In my opinion, a foreign company, who is obligated to register as an external company and maintain a registered office within the Republic, would subsequently create a fixed place of business and with this fixed place of business, it would create a permanent establishment. Furthermore, if the reason for registration as an external company is an employment contract in which such employee has been given authority to

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[62] This is an agreement which is entered into by two or more countries in order to enable the administrations to eliminate or prevent double taxation.

[63] The reason for this is that the South African Revenue Services will only be entitled to claim tax if a permanent establishment is established in the Republic. In other words, if a permanent establishment is identified, that company will for income tax in South Africa and will no longer be protected by a double tax agreement.

[64] The OECD Model Tax Convention is a convention regulates legal situation regarding the tax treatment between different states. The Convention therefore serves as a guideline, which provides for a set of rules for allocating taxing rights on cross-border income between two countries, so that a foreign company is free from double taxation on its income.

[65] South Africa is a non-member economy of the OECD but there still exists a working relationship between South Africa and the OECD. Consequently, the OECD recommendations will serve as a guideline for South Africa.

[66] Article 5(4) (a) (b) and (d) of the OECD Model Tax Convention.

[67] Article 5(5) of the OECD Model Tax Convention.

[68] Article 5(6) of the OECD Model Tax Convention.

[69] Article 5(7) of the OECD Model Tax Convention.

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enter into agreements on behalf of the foreign company in South Africa, then a permanent establishment can also be created on this basis. Whether or not a permanent establishment is automatically created upon registration as an external company is a question that needs to be considered. In Binding Private Ruling 102,[70] SARS held that the registration as an external company and subsequent maintenance of an office in South Africa will not automatically create a permanent establishment for that company in South Africa, contingent upon the fact that the company's place of effective management is not within the Republic and that it will not have any employees in South Africa, conduct any business activities in South Africa[71] or have a dependant agent acting on their behalf in South Africa. It is important to note that the BPR 102 is a private ruling which is only binding on the parties to the dispute. Furthermore, this ruling was made using the provisions of the previous, now repealed, Companies Act 1973 which required a foreign company to register as an external company within 21 days after "a place of business" had been established in South Africa.[72] In comparing this to the new legislation, it seems that there have been significant change with regard to the registration process, but nevertheless this private ruling serves as an illustration as to how SARS would consider the question of permanent establishment in the future.

It would seem that although a foreign company, who registers as an external company, does not automatically create a permanent establishment, such a company will do well not to be a party to any employment contracts within South Africa. The reason for this is that it seems that in establishing an employment contract, it substantially increases the chances that SARS will recognise that a permanent establishment has been created. Another way a foreign company could minimise the chances of creating a permanent establishment is to enter into an agreement with a South African company. One of the conditions of this agreement being that the company's employees render services for the foreign company but remain under the authority of the South African company.[73] Seeing as there is no employment contract created between the foreign company and the South African company, the former may be assessed in a fully comprehensive manner in terms of section 23(2A)(a)(f) in considering whether the foreign company intends to regularly conduct business in South Africa.

If there is a need for an employment contract and the foreign company intends on entering into such a contract with a South African employee then, according to Article 5(5) of the OECD Model Tax Convention, such an employee should not be given the authority to enter into agreements or negotiations on behalf of the foreign company in South Africa. This will prevent

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

[71] Other than maintaining an external company status for exchange control purposes.

[72] Sec 322(1) of the Companies Act 1973.

[73] This is similar to a service level agreement in which the South African based company will act as a service provider to the customer (foreign company). This could be an informal contract which creates a "loophole" in the sense that the employees rendering the service will remain under the authority of the South African company and the foreign company will receive the services. Seeing that the employment contract exists between the South African company and its employees, the foreign company will not be a party to an employment contract in South Africa.

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a permanent establishment from being created. In other words, the foreign company registers as an external company (as a result of the employment contract) and must, according to the provision, maintain at least one registered office in South Africa. The foreign company should however guard against employees having the authority to habitually enter into agreements and negotiations on behalf of the company. Instead the appointment of an independent agent to administer and accept documents in South Africa will prevent a permanent establishment from being formed.[74]

But what about the income which a foreign company receives as a result of such an employment contract? It is provided that, where the foreign country in which the company is situated and South Africa are parties to a valid double tax agreement, the income which is generated in South Africa and is received by a foreign will not be subject to tax in South Africa unless such a foreign company has created a permanent establishment in South Africa.[75] Where there is no valid double tax agreement it would seem that the income is generated in South Africa and as such, the income is considered as a South African source and subject to South African Income tax.

2.3.7 Registration as a VAT vendor

The next question that needs to be analysed is whether, according to the provisions of the VAT Act, the foreign company will need to register as a VAT vendor. A foreign company which satisfies the requirements to register as an external company and maintain a registered office in South Africa is not automatically required to register as a VAT vendor. Instead the foreign company will first need to satisfy further requirements which are laid out in the VAT Act. According to the VAT Act, the foreign company must supply goods and services in the furtherance of an enterprise wholly or partially in South Africa[76] and will be liable for compulsory registration as a VAT vendor if their taxable supplies[77] made or to be made are in excess of R1 million in any consecutive twelve month period.[78] Furthermore, a company is required to open a South African bank account[79] as well as appoint a representative vendor.[80]

The question arises whether the opening of a South African bank account places an obligation on a foreign company to register as an external company considering the fact that it may amount to conducting regular business in South Africa?[81] Furthermore, if we consider the above mentioned requirements of registering as a VAT vendor, namely whether the foreign

[74]This example deals with a South African employee but if the employee were a citizen of the country in which the foreign company is based, then it would seem that the foreign company would not, in the strict sense of the words, have entered into an employment contract in South Africa. This would mean that the company did not, according to sec 23(2)(b) and 23(2A), conduct business in South Africa and will not have to register as an external company.
[75] Article 7(1) of the OECD Model Tax Convention.
[76] Sec 7(1)(a) of the VAT Act.
[77] A taxable supply is any supply of goods or services which is chargeable with tax.
[78] Sec 23(1)(a) of the VAT Act.
[79] Sec 23(2)(bb) of the Vat Act.
[80] Sec 23(2)(aa) of the Vat Act.
[81] Sec 23(2A)(b) of the Companies Act.

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company supplies goods and services in South Africa and whether those taxable supplies exceed R1 million in any consecutive twelve month period, it would seem inevitable for a foreign company, who satisfies these requirements, to also register as an external company unless such a company does not do so regularly.

2.3.8 Tax implications for the employees of a foreign company

In analysing this question, there are two positions to consider: firstly, the position if the employee is a South African resident and secondly, the position if the employee is a resident in the country where the foreign company is incorporated.

With regards to the first position, if the employee of the foreign company is a South African resident[82] then, according to section 1 of the Income Tax Act, that person will be taxed on their taxable income on a worldwide basis. It is important, however, to mention section 10(1)(o)(ii) of the Income Tax Act which provides that if the South African resident has received remuneration for services rendered outside of the Republic and such a person was outside the Republic for more than 183 continuous days during a year of assessment, then that income is exempt from tax liability in relation to the remuneration which the taxpayer has received.

With regards to the second position, if the employee is a resident in the country where the foreign company is incorporated (South African non-resident) then the following may apply: if the country, in which the employee is a resident, is a party to a double tax treaty with South Africa, then South Africa does not have the right to tax the employee on the income received by such an employee for work done in South Africa, subject to the fact that the remuneration was paid by a resident employer, the employee was not present in the Republic for more than 183 days in that specific year of assessment and the remuneration was not from a permanent establishment in South Africa.[83] If however, there is no double tax treaty then the employee (as a non-resident) will be subject to tax on the income derived from a South African source. This means that if the remuneration or income is received in South Africa, it is deemed as a South African source and is subject to tax.[84]

2.3.9 Section 23 (6) of the Companies Act

Section 23(6) states that where a foreign company, which is obligated to register as an external company, fails to do so, such a foreign company will be issued with a compliance

[82] A natural person is, in terms of sec 1 of the Income Tax Act, considered to be a resident for tax purposes if he or she is deemed to be an ordinary resident. This concept means that a natural person is a resident if his or her permanent home, to which he or she will normally return, is in South Africa. If the person is not considered an ordinary resident, he or she may still qualify as a resident in terms of the physical presence test. The test consists of three requirements, that is, the natural person must be physically present in South Africa for a period or periods exceeding – 2 i) 91 days in aggregate during the tax year under consideration; ii) 91 days in aggregate during each of the five tax years preceding the tax year under consideration; and iii) 915 days in aggregate during the above five preceding tax years. A juristic person is considered a resident for tax purposes if the entity was incorporated, established or formed in the Republic of South Africa.
[83] Article 15(2) (a) (b) and (c) of the OECD Model Tax Convention.
[84] Sec 1 of the Income Tax Act.

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notice from the Companies Commission requiring the company to register as an external company within 20 business days after receiving such notice or, if it fails to register within the allocated time, cease carrying on its business or activities within South Africa. In my opinion if we consider how onerous it is on foreign companies to register as an external company and maintain an office in South Africa, not to mention the possibility of creating a permanent establishment and the tax liability that it brings about on foreign companies, it seems that the penal provision contained in section 23(6) is not sufficient enough to persuade foreign companies to adhere to the registration. I opine that in order to secure revenue and prevent companies from abusing the system, a more severe penalty should be implemented upon failure to register within an allocated time period.

2.4 Non-profit or public benefit companies

2.4.1 Introduction

A non-profit company or public benefit organisation is a company which is incorporated for a public benefit or another specified object[85] and the income and property are not transferable to any of its members.[86] Schedule 1 to the Companies Act lends an interpretive hand when dealing with and considering non-profit companies. Item 1(1) of Schedule 1 to the Companies Act states that the MOI must establish at least one public benefit object or any object which relates to a cultural, social, communal or group interest. Furthermore, according to item1(2) and (3) of Schedule 1 to the Companies Act, a non-profit company should apply all of its respective assets to advance the above objects and may not, directly or indirectly, pay any portion of its income or transfer any of its assets to any of the members of the company.[87]

2.4.2 Tax implications

Earlier on in this chapter, it was expressed that there are occasions where certain taxing legislation may still require that a company satisfy various other internal requirements before qualifying for a tax exemption or benefit. This is of particular importance when considering non-profit companies or public benefit organisations and the possible tax benefits that they may receive. In other words, although the Companies Act does assist, when categorising a company, in pointing out the tax treatment of such a company, the company will still have to comply with certain other requirements contained within other relevant taxing legislation. For a better understanding, illustrations of this will be discussed below.

According to section 30[88] of the Income Tax Act, a "public benefit organisation" means any company that is formed and incorporated under section 21 of the Companies Act and must

[85] Item 1(1) of Schedule 1 to the Companies Act.
[86] As defined in sec 1 of the Companies Act.
[87] This is subject to a few exceptions as is listed in item 1(3) a-d of Schedule 1 of the Companies Act.
[88] Read with part I of the ninth schedule to the Income Tax Act.

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comply with the various requirements contained therein.[89] In considering section 30, it is evident that a non-profit company, which is formed or incorporated in terms of section 21 of the Companies Act, will still need to comply with the provisions of section 30 of the Income Tax Act to be recognised as a "public benefit organisation" and subsequently receive any possible tax benefits which are associated with such.

Another example would be that of "recreational clubs." The tax implications associated with recreational clubs are governed by section 10(1)(cO) and section 30A of the Income Tax Act. The effect of section 10(1)(cO) is that clubs will now essentially be treated in a similar manner to Public Benefit Organisations. In effect section 10(1)(cO) will restrict the exemptions to situations where the activities are based on the sharing of recreational expenses through membership fees. Income from non-members will generally be subject to tax, with all club income subject to income tax unless that income falls within the provisions of section 10(1)(cO) i.e. where that income constitutes one of the forms of receipt or accrual, it will be exempt from tax.[90] Section 30A of the Income Tax Act states that a recreational club means any company contemplated under section 21 of the Companies Act, society or other association of which the object is to provide social or recreational amenities to the members of the company or association. The section then goes on to list further requirements and procedures that need to be followed in order to qualify as such.[91] Again, we can see that even though a non-profit company is incorporated in term of the Companies Act, that company will still to comply with sections 10(1)(cO) and sections 30A of the Income Tax Act in order to receive any tax benefits. Previously, before the introductions of sections 10(1)(cO) and 30A of the Income Tax Act, all recreational clubs were completely exempt from income tax and any gain or loss which was incurred during the disposal of assets was disregarded for capital gains tax[92] purposes. However, after their introduction, recreational clubs enjoy less favourable tax exemptions. The reason for the changes was the introduction of a new tax system governing public benefit organisations and the growing concern that recreational clubs were treated more favourably than a public benefit organisation.[93] Currently exemptions have been restricted to those instances where clubs share the "recreational expenses" like membership fees.[94] Finally, a non-profit company, which is incorporated in

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[89] Sec 30 (2) – (12) of the Income Tax Act shed light on these particular internal requirements which need to be met in order to be considered, for purposes of the Income Tax Act, as a public benefit organisation.

[90] These types of receipts and accruals are: membership fees or subscriptions paid by its members; business undertakings/trading activities directly and integrally related to the provision of social or recreational facilities, amenities or services provided to members which are carried out for the recovery of costs and will not create unfair competition in relation to taxable entities; fundraising activities of that club provided those activities are of an occasional nature and substantially undertaken with voluntary assistance without compensation; or other source income subject to a *de minimis* rule, i.e. not exceeding the greater of (i) 5 percent of total membership fees and subscriptions in respect of that year or (ii) R50 000.

[91] Read sec 30A (2) – (9) of the Income Tax Act.

[92] See para 4.6.4 below for a better for a better understanding of Capital Gains Tax.

[93] SARS "Guide for recreational clubs" (Issue 2). Available at http://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPDGenG04%20%20Tax%20Guide%20for%20Recreational%20Clubs%20-%20External%20Guide.pdf. (accessed on 14 July 2015).

[94] As above.

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terms of section 21 of the Companies Act, will need to comply with the requirements of a welfare organisation[95] before such a company can apply to be a VAT vendor.

In light of the above illustrations, it is evident how important the interplay is between the Companies Act and the relevant tax legislation. It is for this reason that it is crucial to not only consider how these companies are classified in terms of the Companies Act but also to consider any further requirements that they may need to comply with in order to qualify for the necessary tax benefits.

2.5 Conclusion

Although the Companies Act provides for different categories of companies, such companies may not be recognised by the Income Tax Act. Consequently, a company incorporated in terms of the Companies Act may not qualify as such by the Income Tax Act or may need to comply with further internal requirements of the Income Tax Act in order to qualify for a tax benefit or reduction. Although the need for companies to comply with further requirements within tax legislation existed previously, these extra requirements highlight the significant conceptual differences that exist between modern company law and the Income Tax Act. This has created a situation where it has become necessary for companies to consider the various tax implications of a transaction according to the interplay between the Income Tax Act and the Companies Act. As can be seen from this chapter, the different entities recognised by the Companies Act all differ in structure as well as the way in which they are incorporated. As a result, each entity experiences different tax treatment in accordance with the appropriate legislation. Companies and entities alike will not only need to comply with the requirements of the Companies Act but will also need to fulfil specific internal requirements of the Income Tax Act before qualifying for tax benefits.

[95] Sec 1 of the VAT Act.

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Chapter 3 Tax implications associated with some of the new provisions introduced by the Companies Act 71 of 2008

3.1 Introduction

As has been clear so far, all companies have been affected by the introduction of the new Companies Act which took effect on the 1st of May 2011. The scope of change which the Companies Act has introduced is immense and the effect of such varies amongst the different companies and entities. Given this change and the subsequent uncertainty that it has brought, a number of questions have arisen regarding the tax implications of some of the new provisions - specifically regarding shares, securities and the transfer of such. The purpose of this chapter is to investigate and identify any possible hidden tax consequences associated with a particular provision. Although there are numerous tax-related topics and uncertainties arising from the application of the Companies Act, this chapter will, for the sake of brevity, only investigate a select few provisions in the Companies Act[96] [specifically regarding securities, shares and share transfers] which are new or differ substantially from the corresponding provisions in the Companies Act 1973. The following provisions of the Companies Act will be considered:

- Section 35(2)
- Section 164
- Section 37
- Section 40(5)

Given the fact that the majority of this chapter focuses on the concepts of "shares" and "securities," it is important to consider how these concepts are defined in the Companies Act. "Securities" is defined as "any shares, debentures or other instruments, irrespective of their form or title, issued or authorised to be issued by a profit company."[97] A "share" on the other hand is defined as "one of the units into which the proprietary interest in a profit company is divided".[98] Furthermore the definition of "share" in the Income Tax Act is "in relation to any company, any unit into which the proprietary interest in that company is divided".[99] This new

[96] Sec 35(2), 164, 37 and 40(5) of the Companies Act.
[97] Sec 1 of the Companies Act.
[98] Sec 1 of the Companies Act.
[99] Sec 1 of the Income Tax Act. This definition is the recently amended version, which was brought in to curb the difference in the definitions between the two statutes

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definition is crucial if we consider the interplay between the legislation. In other words, the concept "share" in the Companies Act corresponds with various other concepts such as "share capital" or "share buy-backs" and as such, the Income Tax Act will need to align its concepts with that of the Companies Act in order to fully and effectively tax shareholders. The above mentioned provisions will now be considered.

3.2 Section 35(2) of the Companies Act

The activities and expenses of a company are financed through the issuing of securities by that company in exchange for the payment of a specified amount of money.[100] The company is therefore able to generate sufficient funds through investments made on those securities or by loans made to the company.[101] The money that the company receives in return for the issuing of shares is known as 'share capital'.[102] Although this term is referenced frequently throughout the Companies Act 1973, this is not the case in the new Companies Act. The provisions of the Companies Act 1973 indicate that the proceeds received on the issue of par value shares[103] are to be transferred to the "share capital account" and where such a par value share is sold at a premium;[104] such an amount had to be transferred to the "share premium account".[105] These accounts were strictly policed and controlled. Furthermore, the Companies Act 1973 provided for strict requirements when considering share capital.[106] Many of these control mechanisms and requirements have been removed by the Companies Act. An example of this is found in section 35(2) of the Companies Act which provides that "a share does not have a nominal or par value, subject to item 6 of schedule 5 of the Companies Act". This is a fundamental difference between the two acts as one of the crucial elements of the maintenance of capital rule, which is evident in the Companies Act 1973, was the concept that a share had to have a nominal or par value.[107] The Companies Act has seemingly abolished most of the provisions in the Companies Act 1973 which regulated the "maintenance of capital rule"[108] and replaced it with the solvency and liquidity test.[109]

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[100] There are however instances where securities are issued in exchange for consideration other than money. Examples here include sweat equity and other adequate consideration which will be discussed later in the chapter.

[101] FHI Cassim, MF Cassim, R Cassim, R Jooste, J Shev, J Yeats *Contemporary Company Law* (2012) 213.

[102] As above.

[103] Par value is a per share amount appearing on stock certificates. It is also an amount that appears on bond certificates. In the case of common stock, the par value per share is usually a small amount. The par value of the shares serves as a cap for the minimum amount that share may be sold for.

[104] This is where such a share is sold at a price which exceeds the par value of that share.

[105] Sec 85(5) - 85(9) of the Companies Act 1973.

[106] One of the most important requirements was that a company had to continuously control and maintain its share capital at the level of funding contributed by its shareholders. This is known as the "maintenance of capital rule".

[107] Stein (n 26 above) 20.

[108] As above.

[109] Sec 4 of the Companies Act. See para 4.3.2 below for a brief discussion on the solvency and liquidity test.

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Although the Companies Act has done away with par value shares, it has provided for a transitional phase which permits the continued existence of those par value shares which were authorised and issued by a pre-existing company before 1 May 2011.[110] Furthermore, those shares that are issued by a pre-existing company on the 1 May 2011 may no longer increase the number of its authorised par value shares; or issue another class of par value shares from which it failed to issue any shares before 11 May 2011.[111] The Minister of Finance and the member of Cabinet responsible for national financial matters have created regulations which govern the optional conversion and transitional status of these shares.[112] In doing so, the regulations attempt to provide some clarity on the possible conversion of these shares as well as to preserve the rights of those shareholders associated with such.[113]

This change has led to several significant implications to not only companies but shareholders, not to mention the complete revamp and simplification of the legislation. This is because, as has been mentioned earlier, the terms such as "share capital", "share premium" and "capital reduction" have all been abolished by the Companies Act. Although the change may have several consequences, the focus of this dissertation will solely be placed on the possible tax implications that may arise as a result of this change.

3.2.1 Tax Implications

Previously, before the introduction of the new Companies Act, a company would make distributions to the respective shareholders from the resources within the share capital, share premium or other reserves.[114] As such, the component of equity from which the distribution was made would determine the specific tax treatment.[115] Therefore does section 35(2) of the Companies Act have any tax consequences? In other words, does the removal of par value shares affect the tax treatment of shareholders and companies?

This question requires the consideration of two separate time periods, namely prior to, and after 1 January 2011.[116] Firstly, any distributions made prior to 1 January 2011 from share capital or share premium were not considered as dividends for tax purposes but rather as capital distributions[117] or "returns of capital" as is provided for in the Taxation Laws

[110] part 2 item 6 of schedule 5 to the Companies Act.
[111] Stein (n 26 above) 20.
[112] Regulation 35(4) of the draft regulations published in the Government Gazette 32832 of 22 December 2009.
[113] The conversions are regulated by the transitional arrangements and the regulations. See regulation 31 for a better understanding.
[114] An example here would be "retained earnings".
[115] E.g. Distributions from share capital or share premiums were considered capital distributions for tax purposes.
[116] This date is significant as it marks the day in which the term "Contributed Tax Capital" in the Income Tax Act became effective. Please see below under this para for a clearer understanding of "Contributed Tax Capital".
[117] P Van der Zwan & B Huisman 'Shedding light on the concealed tax consequences of the new Companies Act' (2012) *Tax professional* 4.

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Amendment Act.[118] Other distributions from an entity other than share capital or share premium constituted a dividend which resulted in the following tax consequences:[119]

- The distributing company was liable for secondary tax on companies (STC) and;
- The distribution would, in most cases, constitute exempt income in the hands of the recipient.

As of 1 January 2011, the Income Tax Act- with the guidance of the National Treasury -[120] introduced a new definition of capital for tax purposes, namely "Contributed Tax Capital" (CTC). The CTC of a company plays a pivotal role when considering the new, simplified definition of a dividend[121] which is found in the Income Tax Act. Basically, CTC is calculated using a transitional calculation by considering the share capital and share premium balances on 1 January 2011 and thereafter considering any proceeds or payments made in terms of shareholder transactions.[122] All distributions and payments made from CTC are treated as returns of capital whereas any distribution or payment from another entity will, as a general rule, be regarded as a dividend and subject to dividends tax.[123] In my opinion it seems that the introduction of CTC as well as the new definition of a dividend in the Income tax Act merely simulates the previous position, in the sense that previously it was provided that all distributions from share capital or share premiums were considered capital distributions (which later became returns of capital) for tax purposes and any other distributions were considered a dividend for tax purposes. Now, save for the introduction of CTC, the legal position remains the same. All distributions from CTC are regarded as returns of capital for tax purposes and all other distributions are considered a dividend and subject to dividends tax. As a result of this and the amended definition of a dividend in the Income Tax Act, the fact that the Companies Act has abolished a nominal or par value share will have very little tax significance.[124]

3.3 Section 164 of the Companies Act

The introduction of section 164 of the Companies Act has marked another change within company legislation in South Africa. It provides the legislature with an opportunity to create a remedy which attempts to avoid locking in minority shareholders on the occurrence of certain trigger events.[125] The section has created a new appraisal remedy which is afforded to dissenting shareholders who do not approve or vote in favour of the majority. The

[118] Act 24 of 2011.
[119] Van der Zwan & Huisman (n 117 above) 4.
[120] In 2007 the National Treasury announced a change from the STC system to the dividends tax system. This therefore sparked the introduction of Contributed Tax Capital (CTC) as well as the amended definition of a dividend.
[121] Sec 1 of the Income Tax Act as amended.
[122] Van der Zwan & Huisman (n 117 above) 4.
[123] As above.
[124] As above.
[125] Stein (n 26 above) 298.

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implementation of the "appraisal right" may best be described as an opportunity for a minority shareholder, who does not agree with a particular triggering event, to have their shares bought out at fair value[126] by the company.[127] This has changed the position significantly as before, the only way a minority shareholder could sell their respective shares was if the company was listed.[128] Now on the other hand, section 164 allows a minority shareholder to maintain their investments and preserve the value of their assets regardless of how the company is incorporated.

The appraisal right is not available to a shareholder indefinitely and may therefore only be utilised on the occurrence of a particular triggering event. These events are triggered where a company passes a special resolution[129] to:[130]

- dispose of all or greater part of its assets or undertaking;
- enter into an amalgamation or merger;
- implement a scheme of arrangement;[131] or
- amend its MOI by altering the preferences, rights, limitations or other terms of any class of its shares in any manner materially adverse to the rights or interests of holders of the class of shares.[132]

The rationale behind the introduction of section 164 seems to be that some events may have severe consequences for shareholders as their assets and investments may drastically be altered.[133] It is in these instances where the dissenting shareholders may not be compelled by the decision of the resolution, but instead may request that the fair value of his or her respective shares be paid in cash.[134] When implementing the remedy, the legislature had to balance two opposing interests. Firstly, there is the interest of the company and majority shareholders to be able to expand the business and in order to do this; flexibility, change and restructuring is required. The second involves the interest of the minority shareholders in retaining their investments, establishing their assets and being the proverbial "string-pullers" to their own financial futures. This remedy thus allows for the events, such as a fundamental

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[126] The determination of what fair value is, differs from time to time and in some instances, the determination is made judicially.
[127] Cassim (n 101 above) 796.
[128] As above.
[129] Sec 1 of the Companies Act defines a special resolution as a vote which is passed by a majority of not less than 75 percent of the voting rights exercised at the resolution.
[130] s112, 113 and 114 of the Companies Act; see also MF Cassim *The Introduction of the Statutory Merger in South Africa Corporate law: Majority Rule Offset by the Appraisal Right* (part II) (2008) 147.
[131] A scheme of arrangement is one of the methods of affecting a take-over. A" scheme" is useful because it allows the offeror an opportunity to use the target company to negotiate with its shareholders collectively and then bind them to the arrangement
[132] See sec 37(8) of the Companies Act.
[133] Cassim (n 101 above) 796.
[134] As above.

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transaction, to be subject to a majority whilst at the same time, it provides the dissenting shareholders with a scapegoat in the form of the appraisal rights.

The implementation of the appraisal rights is categorised by three fundamental justifications and objects, which are:[135]

1. The first and most obvious justification for appraisal rights is that it serves as an escape mechanism for non-assenting shareholders in circumstances where they fail to vote in favour of the special resolution. This gives these shareholders an opportunity to escape the constraints of the transformation in the company by giving up their shares in exchange for a fair value in cash. If it were not for these appraisal rights, a minority shareholder would be forced to stay in a newly uprooted company which may contain different assets, shares and investments.
2. The next justification involves the concept of fairness. Therefore, in accordance with fairness, a minority shareholder, who is dissatisfied as to the amount offered for his or her shares, may make use of the appraisal right in order to challenge the correctness and fairness of such.
3. The final justification of the appraisal rights is that it serves as a prevention tool to any dubious business judgements by the board of directors. This is because the more shareholders there are that are willing to exercise their appraisal rights, the more likely the board will be to reconsider the decision given the fact that paying each dissenting shareholder will have serious cash flow implications.

Although this remedy is beneficial to dissenting shareholders in demanding that the company pay them a fair value for their shares, a shareholder will first have to comply with the provisions set out under section 164 of the Companies Act. In other words, before a shareholder becomes entitled to be paid out the fair value of their shares, he or she will first have to satisfy the necessary steps to “qualify” for the appraisal rights.[136]

In order to “perfect” the appraisal remedy, a dissenting shareholder is required to act immediately after the triggering event has been proposed for special resolution. Firstly the shareholder must, by means of a written notice of objection, inform the company that he or she objects to the resolution before the resolution is put to vote.[137] Once the resolution has been passed, the company must, within ten business days, send each dissenting shareholder a notice of adoption.[138] Thereafter, the shareholder is entitled to demand that the company reimburse him or her with the fair value of their respective shares, but only if the following additional requirements are met:[139]

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[135] Cassim (n 101 above) 797.
[136] As above.
[137] Sec 164(3) of the Companies Act.
[138] Sec 164(5) of the Companies Act.
[139] Sec 164(5) of the Companies Act.

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- the shareholder must have voted against the resolution. Merely being absent from the resolution is not sufficient;[140]
- the shareholder must have complied with the aforementioned procedural requirements contained in section 164; and
- in the event that the MOI of the company is amended to alter class rights, the shareholder must hold shares which will be adversely and materially affected by such an amendment.

Thereafter, once the shareholders have made their demands and satisfied the above requirements, the company must send a written offer to each dissenting shareholder who wished to institute their appraisal rights.[141] This offer must be made within five business days after the later of:[142] the day on which the resolution becomes effective or, when applicable, the day the company receives a written notice of demand by a shareholder who failed to receive a notice of adoption. The offer will indicate a price that the directors consider to be "fair value" of the shares. Once a shareholder has received the offer, he or she has the discretion to accept or reject the offer. If the shareholder accepts the offer, the shareholder must tender the relevant share certificates to the company or the transfer agent of the company[143] and in return, the company is obligated to pay the agreed upon amount to the shareholder within ten business days after the shareholder has complied with the requisite steps and accepted the offer.[144] If, on the other hand, the shareholder rejects the offer, he or she may approach a court to determine the fair value of the shares, together with an order obliging the company to pay the determined price.[145]

3.3.1 Tax implications

In light of the above, it is noticeable that section 164 of the Companies Act involves an acquisition of shares by a company in return for a payment of a fair value, in cash, to a dissenting shareholder when fundamental transactions[146] occur, or when the MOI amended which may adversely and materially affect the rights associated with those shares. The question arises what, if any, are the tax implications of this?

firstly, although this is not exclusively a tax implication, it should be noted that the provisions contained under section 164 will have significant cash flow implications for some companies as they will need to carefully structure their budgets in a way that will sufficiently

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[140] Sec 164(5)(c)(i) of the Companies Act.
[141] Sec 164(11) of the Companies Act.
[142] As above.
[143] In the case of uncertified shares, the shareholder is required to take the requisite steps, which are outlined in sec 53, in order to transfer the shares to the company or the company's transfer agent. See also sec 165(13)(a) of the Companies Act.
[144] Sec 164(13)(b) of the Companies Act. It should be noted that if there are reasonable grounds to believe that paying such an amount within this period would prevent the company from paying their debts, the company may apply to the court to have the time period extended.
[145] Sec 16(14) of the Companies Act.
[146] Contemplated in secs 112, 113 and 114 of the Companies Act.

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accommodate the burdensome cash outflows required in implementing the fundamental transaction or amendment to the MOI, as well as the need to budget for the pressures associated with the acquisition of shares from dissenting shareholders.

In addition to the above budgetary constraints, the acquisition of shares by a company and the subsequent payment of a fair value can have tax implications for both the company and shareholders. The Income Tax Act defines a dividend as, amongst others, any amount distributed by a company to its shareholders as consideration for the acquisition of any shares held in the company,[147] but not including payments made out of CTC as that would constitute returns of capital.[148] This means that the payment of a fair value in cash by a company in light of the acquisition of the dissenting shareholder's shares will, in accordance with the above definition, constitute a dividend for tax purposes and subject to dividends tax.[149] In summary, dividends tax is a tax charged at 15% on shareholders when dividends are paid to them and, as a general rule, is withheld by a withholding agent (usually the company) and is paid directly to SARS.[150] This means that the dissenting shareholders will be liable for dividends tax once they have exercised their appraisal rights unless the shareholders fall within any of the exclusions contemplated in section 64F of the Income Tax Act.
Some of the exclusions are:[151]

- a resident company;
- the government, a provincial administration or a municipality;
- a public benefit organisation approved by the commissioner in terms of section 30(3) of the Companies Act;
- a trust or company whose sole purpose is to maintain funds and utilise those funds for purposes of rehabilitation of the environment on the closure of mining activities.

Previously, the above mentioned dividends were subject to STC. Currently, after the transition to a dividends tax system,[152] the payment of dividends tax may impact the value at which the companies will acquire the shares. This is due to the fact that the cash received by the shareholders will be affected by the realisation of dividends tax.[153]

[147] Sec 1 of the Income Tax Act; see also Van der Zwan & Huisman (n 117 above) 5 who allude to a more detailed explanation of the aforementioned.
[148] As above.
[149] Van der Zwan & Huisman (n 117 above) 5.
[150] Prior to April 2012, these dividends were subject to STC. After April 2012 however, dividends tax has now been introduced at a rate of 15%.
[151] Sec 64F of the Income Tax Act. See also A Oguttu et al *Tax Law An Introduction* (2013) 417.
[152] National Treasury Budget Review (2007) 67; see also D Meyerowitz *et al*; *Substituting Shareholders Tax on Dividends in the place of STC* (2007) 101.
[153] Van der Zwan & Huisman (n 117 above) 5.

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3.4 Section 37 of the Companies Act

The basic premise that surrounds the issuing of shares is that all shares enjoy equal rights.[154] However, it is possible for a company to create different classes of shares which means that these classes will be associated with rights, limitations, preferences and terms which differ from the other classes. As a general rule, the different classes which are allocated are based on their respective rights associated with the pay out of dividends, the participation of that share during liquidation proceedings and the respective voting rights.[155] This may not always be the case as on occasions, where the company's shares carry the same rights to the payment of dividends and returns of capital, some of these shares may contain conversion rights i.e. the right to convert shares from one class into another.[156] Basically a company has free reign in designing their share structure which suggests that the rights associated with a particular class of shares may be designed in an infinite number of ways. Despite this, section 37(1) of the Companies Act provides that all the shares of a particular class must have preferences, rights, and limitations and other terms that are identical to those of other shares in the same class. Traditionally shares have been divided into three main classes, namely:[157]

- preference shares, which may or may not be redeemable;
- ordinary shares; and
- deferred shares.

The provision which is of particular importance is section 37(6) of the Companies Act which suggests that the MOI of a company may provide that the preferences, rights, limitations or other terms (mentioned above) of any class may vary in response to any objectively ascertainable external fact or facts.[158] Section 37(7) continues to provide that: (a) an "external fact" includes the occurrence of any event, a variation in any fact, benchmark or other point of reference… or an agreement to which the company is a party and (b), the manner in which an external fact may affect the preferences, rights and limitations must be expressly determined by the company's MOI. It seems that this provision has introduced more flexibility by including all types of securities involved in modern business structuring.[159] My interpretation of this provision is that a company's MOI must provide for the possible variation of the rights, limitations and preferences associated with a particular share and furthermore, it should indicate the nature and extent of the variation. Companies would therefore do well to carefully structure this provision in their MOI as the variation of these rights and limitations will ultimately affect the tax treatment.

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[154] *Birch v Cropper re Bridgewater Navigation Co* (1889) 14 APP Cas 525 (HL) 543.
[155] Cassim (n 101 above) 215.
[156] As above.
[157] Cassim (n 101 above) 216.
[158] Companies include these provisions in their MOI in order to safeguard against rigid rights and preferences associated with certain shares upon the occurrence of an external factor which may significantly impact the company's share structure. I.e. an amalgamation or merger.
[159] i.e. variable rate preference shares.

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3.4.1 Tax Implications

The significant tax implication associated with section 37(6) of the Companies Act arises in instances where a company's MOI provides for the conversion of shares, on the happening of an external fact, into hybrid equity instruments.[160] A hybrid equity instrument is defined in section 8E of the Income Tax and means a share which displays certain characteristics of debt instruments or debentures. These characteristics could include: compulsory redemption by the company and optional redemption by the shareholder within a period of three years from date of issue.[161]

In this instance, section 8E of the Income Tax Act provides that the dividends that are declared on a hybrid equity instrument are treated as interest in the hands of the recipient (shareholder), as opposed to exempt dividends, whilst still being a dividend in the hands of the company.[162] In essence, the effect of section 8E is that the recipient shareholder is taxed on the deemed interest received, whilst the company is precluded from deducting the payment of that dividend from its taxable income.[163] The amount that is paid by the company, which is a dividend, could be subject to dividends tax, considering that the trigger for withholding dividends tax occurs when a company pays any money in the form a dividend.

Another possible tax consequence arises in the form of section 8F of the Income Tax Act which suggests that any interest paid on hybrid equity instruments is to be treated as a non-deductible dividend which is subject to dividends tax in the hands of the payer.[164] It is therefore emphasised that companies should take care, when allocating the rights, not to convert the equity shares into debt as this may trigger the above tax implications.

3.5 Section 40(5) of the Companies Act (Sweat equity)

If the board of directors were permitted to issue shares for any consideration, this may lead to potential prejudice on existing shareholders due to the decrease in value of their shares if future shares are issued for inadequate consideration.[165] It is for this reason that section 40 of the Companies Act stipulates that a board may only issue shares:

a) for adequate consideration to the company, as determined by the board;
b) in terms of conversion rights associated with previously issued securities of the company; or

[160] This is mainly due to the fact that the definition of a hybrid equity instrument has been extended in order to curb the previous situation whereby equity funding was operated like debt.
[161] Sec 8E of the Income Tax Act; see also https://www.ensafrica.com/news/new-definition-of-hybrid-equity-instruments?Id=561&STitle%20ENSight which discusses certain characteristics of a hybrid-equity instrument (accessed 30 July 2015).
[162] Van der Zwan & Huisman (n 117 above) 5; see also https://www.ensafrica.com/news/new-definition-of-hybrid-equity-instruments ?Id=561&STitle%20ENSight which too confirms this. (accessed 30 July 2015).
[163] Van der Zwan & Huisman (n 117 above) 5. This is essentially an anti-avoidance measure designed to prevent equity being disguised as debt.
[164] Van der Zwan & Huisman (n 117 above) 5.
[165] Cassim (n 101 above) 226.

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c) as capitalisation shares, as contemplated in section 47.

The Companies Act maintains the idea that shares may not be issued at a price lower than fair value in order to prevent the above situation where the shares of an incumbent shareholder are diluted.

Before any shares are issued, the board of directors must first determine the requisite "consideration", and terms on which, those shares will be issued.[166] Once this determination has been made, the adequacy of the consideration may not be challenged on any grounds other than in terms of section 76 of the Companies Act.[167] This means that the board's determination of "adequate consideration" may only be challenged on the basis that the board failed to exercise their duties properly, and will therefore be personally liable for any loss suffered by the company. The question however remains whether section 40(3) applies in situations where the "adequate consideration" is not cash? Shareholders and creditors will be unjustly prejudiced if a valuation is not obtained.[168] As a matter of principle, the directors should clearly advise the shareholders on how the non-cash consideration was calculated.[169]

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

a) any money, property, negotiable instrument, securities, investment credit facility, token or ticket;
b) any labour, barter or similar exchange of one thing for another; or
c) any other thing, undertaking, promise, agreement or assurance, irrespective of its apparent or intrinsic value, or whether it is transferred directly or indirectly".[170]

It may be noted that the above definition is extremely broad. One reason for this was to protect the board of directors from a possible claim in terms of section 40(3) in the event of an inadequate consideration being accepted.[171] Thereafter, once all the formalities are satisfied and the company has received adequate consideration - which is approved by the board - the issued shares are deemed to be 'fully paid'.[172]

Section 40(5) of the Companies Act, however, contains an important exception to the above principle: that shares may not be issued unless they are 'fully paid'. This, again, serves as another important indication of the departure from the Companies Act 1973. This section,

[166] Sec 40(2) of the Companies Act.
[167] Sec 40(3) of the Companies Act. sec 76 of the Companies Act regulates the codified common-law duties of directors
[168] Stein (n 26 above) *165.* The reason for this is there is a need for certainty in law and without a proper valuation, shareholders may receive a significantly lower amount or may be unjustly enriched.
[169] As above.
[170] Sec 1 of the Companies Act.
[171] Stein (n 26 above) 166.
[172] Sec 40(4)(a) of the Companies Act.

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which is colloquially referred to as "sweat equity"[173] permits the consideration for any shares that are issued or to be issued in the form of:

- an instrument in which the value of the consideration cannot be realised by the company until a date after the time the shares are to be issued; or
- is in the form of an agreement for future services, future benefits or future payment by the subscribing party.[174]

In both the above instances, the consideration for those shares is deemed to have been received by the company at a time when the value of the consideration has been realised by the company,[175] or in the event that the subscribing party to the agreement has fulfilled its obligations in terms of the agreement.[176] In terms of a 'sweat equity' agreement, the company must issue the shares immediately after it receives the instrument. However, such shares are not issued to the subscribing party but rather, transferred and registered in the name of a third party, which is held in trust and thereafter transferred to the subscribing party once the conditions of the agreement have been met.[177]

So 'Sweat equity' is, in essence, an incentive scheme which is harnessed by modern companies to attract and retain employees with a requisite level of skill, expertise and knowledge. This is an important tool used in black economic empowerment deals (BEE). It is in these instances where employees, who may not be able to afford the shares, are awarded shares in exchange for their knowhow.

In order to protect companies, the legislature has included section 40(6) of the Companies which restricts the rights of subscribing parties during the period in which the shares are held in trust.[178] Section 40(6) provides that, except to the extent that such a trust agreement provides otherwise:

a) neither the voting rights, nor the appraisal rights of those shareholders associated with issued share (that are held in trust) may be exercised;
b) any pre-emptive rights of those shares, held in trust, may be exercised - only if the instrument has become negotiable or the subscribing party has fulfilled its relevant obligations as per the agreement;
c) any distribution of the shares
    I. must be paid or placed on credit by the company to the subscribing party in such a manner to which the instrument becomes negotiable or until the subscribing party fulfils the obligations as per the agreement; and

[173] L Steenkamp 'The tax consequences of sweat equity under the new Companies Act' (2012) *Taxtalk* 12.
[174] Sec 40(5) of the Companies Act.
[175] Sec 40(5)(a)(i) of the Companies Act.
[176] Sec 40(5)(a)(ii) of the Companies Act.
[177] As above.
[178] As above.

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II. the value of the shares may be set-off against the remaining value at a time in which any of the services still need to be performed by the subscribing party, any future payment becomes due and payable, or any benefits still need to be received by the company.[179]

In addition to this, section 40(6)(d)(i) of the Companies Act also suggests that, unless the trust agreement provides otherwise, the issued shares that are held in trust are not transferrable by the subscribing party unless the company unequivocally consents to it. It may however be agreed that the shares are transferred to the subscribing party on a quarterly basis on condition that the instrument has become negotiable by the company or the subscribing party has satisfied its obligations in terms of the agreement.[180] In other words, unless the trust agreement provides otherwise, the subscribing party will enjoy all the economic or financial benefits that are associated with the shares as soon as they are issued, but will be precluded from exercising any voting rights or dispose of or receive any distributions in connection to those shares until they are considered to be "fully paid". If, however, the instrument is dishonoured after it becomes negotiable or if the subscribing party has defaulted in satisfying its obligations under the agreement, the shares, which are held in trust, must be returned to the company, on demand, and be cancelled.[181] A company may only demand the return of the shares where the subscribing party has dishonoured the instrument or failed to fulfil its obligations in terms of the agreement within 40 business days after which the obligations were due.[182]

3.5.1 Tax implications

Given the nature of these agreements that are entered into between a company and the subscribing parties, there are various tax implications that may arise for both parties and as a result, will need to be considered.

3.5.1.1 Receipt v Accrual

As was alluded upon earlier, the subscription price, in terms of the Companies Act, is only deemed to have been received when the benefits have been derived or the services have been rendered.[183] The question arise whether the delay in receiving the subscription price also delay the accrual of such an amount for income tax purposes? In terms of the Income Tax Act, an amount is included as gross income on day the person receives it or on the day it accrues to such a person- whichever occurs soonest.[184] Accrual is deemed only to have occurred once a taxpayer has become unconditionally entitled to the amount.[185] If we consider the fact that the Companies Act merely delays the deemed receipt of the amount,

[179] Sec 40(6) (a)-(c).
[180] Sec 40(6)(d)(ii) of the Companies Act.
[181] Sec 40(6)(d)(iv) of the Companies Act.
[182] Sec 40(7) of the Companies Act.
[183] Sec 40(5)(a)(i) of the Companies Act.
[184] Definition of gross income in sec 1 of the Income Tax Act.
[185] CIR v People's Stores (Walvis Bay) (Pty) Ltd 1990 (2) SA 353 (A) 52 SATC 9.

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SARS could argue that the amount has still accrued to the company, provided the company is unconditionally entitled to the benefit. In my opinion, the company will be unconditionally entitled to the subscription price unless the subscribing party fails to perform in terms of the agreement, in which case there would be no benefit derived or services rendered.

3.5.1.2 Available Tax Deductions

The next question to consider is whether or not either party may qualify for any taxable deductions in terms of the Income Tax Act? In other words, can any amounts that are transferred during these transactions, be deducted from the respective parties' taxable income? In order to effectively answer the question, the position of both parties will need to be evaluated.

3.5.1.2.1 The Company's perspective

When considering a "sweat equity" agreement and assuming that the company is unconditionally entitled to the subscription price on day one, this would create a similar situation where the company gives value in return for benefits or services rendered to the company in the future.[186] It is in this instance where section 24B of the Income Tax Act states that a company is deemed to have actually incurred an amount[187] which is equal to the lesser of the market value of an asset or the market value of the shares in the event that the company settles a purchase consideration for the acquisition of an asset by issuing shares.[188] Section 24B only applies in instances where an asset is acquired by the company and therefore, an agreement which provides for services to be rendered to the company is not applicable. This means that, although section 24B of the Income Tax Act effectively provides for a deduction where shares are issued in return for assets, the idea of shares being issued in exchange for the rendering of services has not been considered and creates uncertainty.

3.5.1.2.2 The subscribing party's perspective

In terms of these agreements, a subscribing party effectively receives a benefit (the shares) in exchange for the services rendered or future benefits to be provided to the company. This being said, it is important to consider that a taxpayer does not need to necessarily receive or accrue a benefit for the amount to be included in their gross income.[189] In *CIR v Genn & Co (Pty) Ltd*,[190] the court did not regard the presence or absence of a benefit to the taxpayer, resulting from something that passes into their possession, as a proper test in applying the definition of gross income. Furthermore, it is contended that a receipt or an accrual in a form other than cash must be valued. If it has no ascertainable money value, it cannot form part of the taxpayer's gross income.[191] The idea behind these agreements is that the subscribing party will be compensated and therefore, the amounts should be included as gross income of

[186] Sec 40(5) of the Companies Act.
[187] An amount being 'actually incurred' is one of the requirements that need to be satisfied in terms of the general deductions formulae contained in sec 11(a) of the Income Tax Act.
[188] Sec 24B of the Income Tax Act. See also Steenkamp (n 173 above) 12.
[189] As above.
[190] 1955 3 SA 293 (A).
[191] AP de Koker, *Silke on South African Income Tax*, *LexisNexis Butterworths* loose leaf (January 2011) at par 2.2.

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the subscribing party. If this is the case, the subscribing party is at risk of having to include the amount as gross income on day one (as an immediate tax liability). The subscribing party could argue that the shares are held in trust and will only be transferred to the subscribing party at a later stage. This will, however be extremely difficult to prove in instances where the subscribing party is entitled to a dividend arising from those shares held in trust, as this would render the party unconditionally entitled to those shares. Another problem that could arise for the subscribing party is that they might not be entitled to any tax deduction if the shares have to be returned. This is due to the fact that the requirements of the general deductions formulae will not have satisfied. This is because one of the requirements of the general deduction formula in section 11(a) is for the amount to be 'actually incurred'. In *Edgars Stores Limited v CIR*,[192] the court considered the principle that was utilised in the *Nasionale Pers Bpk v KBI*[193] case, specifically in the case where the existence of the liability itself is conditional and dependent upon the occurrence of an event after the tax year in question and therefore, the liability is not incurred in that tax year. This means that if a payment is conditional, the expense is only actually incurred and deductible, if all of the other requirements of s 11(a) are satisfied once the condition has been met. Hence, here a subscribing party would be prejudiced on not only the issuing if the shares, but also on the subsequent return of those shares to the company.

3.5.1.3 The creation of interest free loans

As was mentioned earlier,[194] section 40(6)(a) of the Companies Act provides that, unless the trust agreement provides otherwise, the voting rights associated with the shares held in trust may not be exercised by the subscribing party until such a time that the instrument becomes negotiable or the obligations have been fulfilled. Any dividends that are awarded in terms of those shares must either be held in trust or may be set-off against the remaining services still to be performed by the subscribing party. This leads to a situation where these distributions can be used to settle or decrease the outstanding subscription price. This begs the question of whether or not this indirect receipt of a dividend will amount to an interest-free loan for tax purposes.[195] It may be argued that this interest-free loan is in fact a donation. A 'donation' is defined in section 55(1) of the Income Tax Act as any gratuitous alienation of property which includes a gratuitous waiver or renunciation of a right. In considering this definition, it is somewhat doubtful that this form of an interest free loan will constitute the gratuitous alienation of property- given the fact that the company will also benefit in the reduction of the subscription price.

The company may also be liable for pay as you earn (PAYE); given the fact that a taxable benefit arises if the company grants a loan to an employee at no interest or at an interest rate

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[192] 1988 3 SA 876 (A).
[193] 1986 3 SA 549 (A).
[194] See para 3.5 above.
[195] L Steenkamp 'The Tax consequences of sweat equity under the new Companies Act- part 2' (2012) *Taxtalk* 13 – 14.

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lower than the prescribed rate.[196] However, if the loan was granted purely for the purposes of a payment by an employee for a consideration in respect of any qualifying equity share contemplated in section 8B of the Income Tax Act, this will not constitute a taxable benefit.[197]

3.5.1.4 Dividends Tax

As soon as the company receives the instrument or enters into the agreement, it must issue the shares immediately and transfer such shares to a third party, where it is held in trust. Thereafter, once the obligations have been met, the shares are transferred to the subscribing party. As was indicated earlier, any dividend that is awarded will accrue to the trust during the period in which the shares are held in trust. The new dividends tax regime has changed the basis of taxation of dividends by levying a withholding tax of 15% on dividends declared by a South African company.[198] The withholding tax essentially means that the company will withhold the percentage owed to SARS and thereafter pay the shareholder the net amount of the dividend. Although dividends that are declared between South African Companies are exempt from dividends tax,[199] this exception does not apply to trusts. This essentially means that dividends tax of 15% will be payable by a trust in respect of any dividends declared.[200]

3.6 Conclusion

This chapter clarified some of the tax-related issues that may arise from the Companies Act and more specifically, the new “securities” provisions that have been introduced. It is clear that there may be numerous other tax-related debates that may be sparked from the application of the Companies Act. This chapter has thus highlighted some of the important departures that the Companies Act has made as well as how these changes may impact upon the parties involved. This chapter also illustrates how these provisions may drastically effect the amount of tax that the particular companies and parties may pay despite most of the tax implications being concealed and hardly noticeable. It is extremely important for Companies and the respective parties to identify and consider what the tax implications may be once a provision of the Companies Act is triggered. These transactions may have major financial and cash-flow consequences for the parties and thus serves to highlight the importance for legislature to consider and align company legislation and tax legislation.

[196] As above; see also para 2(f) of the Seventh Schedule to the Income Tax Act.
[197] Steenkamp (n 195 above) 13 - 14.
[198] Sec 64D – 64N of the Income Tax Act.
[199] sec 64F(a) of the Income Tax Act. See para 3.3.1 above.
[200] A trust doesn’t fall within any of the exceptions listed in sec 10(1) of the Income Tax Act.

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Chapter 4 Mergers and amalgamations

4.1 Introduction

Chapter 5 of the new Companies Act has introduced the term “fundamental transactions, takeovers and offers”. The introduction of these transactions highlights another departure from the Companies Act 1973 and is governed by sections 112 to 127. Although a “fundamental transaction” is not defined in the Companies Act, it is a term which is used to connote the following three types of transactions, all of which fundamentally impact a company’s structure:[201]

- The disposal of all or the greater part of a company’s assets or undertaking;
- A scheme of arrangement between company and its securities holders; and
- An amalgamation or a merger.

Although the Companies Act makes reference to the above three transactions, this chapter will solely concern itself with the practical, procedural and tax implications of amalgamations and mergers. This is warranted by the fact that the introduction of an amalgamation and merger provision has brought about the first ever statutory merger recognised in South African company legislation.[202]

An “amalgamation or merger” (also known as a statutory merger or a business combination) is regulated by sections 113 and 116 of the Companies Act. The introduction of a merger has seen a radical change in South African company law by introducing an original statutory merger procedure into the legislation.[203] It seems as though this concept has been introduced in order to give effect to the goals of the Department of Trade and Industry by “providing flexibility and enhancing efficiency in the economy”.[204] This was done by introducing a procedure which is simple, effective and flexible enough to encompass various different transactions and business entities.

Although section 113 of the Companies Act 1973 did regulate company structuring as part of schemes of arrangement, this was very rarely made use of.[205] The reason for this was that all the transactions, under the previous Act, which fundamentally impacted upon a company’s structure, contained its own internal procedures and requirements. This proved to be problematic in instances where two or more transactions over-lapped as the various internal procedures and requirements created uncertainty and inefficiency particularly in cases of

[201] Cassim (n 101 above) 677
[202] Cassim (n 101 above) 676
[203] As above.
[204] Stein (n 26 above) 284.
[205] As above.

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internal restructurings of large companies and merger transactions.[206] Now section 113 of the Companies Act has created a procedure, modelled on most Anglo-American jurisdictions as well as the Banks Act,[207] which is flexible enough to enable most form of business structures to be implemented by a way of a single, inexpensive procedure.[208]

This chapter seeks to analyse the section 113 procedure, the different types of mergers and amalgamations which are recognised by the Companies Act as well as the basic tax implications that may arise given the nature of these transactions.

4.2 Definition and concepts of amalgamations and mergers

An amalgamation or merger is defined in section 1 of the Companies Act as any transaction or transactions, pursuant to an agreement between two or more companies, which results in:

a) one or more new companies being formed - which holds all of the assets and liabilities that were originally held by the amalgamating or merging companies at a time immediately before the implementation of the amalgamation or merger, and the dissolution of the amalgamating or merging companies; or
b) At least one of the amalgamating or merging companies continues to exist, regardless of whether one or more new companies are formed, and the vesting in the surviving company or companies of all of the assets and liabilities that were originally held by the amalgamating or merging companies at a time immediately before the implementation of the amalgamation or merger.

The definition above makes no reference to the difference between an amalgamation and a merger. The reason for this is that the Companies Act does not in fact distinguish between the two concepts. They appear to be two different words which represent the same concept. Another noticeable point about the definition is that it is not only broad, but very flexible.[209] This is perhaps to accommodate most forms of amalgamation and merger transactions between companies. The definition is however quite particular in noting that the transaction must amalgamate or merge all (and not a part thereof) of both the assets and the liabilities of all the companies to that transaction.[210]

An "amalgamating or merging company" is defined as a company that is a party to an amalgamation or merger agreement[211] whilst an "amalgamated or merged" company is defined as a company that either:

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[206] Stein (n 26 above) 284.
[207] Act 94 of 1990.
[208] Stein (n 26 above) 284.
[209] As above.
[210] Stein (n 26 above) 284-285.
[211] Sec 1 of the Companies Act.

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a) was incorporated in accordance with an amalgamation or merger agreement (i.e., a new company); or
b) was an amalgamating or merging company which continued to exist after the implementation of the amalgamation or merger agreement, and holds any part of the assets and liabilities that were originally held by any of the amalgamating or merging companies immediately before the implementation of the amalgamation or merger.[212]

In other words, the statutory "amalgamation or merger" is a simple, relatively uncomplicated and effective procedure by which two or more companies may merge by agreement, which is subject to the consent and approval of all the relevant shareholders involved.[213] This is a court-free procedure which means that there is generally no need for court intervention unless specifically required.

4.3 Requirements for an amalgamation or merger

The three essential requirements for amalgamations or mergers are:[214]

1. An amalgamation or merger agreement must be entered into;
2. Satisfaction of the solvency and liquidity test; and
3. Compliance with sections 113(5), 115 and 164 of the Companies Act.

These three requirements will briefly be discussed below.

4.3.1 Amalgamation or merger agreement

Section 113(2) of the Companies Act provides that the two or more companies proposing to amalgamate or merge must enter into and be bound by a written agreement (merger agreement) which sets out the terms, conditions and provisions relating to the merge or amalgamation. These agreements include, amongst other things, the proposed MOI of the new company to be formed. It will also indicate the name and identity of each proposed director as well as the manner in which the securities of each amalgamating or merging company are to be converted into securities of any proposed amalgamated or merged company, or exchanged for other property.[215]

These contractual requirements set out in section 113(2) only relate to the material aspects of the proposed transaction which means that the provision does not prevent the parties from negotiating and agreeing upon other substantive conditions within the agreement.[216]

[212] Sec 1 of the Companies Act.
[213] Cassim (n 101 above) 677.
[214] Stein (n 26 above) 285 - 287.
[215] See sec 113(2) of the Companies Act for a full list of what should be included.
[216] Stein (n 26 above) 285-286.

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4.3.2 Satisfaction of the solvency and liquidity test

Section 113(1) provides that the two or more companies to the agreement, which includes all holding and subsidiary companies, may amalgamate and merge on condition that all the relevant companies, upon implementation, will satisfy the solvency and liquidity test. The solvency and liquidity test has numerous elements to it but basically involves a determination of whether or not a specific company's assets exceed its liabilities.[217] It should be noted that section 113, by virtue of the definition of a profit company, does not apply to foreign companies even if they are registered as an external company.[218] Furthermore, a non-profit company is prohibited from merging or amalgamating with a profit company.[219] The Companies Act reinforces the idea contained in section 113(1) by section 113(4) which effectively prohibits the implementation of an amalgamation or merger agreement unless the board of directors of every company involved in the amalgamation or merger has satisfied itself that every company pursuant to such an agreement will satisfy the solvency and liquidity test upon implementation of the amalgamation or merger agreement.

4.3.3 Compliance with sections 113(5), 115 and 164 of the Companies Act

The final requirement is that the amalgamation or merger must be approved by the independent shareholders of each company which is a party to the agreement by way of special resolution[220] and if such an agreement is approved, the minority shareholders may exercise their appraisal rights in terms of section 164. Section 113(5) also contains a further procedural requirement which provides that a notice of a meeting of shareholders of each amalgamating or merging company must be delivered to each shareholder of each of the respective companies. In addition to notifying the shareholders of the time and place of the meeting, the notice should be accompanied by a summary of the proposed amalgamation or merger agreement as well as the provisions contained in sections 115 and 164, in a manner that satisfies the requisite standards.[221] In other words, an amalgamation or merger must be approved by all the shareholders of the companies that are a party to the agreement, including those companies who are to acquire shares or assets in the process.

4.4 Implementation of an amalgamation or merger

Section 116(1) of the Companies Act provides that, after the resolution for the amalgamation or merger has been adopted, each of those companies must draft a notice in the prescribed form and manner and deliver it to every known creditor of that company. Thereafter a creditor may, within 15 business days after receiving such notice, seek leave to apply to a

[217] See Chapter 22 of Cassim (n 101 above) for more on the solvency and liquidity test.
[218] Cassim (n 101 above) 286.
[219] Item 2(1)(a) of schedule 1 to the Companies Act.
[220] Sec 115 of the Companies Act.
[221] Stein (n 26 above) 287.

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court for the amalgamation or merger to be reviewed. A court may grant leave if it is satisfied with the following:[222]

- the applicant (creditor) is acting in good faith;
- if implemented, the amalgamation or merger would materially prejudice the creditor; and
- there are no alternative remedies available to the creditor.

After all the relevant requirements contained in section 115 have been complied with, a notice of amalgamation or merger must be filed.[223] This notice should include confirmation that the amalgamation or merger:[224]

- has satisfied the requirements of sections 113 and 115;
- has been approved in terms of the Competition Act 89 of 1998, if so required by Competition Act;[225]
- has been granted the consent of the Minister of Finance in terms of section 54 of the Banks Act, if so required by that Act;[226] and
- is not subject to further approval by any other regulatory authority, or to any unfulfilled conditions imposed by or in terms of any law administered by regulatory authority.
- the notice should also include the MOI of any company that is newly incorporated in terms of the agreement. [227]

After receiving the above notice, the Competition Commission must issue each company with a registration certificate which has been newly incorporated in terms of the amalgamation or merger agreement and thereafter, deregister any companies that did not survive the amalgamation or merger.[228]

Section 116(6)(b) is an important provision which seeks to prevent any stakeholder in any amalgamating or merging company from being prejudiced by the agreement. The provision provides that an amalgamation or merger does not have an effect on any-[229]

a) of the existing liabilities of any party to the agreement, or any of the directors of the amalgamating or merging companies;

[222] Sec 116(1)(c) of the Companies Act.
[223] Sec 116(3) of the Companies Act.
[224] Sec 116(4) of the Companies Act.
[225] i.e. if the Competition Commission or Tribunal are of the opinion that the amalgamation or merger is likely to substantially prevent or lessen competition.
[226] Consent of the Minister is required if one of the parties to an amalgamation or merger agreement is bank; and the agreement provides for the transfer of more than 25 per cent of the assets and liabilities of the bank.
[227] Sec 116(4) of the Companies Act.
[228] Sec 116(5) of the Companies Act.
[229] Sec 116(6)(b) of the Companies Act.

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b) civil, criminal or administrative action or other pending investigations against any of the amalgamating or merging companies, and therefore, any action or proceeding may be prosecuted by or against any amalgamated or merged company; or
c) conviction, ruling or judgement in favour of or against an amalgamating or merging company, and therefore any such ruling, order or judgment may be enforced by or against any amalgamated or merged company.

Another important regulatory provision is section 116(7) which provides that, when an amalgamation or merger agreement has been implemented-

a) the property of each amalgamating or merging company becomes the property of the newly amalgamated, or surviving merged, company or companies; and
b) each newly amalgamated, or surviving merged company is liable for all of the obligations of every amalgamating or merging company.

4.5 Types of amalgamations or mergers

The Companies Act provides for two broad categories of amalgamations and mergers structures; these are:[230]

- a new company merger structure and;
- a surviving company merger structure.

Within the above two structures, Cassim et al[231] identifies four further subdivisions. These subdivisions represent the way in which the assets and liabilities of the various companies are to be transferred or pooled as well as the type of consideration that will be used in the transaction, these are:

- pooling type merger;
- cash mergers;
- triangular and reverse triangular mergers; and
- short form mergers.

It should be noted that these are a broad outline of the structures that could be created upon the implementation of the merger and amalgamation procedure. Therefore, the various companies can, in accordance with the amalgamation or merger agreement, vary certain aspects of these structures as they may deem fit by incorporating the changes into the amalgamation or merger agreement. It should also be noted that the forms of mergers and amalgamations that will be discussed is a simplification. This is because the Companies Act also provides for transaction between more than two constituent companies, and also makes provision for the survival of more than one company or the formation of more than one new

[230] As per the definition of an amalgamation and merger in sec 1 of the Companies Act.
[231] MF Cassim 'Introduction of the statutory merger in South African Corporate law: Majority Rule Offset by the appraisal Right (part 1)' (2008) 20 Merc LJ 1-32.

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company. A simplified version of the various forms of amalgamations and mergers will now be discussed below.

4.5.1 New company merger structure

The first example occurs where two or more amalgamating or merging companies (known as 'constituent companies') fuse into a new company, with the result that the two or more constituent companies will dissolve after the amalgamation or merger is implemented.[232] The new company will, after incorporation, hold all the assets and liabilities that were previously held by the two constituent companies.[233] These assets and liabilities will vest in the newly formed company automatically by operation of law, upon implementation of the merger.[234]

4.5.2 Surviving company merger structure

The second example involves a scenario where one constituent company fuses into another constituent company, the result of which sees the latter company surviving or continuing its existence after implementation.[235] As a result of this, the surviving company holds all the assets and liabilities that were previously held by the two constituent companies and the other company (disappearing company) dissolves after the process.[236]

4.5.3 Pooling type merger

The issue of merger consideration[237] is fundamentally important because this is closely connected to the type of merger structures that may be devised under the Companies Act.[238] The Companies Act has been drafted in such a way as to provide flexibility for the merger consideration.[239] This allows the various parties to structure their merger or amalgamation transactions in a way that suits their needs and objectives. It is in this regard that the Companies Act makes reference to a 'pooling type' transaction. This encompasses an idea, under which, the two sets of shareholders of the two constituent companies continue to participate as active shareholders in the surviving company- which is the holder of the combined assets and liabilities of the previous companies.[240] In a 'pooling type' merger, the shareholders in the disappearing company will usually receive shares in the surviving company as their form of consideration.[241] It seems from the wording in section 113(2) that

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[232] Cassim (n 101 above) 678.
[233] As above.
[234] Sec 116(7) of the Companies Act.
[235] Cassim (n 101 above) 679.
[236] As above.
[237] This is the consideration that is usually paid, in effect, to the shareholders of the disappearing company, in consideration for their respective shares in that disappearing company.
[238] Cassim (n 101 above) 686.
[239] As above.
[240] Cassim (n 101 above) 686.
[241] As above.

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the shares in the disappearing company are immediately converted, by operation of law, into the shares of the acquiring company on implementation of the agreement.[242]

4.5.4 Cash mergers

A cash merger is also permissible in the statutory merger procedure under the Companies Act.[243] The recognition of a statutory merger under the Companies Act is somewhat liberal in the sense that several other jurisdictions, such as the Netherlands only recognise cash considerations which are subject to extremely strict limitations.[244] The underpinning principle of a cash consideration is that the shareholders of the disappearing company no longer retain a vested right as a shareholder in the new surviving company and therefore are rather compensated with cash or 'cashed-out'.[245] A cash merger, under South African law, thus creates the possibility to use the merger procedure as a means to force out or eliminate the minority shareholders of a company by compelling them to exchange their shares for cash.[246] A number of factors will influence the choice of what type of consideration is to be used, these include: requirements of the disappearing company's shareholders, who is to receive consideration and the tax consequences associated with each type of consideration. For example, in the case of a cash consideration, the available financial resources as well as liquidity are important, whilst in the case of share consideration, the impact of the market price and the dilution of the shares should be considered.

4.5.5 Triangular and reverse triangular mergers

One of the disadvantages associated with the statutory merger is the fact that the liabilities of the target company (disappearing company) are automatically transferred to and become part of the surviving company. This may discourage companies from entering into merger agreements. It is in this instance that a triangular merger is formed in order to circumvent this problem. Accordingly, a triangular merger involves three companies.[247] One company is the target or disappearing company, while on the other side there are two acquiring companies.[248] These companies are the holding company ('Co H') which is the acquirer in the transaction, as well its wholly owned subsidiary ('Co S').[249] ('Co S') is a newly formed company created by ('Co H') specifically for the purposes of the merger agreement.[250] This structure allows ('Co H') to indirectly enter into a merger agreement by using ('Co S') as a conduit. ('Co S') is a shell company with no assets or liabilities and acts as an acquisition vehicle in the

[242] Sec 113(2)(c) and (d) of the Companies Act states that the amalgamation agreement must set out the manner in which the securities of each merging company are converted into securities of the proposed merged company and if any of the securities are not converted, the consideration that each holder of those securities will receive must be indicated.
[243] Sec 113(2)(d) read with the definition of 'consideration' in sec 1 of the Companies Act.
[244] Cassim (n 101 above) 687.
[245] As above.
[246] Cassim (n 101 above) 688 fn 42.
[247] Cassim (n 101 above) 703.
[248] As above.
[249] Cassim (n 101 above) 703.
[250] As above.

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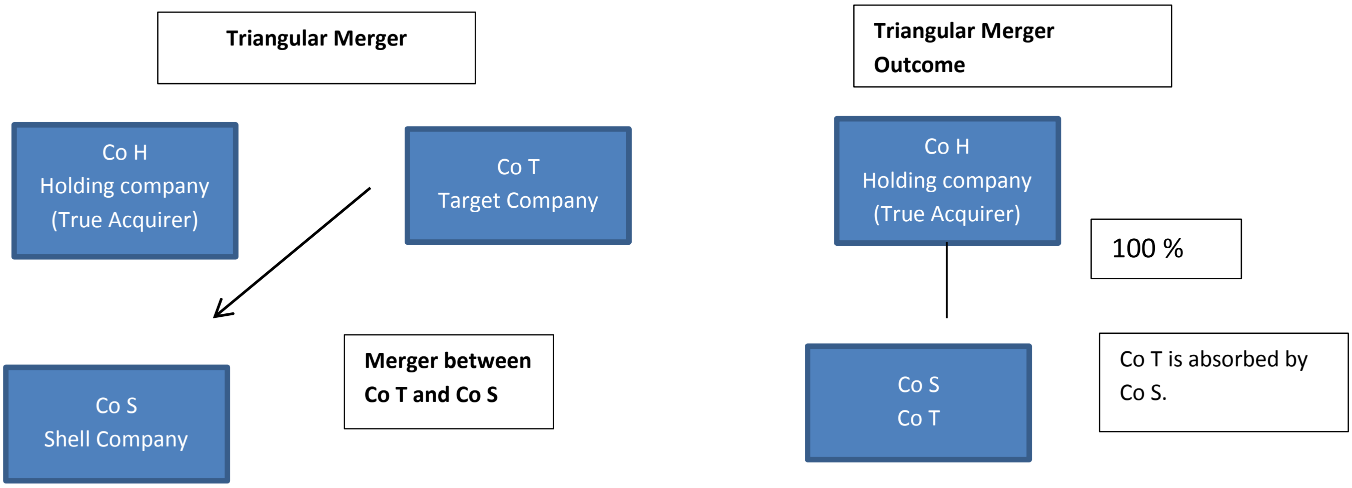
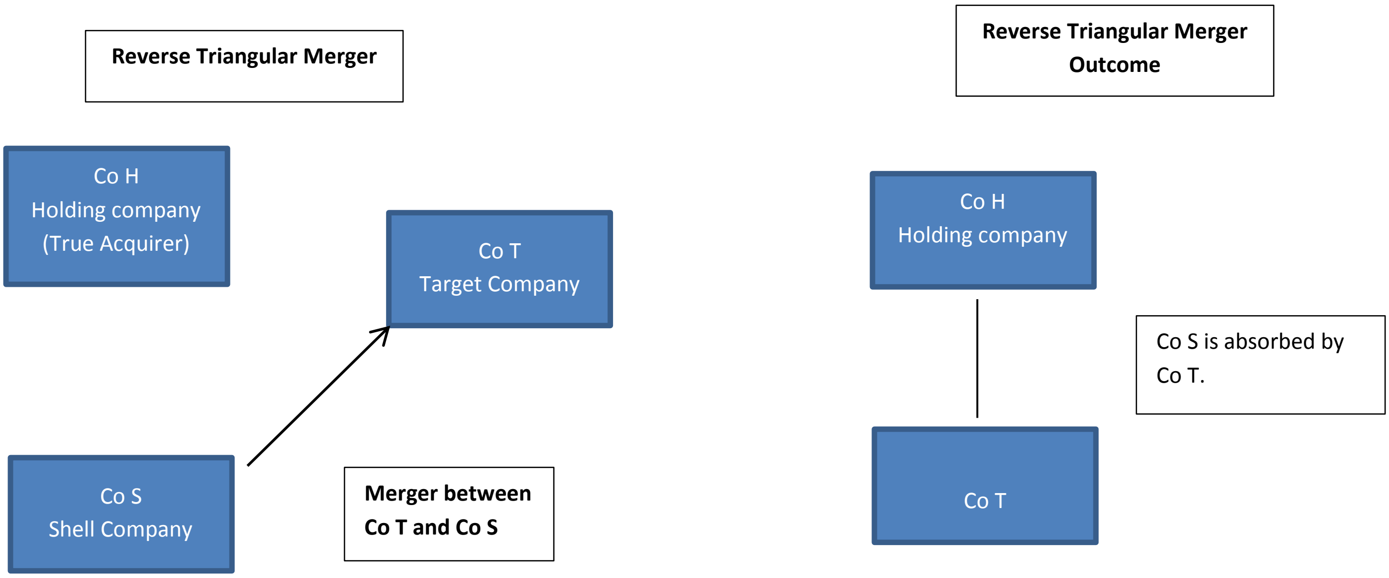
merger agreement.[251] In other words, ('Co S') is directly a party to the merger and not ('Co H') itself which allows ('Co H') an opportunity to ring-fence or isolate the target company's liabilities which includes unknown and contingent liabilities.[252] This will therefore reduce ('Co H's') exposure to the target company's liabilities which effectively neutralises the disadvantages associated with directly acquiring liabilities.[253]



On the other hand, a reverse triangular merger is similar in structure to that of the triangular merger. The material difference between the two merger structures is that the target Company, in a triangular merger, merges into ('Co S'), with ('Co S') remaining in existences; whereas in the reverse triangular merger the opposite occurs, in the sense that it is ('Co S') that mergers into the target company.[254] As a result of this, the target company (and not Co S) remains in existence. See illustration below.



[251] Cassim (n 101 above) 703.
[252] Cassim (n 101 above) 705.
[253] As above. See diagrams below.
[254] Cassim (n 101 above) 707.

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4.5.6 Short-form mergers

It seems to be a major oversight that the Companies Act does not provide for a short term merger procedure.[255] A short-form merger is a simplified merger procedure between both, a holding company and its wholly owned subsidiary (vertical short-form merger) or between two wholly owned subsidiaries of a holding company (horizontal short-form merger).[256] Although the Companies Act does recognise mergers between a holding company and its subsidiary,[257] it does not provide for a procedure to facilitate such a merger.[258] A short-form merger is a simplified procedure which dispenses with the requirement of a shareholder resolution by each company and instead, may be affected by resolution of the board of directors of each merging company.[259] This therefore avoids unnecessary delays, costs and inconvenience associated with a shareholders meeting and, more importantly, it avoids the exercise of appraisal rights.[260] In my opinion, the inclusion of a short-form merger procedure would not only have economic benefits, but would also minimise complexities and compliance costs.

4.6 Tax implications

4.6.1 Definitions of the Companies Act v the Income Tax Act

The definition of an amalgamation or merger in section 1 of the Companies Act accommodates the idea that there is either the formation of a new company (with the dissolution of the constituent companies) or the survival of one of the constituent companies. This is important as it represents a far wider reaching merger concept than anything else that has been found in South African company legislation.

Comparing the definition of an amalgamation and merger in section 1 of the Companies Act to that of section 44 of the Income Tax Act, which provides a roll over relief for amalgamation and merger transactions, it seems that the definition in the Income Tax Act is not aligned with the relevant provisions in the Companies Act.[261] This is because the definition in the Income Tax Act recognises more forms of amalgamations and mergers than the definition in the Companies Act. As a result of this, section 44 does not extend to all of the amalgamation and merger transactions defined in Companies Act. The reason for this is that The Standing Committee of Finance (SCOF) rejected the suggestion that the provisions of the two Acts be aligned. Their reasons are that the Income Tax Act caters for various types of amalgamations and mergers, such as amalgamations, conversions and mergers. This means that the purpose

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[255] Cassim (n 101 above) 714.
[256] Cassim (n 101 above) 715.
[257] Sec 113 (1) Companies Act.
[258] Cassim (n 101 above) 715.
[259] As above.
[260] Cassim (n 101 above) 715.

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of amalgamation rules in the Income Tax Act differs to that of the Companies Act. [262] The committee thus held that these Acts seek to achieve diverse aims.[263]

The Taxation Laws Amendment Act[264] thereafter amended the rules in the definition of "amalgamation transactions" in the Income Tax Act to include foreign companies.[265] The *proviso* to the definition of "amalgamated transaction" now forms part of the exclusions listed in subsection (14)(g) of the Income Tax Act, although the requirements for the termination of the amalgamated company's existence remains unaltered.[266] The current definition of an amalgamated transaction in terms of the Income Tax Act is any transaction:

(a) in terms of which any company (thereafter the 'amalgamated company') disposes of all of its assets (other than assets it elects to use to settle any debts incurred by it in the ordinary course of its trade) to another company (thereafter the 'resultant company') which is a resident, by means of an amalgamation, conversion or merger; and
(b) as a result of which that amalgamated company's existence will be terminated.

Section 44 of the Income Tax Act therefore only recognises an amalgamation, conversion or merger in instances where a company transfers all of its assets to another company, as a result of which that amalgamated company's existence is terminated. The above scenario is similar to that mentioned in paragraph (a) of the definition of an amalgamation or merger in the Companies Act. This will mean that if an amalgamation in terms of paragraph (b) of the amalgamation or merger definition in the Companies Act is implemented, such transaction will not qualify for any available roll-over relief applicable in terms of section 44 of the Income Tax Act.[267]

In addition, the roll-over relief which is applicable in terms of section 44 of the Income Tax Act only extends to instances where the amalgamating company transfers all of its assets to another company in exchange for the issuance of equity shares in that company. If the consideration is in the form of anything other than equity shares, this may constitute a part-

[262] The Standing Committee on Finance (SCOF) Report-back Hearings on the Taxation Laws Amendment Bill 2010 (25-08-2010) Available at <http://www.treasury.gov.za/public%20comments/.Full%20Response%20Doc%20Draft%2025%20August%202010.pdf.>. (accessed 9 September 2015).
[263] The Standing Committee on Finance (SCOF) Report-back Hearings on the Taxation Laws Amendment Bill 2010 (25-08-2010) Available at <http://www.treasury.gov.za/public%20comments/.Full%20Response%20Doc%20Draft%2025%20August%202010.pdf.>. (accessed 9 September 2015).
[264] Act 24 of 2011.
[265] L Steenkamp 'Aligning the Income Tax Act and the Companies Act for amalgamations and mergers' (2012) *Taxtalk* 15.
[266] As above.
[267] A Lewis 'New Amalgamation Provisions not aligned with the Income Tax Act' (27-05-2011) Cliffe Dekker Hofmeyr's Tax Alert. Available at <http://www.cliffedekkerhofmeyr.com/news/files/CDH-Tax-Alert-27-May-2011.pdf>. (accessed 8 September 2015).

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disposal and trigger capital gains tax.[268] Furthermore, paragraph 76A of the Eighth Schedule of the Income Tax Act provides that if a shareholder receives a capital distribution on shares (I.e. distributions that are not subject to dividends tax) then the amount of the capital distribution is regarded as a proceed in exchange for the part-disposal of the shares. According to the provisions, a deduction of a 'base cost'[269] from the proceed received in exchange for the part disposal of the shares may be made in accordance with paragraph 33 of the eighth schedule of the Income Tax Act.

4.6.2 Intra-group transactions

Section 45 of the Income Tax Act regulates the position where a company disposes of an asset to another resident company, in instances where the companies form part of the same group of companies after the disposal or transaction (intra-group transactions). According to the Taxation Laws Amendment Act 2014, all intra-group transactions are subject to specific anti-avoidance rules aimed at limiting interest deductions on debt-funded transactions.[270] The interplay between sections 45 and 23K of the Income Tax Act as well as the provisions regulating the amalgamation and merger procedure in the Companies Act could affect the possible qualification for roll-over relief.

There are possible scenarios to consider. Firstly, if all the target companies dissolve upon the implementation of the merger or amalgamation (as per paragraph (a) of the definition in the Companies Act), the relief afforded in section 45 would not be applicable unless the acquiring companies holds at least 70% of the equity shares in the target companies.[271] Secondly, if the target company survives in accordance with paragraph (b) of the definition and together with the acquiring company, forms part of the same group of companies, section 45 will in all probability apply and provide roll-over relief. This is however contingent on the fact that none of the anti-avoidance rules apply.

4.6.3 Unbundling transactions

Section 46 of the Income Tax Act provides that all the equity shares of a company, known as the 'unbundled company', that are held by another company, the 'unbundling company', are to be transferred to the shareholders of the 'unbundling company'. This is dependent on the fact that, in the context of private companies, those shares are transferred to a shareholder

[268] See sec 113(2)(c) of the Companies Act.

[269] Base cost is the amount against which any proceeds upon disposal are compared in order to determine whether a capital gain or loss has been realised. For assets that were acquired before 1 October 2001, the base cost is equal to the "valuation date value" of the asset plus any further qualifying costs incurred on or after that date (paragraphs 20 and 25 of the Eighth Schedule). For assets acquired on or after the aforementioned valuation date, the base cost of the asset generally comprises the costs incurred in acquiring the asset and improving it. Paragraph 20 of the Eighth Schedule sets out what costs qualify to be part of base cost.

[270] These rules are encompassed in sec 23K of the Income Tax Act.

[271] This is due to the fact that if the target company dissolves, sec 45 will not apply as this will not constitute an intra-group transaction. The target company will, in this instance, seize to exist and consequently, the two companies will not form part of the same group of companies.

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which forms part of the same group of companies as the unbundled company.[272] Section 46 may therefore apply to the statutory amalgamation or merger procedure in instances where the Target company is the unbundling company and the acquiring company is a shareholder of the target company.

4.6.4 Capital Gains Tax

The underlying premise of an amalgamation or merger involves the transfer or conversion of shares from one company to another as well as the transfer of assets from one company to another. What does this mean for purposes of capital gains tax? Capital gains tax (GCT) is a tax liability which forms part of income tax and is triggered when a taxpayer 'disposes' of an asset for a proceed which exceeds its base cost (the cost that it was initially valued at).[273] 'Disposal' is defined in the Income Tax Act as "any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset."[274] Firstly, it is noticeable from the above definition that the conversion of shares held by the amalgamating company into shares in the amalgamated company will, in terms of section 113(2)(c) of the Companies Act, trigger CGT. Secondly, the disposal of assets by the amalgamating company to the amalgamated company will, by the very nature of CGT, trigger CGT as well as normal tax on any recoupments[275] made on those assets for the amalgamating company itself.[276] The amount of capital gain (or loss) will be the difference between the proceeds made from the disposal and the base cost of the asset.[277]

4.6.5 Dividends Tax

According to section 44(9) of the Income Tax Act, all distributions of equity shares acquired in terms of the amalgamation transaction to the shareholders of the amalgamated company will not be subject to any dividends tax.

4.6.6 Securities transfer Tax

According to section 8(1)(a) of the Securities Transfer Tax Act,[278] the distributions of equity shares during the implementation of the amalgamation or merger transaction will not be subject to any securities transfer tax. The reason for this is that according to the provision, all distributions will be exempted in instances where a person receives a distribution in terms of a corporate rule transaction and thereafter, becomes the beneficial owner of the security.

[272] Sec 46(1)(a) of the Income Tax Act.
[273] The disposal must however have taken place on or after 1 October 2001.
[274] Sec 1 of the Income Tax Act.
[275] This refers to an amount which the amalgamating company may receive when the company makes use of more than one asset to replace the asset which was disposed of. The recoupment must then be allocated between the replacement assets in proportion to the proceeds spent on each.
[276] Steenkamp (n 265 above) 15.
[277] Paragraph 3(a) of the Eighth Schedule to the Income Tax Act.
[278] Act 25 of 2007.

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4.6.7 Value-added Tax

According to the VAT Act, output VAT is levied on the supply of goods and services by a vendor in the course or furtherance of an enterprise.[279] Supply is broadly defined to include "performance in terms of a sale, rental agreement, instalment credit agreement, and all other forms of supply, whether voluntary, compulsory or by operation of law."[280] The transfer of goods during an amalgamation or merger procedure will constitute a supply in respect of goods sold for a consideration or performances made "by operation of law". Thereafter, once a transfer constitutes a supply, the VAT Act further stipulates that the value of such a supply must be determined in regard to its consideration.[281] The VAT Act regards consideration as payments made or to be made in respect of, in response to, or for the inducement of, the supply of any goods or services.[282] Even in instances where there is no specific consideration, section 10(4) of the VAT Act indicates that the consideration for the supply is deemed to be the open market value of the supply, if all of the following requirements are met:

- the supply must be made for no consideration or for a consideration which is less than the open market value of the supply;
- the supplier and recipient must be connected persons in relation to each other; and
- the recipient may not be entitled to make a deduction of the full amount of VAT in respect of the supply if VAT was charged.

In considering the nature of an amalgamation or merger transaction and applying it to the provisions of the VAT Act, it would seem that the amalgamated company (target company) will levy VAT on the amount of consideration received in exchange for the transfer of goods.[283] This is dependent on the particular amalgamation agreement as well as whether consideration will be given in exchange for assets. Consequently, if the transaction is subject to VAT, the amalgamating company may claim input tax.[284] The principle of payment is particularly important in property transactions.[285] As a result, problems in deducting the full amount of VAT charged will arise where the target company makes a mixed supply, i.e. a supply that is partially subject to VAT and partially exempt from VAT- as only the portion of

[279] Sec 7(1)(a) (b) and (c) of the VAT Act.
[280] Sec 1 of the VAT Act.
[281] Sec 10(2) of the VAT Act.
[282] Sec 1 of the VAT Act.
[283] The Vat will be levied on the supplies made by the target company, in the form of a transfer of goods, in return for the payment or consideration by the amalgamating company. This is in accordance with sec 7(1)(a) of the VAT Act.
[284] Sec 17(1) of the VAT Act, provided that the amalgamating company is a registered vendor who is a South African resident as defined in the VAT Act. See also R Gad & J Strauss The impact of statutory mergers on current tax legislation. Available at <https://www.ensafrica.com/news/the-impact-of-statutory-mergers-on-current-tax-legislation-part-2?Id=591&STitle=tax%20ENSight. (accessed 27 September 2015).
[285] As above. Provided the full purchase price has been paid and the transfer property must have been registered in the Deeds Office. See also R Gad & J Strauss (n 284 above) (accessed 27 September 2015).

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input tax that relates to taxable supplies can be claimed by amalgamating company.[286] The statutory merger procedure does not eliminate this exposure. If the target company is not a vendor and no VAT was charged, the amalgamating company may still be eligible for notional input tax.[287] Broadly speaking, this special credit is allowed where a non-vendor, who is the target company, supplies second-hand goods by way of a sale.[288]

Where an asset is disposed of as part of a going concern, the supply may be zero-rated provided the requirements of section 11(1)(e) of the VAT Act are met. For the zero-rating to apply

(i) the parties must agree in writing that the enterprise will be an income-earning activity on the date of transfer thereof,

(ii) the parties must agree in writing that the consideration for the supply will be inclusive of VAT at the rate of zero percent, and

(iii) all assets necessary for carrying on such enterprise must be disposed of.

4.6.8 Transfer Duty

Transfer duty arises upon the transfer of immovable property. As a general rule, transfer duty or VAT will apply to a transaction, but not both.[289] Section 9(15) of the Transfer Duty Act[290] states that no transfer duty is payable on the acquisition of property which is regarded as, for the purposes of the VAT Act, a taxable supply of goods to a person acquiring that property. This is however dependant on the fact that the transferor of the property certifies that any VAT that is payable has been paid; any security for the payment has been lodged; and the commissioner of South African Revenue Services has issued a certificate indicating that the requirements of this section have been met.[291] As a result, the amalgamating company may incur a transfer duty liability upon the acquisition of immovable property.

4.7 Conclusion

Given the nature of which and the amount of variables which may arise, there are may be a variety of tax implications involved. For purposes of this dissertation, the above tax implications that have been discussed represent, for the most part, the general implications which may arise as a result of the interplay between the Companies Act, the Income Tax Act and the VAT Act. Should an "amalgamation or merger" wholly or partly fall outside the ambit of the tax rollover relief provisions of the Income Tax Act, the transactions may lead to unexpected income tax, capital gains tax, VAT, transfer duty and securities transfer tax

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286 As above

287 R Gad & J Strauss (n 284 above) (accessed 27 September 2015).

288 Sec 29(a) of the VAT Act.

289 The impact of statutory mergers on current tax legislation. Available at <https://3.ensafrica.com/news/the-impact-of-statutory-mergers-on-current-tax-legislation-part-2?Id=591&STitle=tax%20ENSight. (accessed 27 September 2015).

290 Act 40 of 1949.

291 Sec 9(15)(a) (b) and (c) of the Transfer Duty Act.

consequences in the hands of any parties involved. As was mentioned earlier, the legislature erred in not aligning the two Acts. As a result, the implementation procedure is inundated with a lack of efficiency and certainty when it comes to amalgamation and merger transactions. It is hoped that SARS and the legislature will address these issues in order to align the purposes and goals of the two Acts.

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Chapter 5 Conclusion

5.1 Tax implications associated with the some of the new concepts introduced by the Companies Act

This dissertation analyses the effect that the Companies Act has made on South African corporate legislation. The Companies Act symbolises a conduit, which the legislature has used, in creating somewhat of a corporate reform in South Africa. This has been done by introducing new concepts into the Companies Act and changing the provisions and procedures which were problematic in the past. Given the fact that the Companies Act marks a relatively new change in South African legislature, many of these concepts have not been considered from a tax viewpoint. The dissertation therefore considered the tax implications that may arise upon the implementation of these concepts as well as the changes that were made. The dissertation also acknowledges that there a significant conceptual differences between the Companies Act and the various taxing legislation in South Africa. As a result, it has become necessary to first consider the tax implications that arise from a particular transaction in terms of tax legislation such as the Income Tax Act and VAT Act before considering the provisions in the Companies Act.

5.2 Types of companies recognised by the Companies Act

The introduction of the Companies Act has removed the difficulties associated with recognising the different types of companies that may be formed. The Companies Act now provides for two broad categories of companies, namely profit and non-profit Companies. Within profit companies, there are four further subcategories of companies - private companies, private companies, state-owned companies and personal liability companies.

A private company is a profit company who is prohibited from offering any securities to the public whilst a public company has no restrictions regarding the transferability of any of its securities. Typically, the tax implications do not differ between public and private companies however, a public company must first satisfy the requirements of section 38(2) of the Income Tax Act before qualifying for any tax benefits which may be associated with a public company.

An external company is a foreign company which conducts business or non-profit activities in South Africa and as a consequence, is obligated to register with the intellectual property commission within 20 business days after it first begins to conduct business or non-profit activities. Accordingly, a foreign company is regarded as conducting business or non-profit activities in South Africa if the company ‘is a party to one or more employment contracts within the Republic.’[292]

[292] Sec 23(2)(a) of the Companies Act.

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Furthermore, a foreign company that is obligated to register as an external company must maintain at least one registered office in the Republic. The registration as an external company does not automatically give rise to a South African resident company however; the profits made on that company may well be liable for tax as a source within South Africa. If, on the other hand, the external company were to give rise to a permanent establishment, South Africa then may exercise the taxing rights on the profits which are attributable to that permanent establishment. However, the risk of creating a permanent establishment may be minimised by making use of a South African service provider or have an employee of a South African resident company work as an agent.

An external company will still need to satisfy the requirements of the VAT Act regarding registration as a VAT vendor, which includes meeting the taxable supply threshold of 1 Million Rand within 12 months for compulsory registration. There is also seemingly no provision in the Companies Act which renders an external company liable to any form of audit for tax purposes.

An employee of a foreign company who is rendering services in South Africa may, provided that a double tax agreement is applicable, make use of article 15(2) of the agreement in order to receive tax relief to on their remuneration. Accordingly, South Africa would not be entitled to any tax on the employee's income if the employee was not in South Africa for more than 183 days in twelve-month period, the income was paid by the foreign company and the income is not borne by a permanent establishment is South Africa.

The consequences of not registering as an external company do not seem severe enough to force foreign companies into doing so, given the risk of creating a permanent establishment and the onus of maintaining a registered office.

A non-profit company or public benefit organisation is a company which is incorporated for a public benefit or another specified object and the income and property are not transferable to any of its members. Although a non-profit company or public benefit organisation is recognised by the companies Act, these companies will first need to comply with the internal requirements of the Income Tax Act before qualifying for any tax reductions or benefits.

5.3 Tax implications associated with some of the new provisions introduced by the Companies Act

Chapter 3 attempted to clarify some of the tax-related issues that may arise from the Companies Act and more specifically, the new provisions that have been introduced by the Companies Act. Although the Companies Act has abolished par value shares, this has seemingly had very little tax significance. The reason for this is due to the introduction of the term CTC as well as the amended definition of a dividend in the Income Tax Act.

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The introduction of section 164 has significantly impacted on company legislation in South Africa. It has provided shareholders with an opportunity to maintain their investments and assets which would have otherwise been affected upon the occurrence of a particular event. The section has marked a shift in the legislation by allowing shareholders to sell their shares on occasions other than the company being listed. Here, the minority shareholders may demand that the fair-value of their respective shares be paid back to them as a result of the event being passed by special resolution. The implementation of section 164 (appraisal right) will have various different cash flow implications for the company. Besides the relevant tax liability that may come about, the obligation of company to pay out the fair-value of the shares may be extremely onerous on the company. In terms of the tax significance, the acquisition of shares by a company in return for the payment of a fair value will result in tax liability for both parties. The minority shareholder will be liable for dividends tax, which will generally be withheld by the company unless the shareholder is excluded in terms of section 64F of the Income Tax Act. The company on the other hand may, in my opinion, institute a possible case for the fair value which is paid out to be deducted from their taxable income in terms of section 11(a) of the Income Tax Act.

Section 37 of the Companies Act recognises that companies may create different classes of shares with different rights, limitations and preferences. The section thus provides that, in the event of there being different classes of shares, the preferences rights and limitations should be identical to those of other shares in the same class. Section 37(6) of the Companies Act is also a new addition which has been introduced in order to safeguard against any rigid rights, preferences and limitations of a class of shares which may be detrimental to a company upon the occurrence of an objectively ascertainable fact or facts. The Section therefore permits a company to indicate, in the MOI, how the rights, preferences and limitations of the shares will change as well as the nature of such changes. This variation will only be implemented once a recognised, ascertainable event occurs. The only tax implication of concern would be in instances where a Company's MOI provides for the conversion of the shares into hybrid equity instruments. In this event, section 8E of the Income Tax Act stipulates that the dividends declared on the debt instruments is considered as interest in the hands of the shareholder whilst still considered a dividend in the hands of the company. Essentially, the shareholder is taxed on deemed interest received, whilst the company is precluded from deducting the payment of that dividend from its taxable income. Also, interest that is paid on a hybrid equity instrument is regarded as a non-deductible divided. This will therefore be subject to dividends tax in the hands of the payer.

Section 40(5) of the Companies Act has also marked a major shift in company legislation by departing from the previous position which stipulated that a company would only issue shares once the requisite consideration for those shares has been determined and that the shares are considered 'fully paid'. Currently section 40(5) now permits the issuance of shares in exchange for an instrument of which such a value may only be realised at a time after the

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shares are issued or in exchange for an agreement for future services, benefits or payment. This has colloquially been referred to as "sweat equity" is fast becoming a popular mechanism used in black economic empowerment deals in order to attract and retain employees with the requisite level of skill and expertise, but lack in financial resources. Given the definition of 'accrual' in the Income Tax Act, the subscription price or consideration will still be included in the Company's gross income in the event that the company is considered unconditionally entitled to such an amount. Secondly, in terms of section 24B of the Income Tax Act, the company may only deduct the amount from their taxable income in instances where an asset is acquired by the company in exchange for the shares. Section 24B doesn't however extend to instances where shares are issued in exchange for benefits or services rendered to the company in the future. In terms of these agreements, the subscribing party is compensated and therefore the amount should be included as gross income on day one. The subscribing party could argue that the shares are held in trust and will only be transferred at a later stage. The problem with this argument would be if the subscribing party were entitled to dividends on those shares which would render the part unconditionally entitled to those shares. Also, if the party decides to return the shares, he or she may not qualify for a deduction in terms of section 11(a) of the Income Tax Act as the amount will not be 'actually incurred'. A subscribing party may thus be prejudiced on the receipt of the shares as well as the return of those shares.

5.4 Mergers and amalgamations

One of the main aims behind the reform of South African corporate law was to provide for a more equitable and efficient amalgamation and merger procedure. Accordingly, the Companies Act introduced a new statutory procedure by which a merger or amalgamation can be achieved. The procedure provides for a comprehensive mechanism in which the formation and dissolution of companies, the allocation of shares and liabilities and the conversion of securities are facilitated. As a result, these company reorganisations and their adverse tax consequences can be extremely detrimental to the financial status of not only existing companies but new companies too.

A comparison between the definition of an amalgamation and merger in section 1 of the Companies Act to that of section 44 of the Income Tax Act would suggest that a company would need to structure the amalgamation or merger in the specific manner set out in section 44 in order to enjoy the roll-over relief that is offered. This obviously restricts the amount of flexibility that is offered by the companies Act, especially regarding the form in which consideration is payable to the shareholders of the dissolving merging company.

If the transferee company and transferor company are in the same group of companies, any assets that are transferred are considered part of an intra-group transaction provided for in section 45 of the Income Tax Act. These transactions are however subject to specific anti avoidance rules which are aimed at reducing interest deductions on debt-funded transactions

Similarly, if the shareholder and the transferor company are in the same group of companies, the equity shares of the transferee company may even be unbundled to the shareholders in terms of an unbundling transaction provided for in section 46 of the Income Tax Act. This section may thus apply in instances where a target company is the unbundling company and the acquiring company is a shareholder of the target company.

The conversion of shares from the amalgamating company to the amalgamated company will, in terms of section 113(2)(c) of the Companies Act, trigger Capital Gains Tax. Furthermore, any disposal of assets made by the amalgamating company to the amalgamated company will also trigger CGT as well as normal tax on any recoupments made on those assets for the amalgamating company itself.

The transfer of goods during an amalgamation or merger procedure will, in terms of the VAT Act, constitute a supply in respect of goods sold for a consideration or performances made. Once a transfer is considered a supply, the VAT Act further requires that the value of such supply be determined with reference to the amount of consideration that is payable. Consideration is defined in the Companies Act as payments made or to be made in respect of, in response to, or for the inducement of, the supply of any goods or services. Where the specific consideration cannot be determined, the supply is deemed to be the open market value of that supply – provided that the requirements of section 10(4) have been met. The amalgamated company would therefore levy VAT on the amount of consideration that is received in exchange for the transfer of goods. Thereafter, if the transaction is subject to VAT, the amalgamating party may claim it as input credit. Where an asset is disposed of as part of a going concern, the supply may be zero-rated provided the requirements of section 11(1)(e) of the VAT Act are met.

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