A PROPOSED GROUP TAX SYSTEM FOR SOUTH AFRICA

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ABSTRACT

A PROPOSED GROUP TAX SYSTEM FOR SOUTH AFRICA

by

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DEPARTMENT: Faculty of Economic and Management Sciences

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This study is concerned with the taxation of corporate entities in South Africa. More particularly, it explores and evaluates the manner in which groups of companies are presently dealt with for tax purposes, considers international best practice and makes recommendations for reform of the South African corporate group tax regime. The law in South Africa currently treats each company in the corporate group as a separate taxable unit, ignoring the fact that the companies in the corporate group, under the common control of the parent company, act as one economic unit and should accordingly be regarded as a single enterprise for tax purposes. Internationally, the tendency to tax the corporate group as a single enterprise is becoming increasingly common and most countries have introduced formal group tax systems in recent years. The aim of this study, therefore, is to propose an appropriate group tax system for South Africa.

The study adopts a legal doctrinal research approach. It finds that the recognition of the single enterprise principle under the current corporate tax restructuring regime is complex and fragmented and fails to adequately recognise economic unity in corporate groups. It recommends the introduction of a formal group tax system.

The study makes a contribution by developing a method or framework to be used to design a suitable group tax system for the South African context, by determining the optimal design options in respect of each of the seven identified structural elements, based on current tax policy objectives, taking account of the limitations of the two main design options, as well as the relief provisions and the restrictions that exist in the South African tax system. The method is then applied in order to recommend a formal group tax system for South Africa. The need is identified for future studies that will focus on the detailed implementation of these design parameters, particularly the rules to be used to calculate the tax base.

Key words: formal group tax system, economic unity, single enterprise principle, groups of companies.

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LIST OF ABBREVIATIONS

AICPA	American Institute of Certified Public Accountants
BEPS	Base erosion and profit shifting
BRICS	Brazil, Russia, India, China and South Africa
CCCTB	Common Consolidated Corporate Tax Base
EEA	European Economic Area
EFTA	European Free Trade Association
EU	European Union
GDP	Gross domestic product
G20	Group of 20 countries comprising Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, México, Russia, Saudi Arabia, South Africa, Korea, Turkey, the United Kingdom, United States and European Union
IAS	International Accounting Standard
IFA	International Fiscal Association
IFRS	International Financial Reporting Standard
NEPAD	New Partnership for Africa's Development
OECD	Organisation for Economic Cooperation and Development
PEX regime	Participation exemption regime
REIT	Real estate investment trust
RIC	Regulated investment company
SACCI	South African Chamber of Commerce and Industry
SAICA	South African Institute of Chartered Accountants
SARS	South African Revenue Service

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A PROPOSED GROUP TAX SYSTEM FOR SOUTH AFRICA

CHAPTER 1: INTRODUCTION AND BACKGROUND

1.1 A BRIEF HISTORY OF COMPANIES AND CORPORATE GROUPS

Corporate groups are major influences in the modern economic world, operating across borders as large multinational corporations (Anderson, 2008:3). It is estimated that multinational corporations account for over 70% of international trade (Schermerhorn, 2011:115). It is further estimated that multinational corporations contribute over 25% of gross world product (Howard, 2010:105). The economic power these multinational corporations wield is further revealed by the fact that, according to estimations, they control more than a third of the world's productive assets (Roach, 2007:14).

Although today's multinational corporation differs significantly from the original entity form introduced in the late 1700s, the characteristics of the company remained intact. Stewart Kyd (1793:12-13), the author of the first legal paper on English company law in the 18th century, defined the company

"as a collection of many individuals, united into one body, under a special denomination, having perpetual succession under an artificial form, and vested, by policy of the law, with the capacity of acting, in several respects, as an individual, particularly of taking and granting property, of contracting obligations, and of suing and being sued, of enjoying privileges and immunities in common, and of exercising a variety of political rights, more or less extensive, according to the design of its institution, or the powers conferred upon it, either at the time of its creation, or at any subsequent period of its existence."

The legal form of the original company has remained intact, to a large extent. This is evident from the four characteristics identified by Dean Robert Clark of the Harvard Law School (1986:2) as essential to the vitality and appeal of the corporate form today: the company's separate legal personality, the free transferability of investors' interests, the limited liability for investors, and its centralised management.[1] To a considerable extent, these four characteristics that appeal to businessmen today are the same characteristics that distinguished the company as entity form in 1793.

Today, the company as an entity form, with its individual rights and obligations distinct and separate from the rights and obligations of its shareholders, is the foundation of modern economic organisation and its advantages are well appreciated (Dari-Mattiacci, Gelderblom, Jonker and Perotti, 2013:24). However, this entity form evolved from a time when corporate groups had not yet existed.

Currently, companies mainly operate in corporate groups. In general, the companies in a group of companies are affiliated or connected in a manner that depends significantly on shared ownership (Eisenberg, 1993:1). A group of companies is, therefore, a collection of parent and subsidiary companies. According to Kalss (2008:5-6), corporate groups are normally formed in one of two ways: either by taking over another company (acquisition) or by merging one business with another into a newly established company (merger). After the merger or acquisition, the merged or acquired company remains in existence rather than being dissolved by the parent company (Kalss, 2008:6).

During times of favourable opportunities, mergers and acquisitions of other companies normally occur as a means to grow (Pettit & Ferris, 2013:4). Growth is usually established by acquiring a larger market share or for other economic purposes to increase a company's profits. In general, a company will participate in a merger and acquisition activity if synergies can be established. Synergies can take three forms: operating, financial, and/or managerial (Pettit & Ferris, 2013:6). A resource company could, for example, instead of building its own processing facilities rather merge with its competition, which already possesses processing facilities. It is proposed that, in the end, both companies should benefit from the merger transaction.

As corporate groups are normally created through mergers and acquisitions, it comes as no surprise that the first corporate groups were created during the late 1800s when the

1 Although these four characteristics were identified in Robert Clark's writings in 1986, more recent legal works (Monks & Minow, 2011:7; Prasad, 2011:9; Kraakman, Armour, Davies, Enriques, Hansmann, Hertig & Rock, 2009:5) still refer to Clark's four characteristics as the most appealing four characteristics of the present corporate entity form.

United States[2] experienced its “greatest merger movement in American history” (Chandler, 2000:41). By the end of the 1900s, 51 of the 100 largest economies in the world were corporate groups, not countries (Anderson, 2008:3). The five largest corporate groups had combined turnovers exceeding the gross domestic product (GDP) of the 46 poorest of all countries (Sikka, 2008:268). According to a United Nations report based on a comparison of corporate sales and country GDPs (United Nations, 2008:26-35), 14 out of the 50 largest economies globally in 2008 were corporate groups, while 36 were countries (United Nations, 2008:26-35). It confirms that multinational companies or corporate groups are extremely powerful entities, while poorer governments and natural persons are only found further down on the list (Vitali, Glattfelder & Battiston, 2011:32).

In South Africa, the top 45 companies on the JSE (Johannesburg Stock Exchange) represent approximately 85% of the market capitalisation of the companies on the JSE (Venter, Stiglingh & Smit, 2017:403). These companies mainly represent companies that operate in groups (Hertzog, 2019). It is therefore clear that the trend that is evident globally, where group companies, although fewer in number, represent the majority of wealth, is also evident in South Africa.

Furthermore, modern multinational corporate groups operate in a completely different and vastly more complex environment than the corporate groups of the previous centuries. These multinational corporate groups operate in a globalised, digital, mobile business environment (Moscovici, 2015). In addition, the majority of the assets of these multinational corporate groups consist of intangible assets, and not tangible assets, as was the case with corporate groups of the 1800s and 1900s (Moscovici, 2015). Finally, to complicate matters even further, these corporate groups operate in a multi-tiered corporate group entity form that is far from the simpler entity forms of earlier corporate groups. It is, therefore, clear that the simpler corporate groups of the early 1900s have evolved into today’s multinational corporate groups, which are not only powerful, but also extremely complex, operating with assets that are imperceptible in a business environment that is moveable and highly technical. Clearly, jurisprudence that is more sophisticated is needed to deal with today’s multinational corporate groups.

2 For purposes of this study the United States means the United States of America.

According to Blumberg (1986:608), the development of corporate groups extended separate legal personality to the entire corporate group. It created an additional tier of limited liability by allowing protection from creditors, not only to the shareholders of the parent company but also to the parent company with regard to the creditors of its subsidiary.[3]

By the end of the 20th century, there were approximately one million private companies in the United States contributing to a very small percentage of the United States' corporate earnings. At the same time there were about 10 000 large, widely held corporate groups that dominated the corporate space by holding 80% of all corporate assets and earning 93% of corporate earnings (United States, Census Bureau, 2003:742). According to Blumberg, Strasser and Georgakopoulos (2007:10-4), "both of these two very different worlds are governed by the same entity law." This means that the separate-person legal principle applies to a parent company and its many subsidiaries in the same way it applies to a private company and its shareholders.

Some jurisdictions have, however, created exceptions to this rule. As Germany has never been constrained by the same devotion to the concept of a company's separate legal entity as the United Kingdom has, it was able to develop its "law of concern".[4] Under Germany's "law of concern", a more systematic approach is taken by treating the whole of the corporate group as a separate legal entity, ignoring individual companies.

The German "law of concern" relates only to corporate groups and does not apply to public limited companies or to private limited liability companies (Immenga, 2007). The German "law of concern" accepts the reality of a group of companies acting as a single enterprise and provides a comparative tool for other jurisdictions that are still applying the separate legal entity principle in respect of groups of companies.

It is not clear why some jurisdictions still follow a strict legal application of the separate entity principle, while others (like Germany) have managed to create legislation that deals with the corporate group as one enterprise instead of multiple separate companies. Blumberg *et al.* (2007:6-3) are of the opinion that courts and legislatures are increasingly being faced with the difficulty of choosing whether to focus on the individual company

3 This creates the possibility of limited liability within limited liability (Grantham & Rickett, 2002:250-255).
4 Known as "Konzernrecht".

components of the corporate group, or on the group enterprise as a whole (Blumberg *et al.*, 2007:6-3). According to Blumberg (1990:328), “the thousands of decisions in the United States courts involving ‘piercing the veil jurisprudence’[5] indicates the intensity of the problem for the legal system.” The challenge for legal systems the world over is the adaptation of company legislation to reflect the economic realities of corporate groups with the development of principles to supplement or replace the separate entity principle (Blumberg, 1990:328).

Internationally, a newer jurisprudence is needed for determining the legal rights and responsibilities of companies that constitute a larger corporate enterprise conducted under common control. This is the “emerging law of corporate groups”. The older separate entity principle has begun to be supplemented and supplanted by the new enterprise principle (Blumberg *et al.*, 2007:6-3).

In line with the new enterprise principle, the concept of a group has been applied in accounting since the early 1900s in the United States, and since the 1920s in the United Kingdom. At the 1922 annual meeting of Nobel Industries Ltd in the United Kingdom, the company’s chairman insisted that the balance sheet did not reflect the full story about the position of the business with regard to the item “Cost of Shares in Constituent Companies” (Walker, 2006: 41-42). He then demanded that “the fullest possible information about the real position” be given. Thereafter, shareholders were provided with an aggregate balance sheet showing the real state of the merger companies “taken as a whole”. These events were described in “The Accountant” journal of 10 July 1920 and probably constituted the first attempt in the United Kingdom to provide consolidated financial statements[6] that reflect the actual financial position of a corporate group as an economic entity (Walker, 2006: 41-42). However, it was not until the 1940s that legislation was introduced to oblige corporate groups to provide consolidated financial statements. Today, consolidated financial statements are recognised as part of the commercial reality when dealing with corporate groups and a familiar concept in accounting.

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5 ”Piercing the veil jurisprudence” refers to case law where the courts have ignored the company’s separate legal personality, in other words, where the courts have not distinguished between the shareholder and the company, but have dealt with them as one and the same party (Blumberg *et al*, 2007:25-5).

6 Consolidated financial statements refer to the financial statements of a group of companies in which the assets, liabilities, equity, income and expenses of the parent company and its members are presented as those of a single enterprise, in line with the International Accounting Standard 27 and International Financial Reporting Standard 10.

Although accounting consolidated financial statements are now a common phenomenon, income tax legislation generally still treats a company as a separate unit for tax purposes' even if it operates as part of a group of companies (Ting, 2013b:3). This tax policy, by which a company is regarded a legal entity form, separate and distinct from its shareholders, is in line with the traditional separate entity principle that has been in place for centuries.

From the early 1900s, this tax policy – to tax the company as separate taxable unit – has come under continuous threat and "judge-made law" developed the core of the first group tax system. In 1902, judges made the decision to treat the subsidiaries of a group as parts of the parent company in a Prussian High Administrative Court Decision[7] which eventually led to the development of the *Organschaft* model (Masui, 2004:29). In 1922, a German court applied this *Organschaft* group tax model, created by the 1902 Prussian court, when it deemed a subsidiary in Cologne (controlled by a parent company in the Netherlands) as part of the parent company in the Netherlands (Masui, 2004:26). The *Organschaft* model, where all profits and losses are consolidated at the level of the parent company, is based on the same principle that is embraced in Germany's corporate law, its "law of concern", dealing with corporate groups (Sargent, 1985:327 – 358).

In 1940, a Dutch court in the Netherlands also decided to treat "concerns" as a single taxable entity (Masui, 2004:27). The same happened in Denmark in 1943 when the Danish Supreme Court favoured a decision of "joint taxation", where a "Danish parent company and its Swedish subsidiaries could apply a system of joint taxation" (Masui, 2004:27). It was these decisions that spearheaded the development of tax laws to accommodate group taxation within the taxing structures. It appears that, by applying "judge-made" tax laws in respect of corporate groups these countries, Germany, the Netherlands and Denmark led the way in the development of group taxation laws. It also appears that these countries acted proactively and well-ahead of their time, while the rest of the world followed reactively by only introducing group tax legislation in answer to the manifestation of increased numbers of corporate groups.

7 *Preußische Oberverwaltungsgericht* (PrOVG), 1902 (OVG in Staatssteuersachen Bd 10:391).

During the 2004 International Fiscal Association's conference on group taxation, 30 countries reported on their group tax regimes.[8] Masui (2004:26) stated in the report of the 2004 International Fiscal Association's conference that 20 of these 30 countries indicated that they had a group tax system in place, and ten countries indicated that they did not have a group tax regime, but that they were considering the introduction of group tax regimes.[9] Since the 2004 International Fiscal Association's conference on group taxation, all the countries that had indicated that they were considering the introduction of group tax regimes have abandoned the introduction of such a regime, except for Pakistan and South Korea, where consolidation regimes were introduced (Ting, 2010:163). A more recent country to consider the introduction of a group tax system is Canada, where the Minister of Finance confirmed that the government had completed its investigation into a group tax regime and moving to a formal group tax system was not a priority at that time. A reason provided by the Canadian Government for its decision was the significant upfront costs associated with introducing a group tax system, because of the perceived complexities and the potential loss of revenue for provinces[10] (Canada, Department of Finance, 2013).

It is therefore clear that historically, companies have been recognised as separate legal entities under both general and taxation law. Today, the companies in a corporate group may still be separate legal entities but are likely to operate as one economic unit with one economic "mind". Internationally, there has been a move in income tax law away from taxing each company in the group as a separate taxpaying entity, towards taxing the group as one single or consolidated taxpayer. Since the beginning of the 21st century, an increasing number of jurisdictions have implemented group tax systems[11] that

8 The 2004 International Fiscal Association conference followed the 1998 International Fiscal Association conference on corporate losses, when only 15 of the 34 countries reporting to the International Fiscal Association reported that it was possible for corporate groups in their countries to consolidate profits and losses. In addition, these 15 countries reported that the cross-border use of losses incurred by subsidiaries was limited (Masui, 2004:25). This discussion in 1998 led to the first conference by the International Fiscal Association in 2004, with group taxation as the main topic.

9 Amongst these ten countries were Pakistan[9], Canada, Belgium, and South Korea (Masui, 2004:28).

10 Canada uses a federal system where each province determines its own tax laws. There is, therefore, a potential for abuse in the form of profit shifting between provinces, which was seen as one of the major reasons for not employing a corporate group tax system in Canada.

11 The definition of a formal group tax system for purposes of this study is provided in Chapter 3, Section 3.2.

acknowledge the economic unity of the corporate group.[12] Despite this international shift, South Africa has not yet introduced a formal group tax system.[13]

1.2 RATIONALE FOR THIS STUDY

Only limited research has been conducted on group taxation in a South African context, to date. Three work groups, appointed by the South African Government, have investigated the viability of a formal group tax system in South Africa: the Margo Commission (1987), the Katz Commission (1995), as well as a tax review committee, the Davis Tax Committee (2018). The Margo Commission (1987:199–201) was in favour of a system of group taxation, but decided that the time was "not ripe for group taxation in South Africa". More recently, the Davis Tax Committee (2018:8) similarly recommended that a formal group tax regime should only be considered once the economy is "strong enough". In contrast to the Margo Commission's findings and the Davis Tax Committee's recommendations, the adoption of a group tax system was recommended by the Katz Commission (1995:179) in 1995 as a matter of importance.

Following the Margo Commission's report, provisions were introduced in 1988[14] that allowed companies to restructure their affairs without incurring income tax liabilities (South Africa, 1988). The fact that these relief measures were introduced indicates that the tax authorities recognised the asymmetry between the tax treatment and the economic reality. Unfortunately, the relief provisions were only available where a qualifying group of companies restructured its affairs within a limited period (between 17 June 1988 and 30 June 1991) provided certain specified requirements were met (South Africa, 1988). It is submitted that these relief provisions were the first statutes enacted which acknowledged economic unity within groups in South Africa, albeit only partially and for a limited period.

It was in terms of these relief provisions that Wooltru Property Holdings, in *CSARS v Wooltru Property Holdings (Pty) Ltd.*, received certain leasehold rights tax free, as part of a

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12 For example, Australia in 2002, Japan in 2002, Malaysia in 2008, South Korea in 2010 and Italy in 2014.

13 South Africa did, however, introduce separate provisions to allow for tax-free intragroup asset transfers, one of the objectives of a formal group tax system. These provisions introduced in 2001, known as the corporate restructuring rules, apply only in limited situations.

14 Section 48 of the Taxation Laws Amendment Act, 87 of 1988.

rationalisation process.[15] In terms of the provisions, the Commissioner had to allow the submission of a consolidated return by the group as "taxpayer" in order for the restructuring transaction to occur tax-free. After the rationalisation agreement was completed, the subsidiaries were again taxed in their own right. Unfortunately, for the Commissioner, the subsidiaries could therefore not be held liable for any recoupment when the parent company eventually sold the property rights to an outside party. It is suggested that the negative outcome for the Commissioner could have been avoided if a formal group tax system, whereby all intragroup transactions are eliminated, had been in place. A formal group tax regime involves the treatment of the group as one economic unit.

In 1995, the implementation of a formal group tax regime was recommended by the Katz Commission as a matter of urgency (South Africa, 1995:96). Although the recommendations of the Katz Commission were accepted in principle (Joint Standing Committee on Finance, 1996:25), the Department of Finance only once referred to a group tax system after 1995. In his 1996 Budget Speech, the then Minister of Finance[16] indicated that a simplified group tax regime, in line with the recommendation by the Katz Commission, would be introduced. The Minster, however, suggested in his speech that such a group tax regime would impose a severe strain on the tax administration at that stage and should be "held in abeyance until the South African Revenue Service (SARS)[17] is fully operational" (Department of Finance, 1996). Since 1996, government has become silent on the subject of group taxation.

In 2001, a new set of rules that recognises the group as economic unit, the "corporate restructuring rules", were introduced into the Income Tax Act.[18] The corporate restructuring rules were introduced to provide some relief to groups in the case of restructuring transactions. The intention was to provide tax relief to groups in South Africa

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15 Specifically, an *in specie* liquidation distribution, allowing the group of property-owning companies to restructure, which qualified as a rationalisation process in terms of section 48 of the Taxation Laws Amendment Act, 87 of 1988.

16 Mr. CF Liebenberg.

17 The SARS (South African Revenue Service) is the government department dealing with South African tax administration. SARS was founded in terms of the South African Revenue Service Act, 34 of 1997, as a sovereign organisation, in charge of managing the South African tax system and customs service (SARS, 2016).

18 The corporate restructuring rules are contained in sections 42 to 47 of the Income Tax Act, 58 of 1962, and provide only partial relief to groups in the case of mergers, intragroup transfers, unbundling deals and liquidations.

that is identical to the relief measures offered by international tax systems when restructuring transactions are undertaken and, therefore, adhere to competitiveness as a policy objective (National Treasury 2001:6; Parliamentary Monitoring Group, 2001).

In general, the corporate restructuring rules are grounded in the notion that if the corporate group or the shareholders have maintained a significant interest in the asset disposed of, it is acceptable to permit the tax-free transferral of assets to a body where they can be most effectively applied for commercial reasons (National Treasury, 2001:6). In terms of one of these corporate relief provisions,[19] a taxpayer (including a natural person) is permitted to transfer its assets to a company in exchange for shares in the recipient, without suffering any immediate tax liabilities.

It seems that the intention of the legislature with the introduction of the corporate restructuring rules, which was to provide tax relief to groups restructuring their affairs, was sound. Unfortunately, the numerous significant amendments to the Act indicate that problems have been experienced with the corporate restructuring rules since their introduction in 2001 (Croome, 2011; Cornelissen, 2009:64). Furthermore, since their introduction, these measures have often been used in tax avoidance schemes[20] (SAICA, 2009). The problems with the corporate restructuring regime were recently acknowledged by the Davis Tax Committee (2018:6), which recommended certain amendments to the corporate restructuring regime. The Davis Tax Committee (2018:8), however, recommended that a formal group tax system should not be implemented at this stage.

Only six unpublished master’s degree dissertations (Kannenberg, 1999; Middelmann, 2004; Cornelissen, 2009; Omar, 2009; Skalet, 2010; and Sprout, 2010[21]) and two accredited journal articles, have been undertaken to investigate group taxation in the South African context. In the first study published as an accredited journal article, Wilcocks

19 Section 42 of the Income Tax Act, 58 of 1962.

20 For example, section 45 of the corporate rules was used in debt push-down structures, as it allows for the tax-free movement of target company assets. Before being amended, section 45 was used to place assets in a location where substantial interest deductions could be claimed against operating target company income. Some taxpayers went even further to obtain a more beneficial structure (using section 45) by creating mismatches between interest deductions on one hand and exempt income on the other. Although these debt/share schemes existed outside the context of section 45, section 45 facilitated the use of these schemes. Section 45 had to be amended in 2011 to avoid these schemes (South Africa, 2011:8).

21 An unpublished technical report by Davids (2009) also investigated group taxation in South African context.

and Middelmann (2004) focus on the principles and matters of group taxation in a broad sense, rather than on the detailed design, which includes the structural elements of a group tax system in South Africa. Wilcocks and Middelmann (2004) did not investigate whether the relief measures provided by the corporate restructuring rules (introduced in 2001) provide a viable alternative to a formal group tax system.

In the second study published as an accredited journal article, three South African court cases[22], heard on the issue of economic unity, were analysed (Stack, Stiglingh & Koekemoer, 2015).[23] In their analysis of case law Stack, *et al*. found that there is an asymmetry between the tax treatment of corporate groups in the South African judicial system and the economic reality of corporate groups acting as single economic unit. Based on their analysis of case law, Stack *et al.* concluded that the solution to the problem requires a review of tax legislation and the introduction of an appropriate group tax system that adheres to the canons of equity, neutrality and flexibility. The study by Stack, *et al.* focused on case law. The suitability of the current[24] corporate restructuring regime as an ideal group tax system for South Africa was not evaluated. No specific group tax model was recommended and no framework or method to design a suitable South African group tax system was proposed.

The commissions of inquiry and the tax review committee, however, included lengthy discussions on the choice of a suitable group tax system for South Africa in their reports (Margo Commission, 1987:7-20; Katz Commission, 1995:96-111; Davis Tax Committee, 2018:65-85). It appears that the choice of specific group tax model was considered of the utmost importance by both commissions of inquiry and the tax review committee, yet to date, no detailed research on developing a framework or a method to design a formal group tax system within the South African context has been performed.

The present study intends to evaluate the taxation of groups of companies in South Africa, taking into account accepted principles of a good tax system. It proposes to develop a framework that can be used to design a suitable South African group tax system.

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22 The three court cases analysed in the study by Stack, *et al*.(2015:139-160) are CIR v Niko, 1940 (AD) 416 (11 SATC 124), CSARS v Wooltru Property Holdings (Pty) Ltd., 2008, 70 SATC 223 and Ackermans Ltd. v CSARS, 2010, 73 SATC 1.

23 This study was published as a journal article in the South African Business Review, Volume 19(1) in 2015, namely, CIR v Niko: A Question of Economic Reality by Stack, Stiglingh & Koekemoer.

24 Current up and until December 2018.

Ultimately, this study is performed with the main objective to propose an appropriate group tax system in South Africa.

1.3 RESEARCH OBJECTIVES

The aim of this study is to recommend an appropriate group tax regime for South Africa.

In order to propose a group tax system for South Africa, it is necessary to:

- explore international best practice by comparing formal group tax systems employed in comparable tax jurisdictions;
- analyse the policy objectives of countries or country groups that considered introducing formal group tax regimes, by identifying the relevant policy objectives and by evaluating these policy objectives against established principles of a good tax system;
- evaluate the suitability of the current corporate restructuring regime as an ideal group tax system for South Africa;
- examine a basic framework of international group tax systems developed according to their design in order to identify feasible options for designing a group tax system for the South African situation;
- identify and analyse the structural elements in respect of feasible design options identified previously; and
- align the structural elements to the South African context, taking into account South Africa's policy objectives, in order to determine the design options that could be used in the development of a formal group tax system for South Africa.

1.4 SCOPE

This study focuses on an appropriate group tax system for income tax purposes, and therefore excludes value-added tax and taxes other than income tax. This study will be limited to groups of companies under the common control of a single parent company and not include other independent legal entities. This is because most formal group tax systems only provide for companies to form part of the group (Oestreicher, Spengel & Koch, 2011:8) and because, as noted at the outset of this chapter, corporate groups are major influences in the economic world today (Anderson, 2008:3). This thesis is current as at 31 December 2018.

1.5 SUMMARY AND STRUCTURE

This study aims to recommend an appropriate group tax system for South Africa.

Chapter 1 has laid the basis for this study by providing the context and background of the study. The chapter commences with a brief history of companies, corporate groups and tax developments relating to corporate groups. The chapter concludes by addressing the specific research objectives in order to achieve the purpose of this study.

In Chapter 2, the research methodology and design applied in the present study are explained. The research design is applied to ensure that appropriate research methods are followed to achieve the research objectives as set out in this chapter and to ensure the validity of the results.

In Chapter 3, a comparative analysis of the formal group tax systems that apply internationally in comparable tax jurisdictions is performed in order to identify the group tax regime that is perceived to represent best practice in a South African context.

An appropriate group tax system not only needs to be in line with South Africa's policy objectives, but also needs to be in line with the recognised principles of a good tax system. In Chapter 4, the policy objectives are identified that have been taken into account by countries or country groups that have had to decide on whether to introduce a formal group tax system.

In Chapter 5, the suitability of the current corporate restructuring regime in South Africa as an appropriate group tax system for South Africa in the economic environment of the 21st century is evaluated.

In Chapter 6, a basic theoretical framework of group tax systems, worldwide, is considered according to their design in order to gain an understanding of where the different international group tax systems fit into this framework, and to identify the design options available when designing a group tax system for South Africa.

In Chapter 7, the structural elements underlying the main design options identified in Chapter 6 are analysed in detail. The influence of the policy objectives on these structural elements, which are essential to consider when contemplating a formal group tax regime (as identified in Chapter 4), are also explored.

Chapter 8 suggests an optimal set of group tax provisions that might be adopted in South Africa. Different design options are contemplated for each of the structural elements identified. Thereafter, the viability of the different design options for the South African situation is considered and the relevant policy objectives are reflected on. At the end of the chapter, the most suitable option for each structural element in a South African group tax situation is suggested.

The final chapter of this study (Chapter 9) concludes the study by recommending an appropriate group tax regime for South Africa.

CHAPTER 2: RESEARCH METHODOLOGY AND DESIGN

2.1 INTRODUCTION

The aim of this chapter is to describe the research methodology and design applied in the present study. The research design described in this chapter is applied to ensure that appropriate research methods are followed to achieve the research objectives as set out in Chapter 1 and to ensure the validity of the results. The main objective of this study is to recommend an appropriate group tax regime for South Africa. The study is in the field of taxation, and more specifically tax policy, as it seeks to build knowledge regarding the taxation of corporate groups, the policy considerations underpinning group tax systems, the main design options when developing group tax systems, and the structural elements of a group tax system. The study endeavours to provide the legislator with a framework that could be used in developing a South African group tax regime, reflecting South African tax policy objectives and the unique South African circumstances. In pursuit of the main research objective, the research design is applied within a certain research paradigm and research methodology that will be discussed first, before explaining the research process.

2.2 RESEARCH PARADIGM AND RESEARCH METHODOLOGY

The research paradigm refers to the belief system that guides the researcher's actions and affects how the research is performed (Stack, 2012:9). The research paradigm is therefore a framework for observing and understanding what is to be known (the truth). As a set comprising a belief system, the research paradigm is based on certain ontological, epistemological and methodological assumptions (Stack, 2012:9).

Ontology is how the researcher views the truth (what can be known), in other words his or her "world view". Epistemology refers to how the researcher believes that knowledge is created (McKerchar, 2008:6). Epistemology is influenced by the way in which the researcher relates to the truth, which can be subjective or objective (Stack, 2012:11). The ontology and the epistemology viewpoints determine how the tools of research (the methods) are deployed in order for the researcher to find out what can be known. In designing the research, the researcher needs to identify the ontology and the epistemology in order to choose suitable methods to carry out the research (the methodology) (Stack, 2012:11).

Although the researcher's belief system set can influence the chosen research paradigm, the researcher should work within the most suitable paradigm, given the specific research question (McKerchar, 2008:7). Research can be carried out within a wide array of possible research paradigms, such as positivism, interpretivism, post-positivism and critical realism. In the subject of taxation, which falls into the legal research field, reality is based on legal systems that are constructed socially. Legal or tax research, therefore, falls within the social and human sciences. Four different research paradigms are now discussed within a social science context: positivism, interpretivism, post-positivism and critical realism.

Positivism assumes an objective reality that exists outside personal experiences. The positivist believes that truth is out there to be discovered, studied and understood, and that it is possible for the researcher to maintain a neutral, objective and detached position (Babbie & Mouton, 2009:23). Although the positivist approach is most used in natural sciences, reality can also be applied within the social sciences as people are assumed to act rationally. According to McKerchar (2008:7), the knowledge constructed from a positivist paradigm is based on deductive reasoning, as the purpose of the positivist is to seek generalisation. The researcher normally uses a precise and structured process to identify cause-and-effect relationships, to draw logical conclusions, and to make predictions (McKerchar; 2008:7). It is clear that quantitative and empirical methods fit into this paradigm – methods using direct or indirect observation. Positivism presents some shortcomings. According to Babbie (2010:41), people do not always act rationally as assumed by positivists. Another weakness of this paradigm is that, to a certain extent, everyone thinks and interprets subjectively and it is therefore impossible to maintain an entirely objective position (Babbie; 2010:42).

Positivism adopts the following assumptions:

- Ontology: Reality is stable and external. It is "out there", and is rational and observable – "law-like" (Stack, 2012:10).

- Epistemology: The truth can be discovered by an impartial, distant observer (Stack, 2012:10).

- Methods: In line with its ontology and epistemology, precise and structured methods are used by positivists to identify cause-and-effect relationships, to draw logical conclusions and to make predictions. This approach involves mostly quantitative methods, but can include qualitative methods like surveys, case studies and content analysis.

Interpretivism, also called anti-positivism, assumes a subjective reality with the goal to understand and interpret people, happenings, incidents and social constructions, including what these phenomena mean to people (Babbie & Mouton, 2009:28, 37). Interpretivism assumes that the researcher is subjective and cannot be separated from the subjects being studied. It offers comprehension for the social truth based on the researcher's subjective interpretation of reality. Interpretivism is often criticised for being too subjective and placing too much emphasis on human opinions while ignoring broader trends (Neuman, 2011:108).

Interpretivism adopts the following assumptions:

- Ontology: Reality is a concept created by the human mind, shaped through shared cultural and social habits, as well as a common belief system, and, therefore, several realities exist (Stack, 2012:10).

- Epistemology: Observer closeness to the subject may affect what is observed and it is, therefore, not necessarily objective (Stack, 2012:10).

- Methods: Methods are adopted that lead to comprehension, as well as methods that lead to identifying research questions or theories. Involves mostly qualitative methods like discourse analysis and grounded theory.

Previously, interpretivism was considered the opposite of positivism (Neuman, 2011:94). However, since the 1970s, it has been acknowledged that interpretivism and positivism can be considered the extremes on a continuum with other paradigms, like post-positivism and critical realism, covering the middle ground (McKerchar, 2008:7). It is submitted that both post-positivism and critical realism fall within the realism paradigm.

Realism shares viewpoints from both positivism and interpretivism. The realist asserts that the truth exists independently of human awareness and behaviour. To gain an understanding of the truth, however, the researcher has to understand people, their behaviour and their subjectivity. Realism assumes that the truth lies beyond the control of people (at macro level), although it affects and influences people (Saunders, Lewis & Thornhill, 2009:114). Because people share similar interpretations, people's subjective interpretations of the truth (at micro level) can assist in fully understanding the truth. Realism requires that the researcher should identify the external reality and then investigate how humans interpret and react to the reality to understand the truth in its entirety (Saunders *et al.*, 2009:114).

Post-positivism, which also adheres to realism, developed because of a growing discontent with the disadvantages of the pure positivist paradigm. Post-positivism, an extension of positivism, assumes that the reality is "out there" but can never be fully captured and understood – it can only be approximated (De Vos, Strydom, Fouché & Delport, 2011:7). The focus is on understanding "why" people or structures operate in the way they do, instead of "how" (McGregor & Murnane, 2010:419). The objectives are to seek patterns and commonalities, discover underlying structures, reveal beliefs, describe realities, and uncover principles and correlations, with an overall intent of finding meaning in social contexts rather than general laws (McGregor & Murnane, 2010:419). The researcher is part of the research process, rather than isolated from it. The emphasis is on the verification of the truth, and the post-positivist relies on several methods for attaining as much of the truth as possible (Denzin & Lincoln, 2011:8).

Post-positivism adopts the following assumptions:

- Ontology: The post-positivist believes that the researcher can never fully capture the truth – instead, the focus is on having certainty and confidence.

- Epistemology: There are many ways of knowing, aside from the "scientific method". Social reality (knowledge constructed by humans) is relative to the observer and can be discovered through interpretation.

- Methods: Under this paradigm, the researcher is allowed to use more subjective methods, which include qualitative methods, such as interpretive inquiry and content analysis that seek meaning and interpretation (McGregor & Murnane, 2010:419).

In the social sciences, the most prominent manifestation of realism is in critical realism (Maxwell, 2012:4). Critical realism pursues answers to ‘how’ and ‘why’ questions, with the objective of not only to understand, but also to criticise and transform (McKerchar, 2008:8). In terms of the critical approach, the truth is continuously influenced by social, political and cultural factors (Neuman, 2011:109). Researchers applying the critical realism approach would normally allow the research design to be guided by what the researcher wants to learn, rather than to be preordained (McKerchar, 2008:8). According to Neuman (2011:101), all researchers in the critical paradigm commence with a particular viewpoint, and to deny this viewpoint is in itself a point of view.

Critical realism adopts the following assumptions:

- Ontology: Truth is a socially constructed reality that is continuously affected by social, political and cultural factors (Neuman, 2011:109).

- Epistemology: The observer is objective but takes into account the subjectivity of human beliefs and behaviour.

- Methodology: Methods are adopted that lead to understanding the ‘how’ and the ‘why’ questions, as well as to evaluate, criticise and recommend change. Mixed methods are normally used (McKerchar, 2008:8). Qualitative methods include action research, critical analysis and reflective phenomenology.

Several research paradigms can be applied within the field of taxation, from those of the positivist to the interpretivist, including paradigms that can be plotted between these extremes (McKerchar, 2008:8). McKerchar (2008:7-8) is of the opinion that legal research could be positivist (based on an external truth) or interpretivist (based on social construct), or alternatively, it could fit between the two extremes of positivism and interpretivism. Here, a paradigm like that of the critical realist or the post-positivist may well offer a more appropriate fit for tax researchers. Babbie (2010:43-44) explains that the researcher should be careful to fully negate a specific paradigm, because one paradigm often compensates for another and that the different paradigms can be applied in different situations.

Following the above discussions, the assumptions underlying this study have footprints of positivism and interpretivism (falling into the middle ground) as well as critical realism, but the study mainly manifests the assumptions of the post-positivist paradigm. In order to gain an understanding of group tax models that are applied internationally, the post-positivist paradigm is applied. By using qualitative methods like a comparative analysis, an understanding of international group tax models is obtained. The underlying elements of international group tax systems are also identified using a post-positivist approach. An evaluation of the current group tax regime in South Africa is performed by taking the position of a critical realist. Current legislation relating to corporate groups and the history of corporate group tax in South Africa are investigated, and “how” and “why” questions are asked. This is done not only to understand, but also to evaluate, to criticise and to recommend changes. The researcher accepts that reality continuously changes, depending on external factors. In the South African context, the research design is driven by what the researcher wants to learn, which is typical of the critical realism paradigm. Apart from interpreting tax legislation, the opinions of experts are also analysed and interpreted in an attempt to discover the entire reality. Ultimately, the current situation surrounding group tax in South Africa is evaluated and assessed with the aim of recommending a more appropriate regime.

In order to achieve the main objective of this study (to recommend an appropriate group tax system and develop a framework of a group tax system for South Africa), the position of the post-positivist, leaning slightly towards the positivist side, is assumed. Four group tax models (three pooling models and one loss-transfer model) are used as case studies. These group tax models are compared to test and examine the realities discovered in the first part of the study (Chapters 3 to 6). By following a deductive reasoning process, the research follows a structured method to identify cause-and-effect relationships, to draw logic conclusions and to make predictions in order to propose a suitable group tax system for South Africa.

According to McKerchar (2008:18), the legal research paradigm is rather vague and legal research has fallen a bit behind when it comes to research paradigms. McKerchar (2008:8) suggests an alternative view with legal research as a different paradigm altogether – a paradigm that lies outside the standard continuum discussed up to now. The Arthurs Report (1983) identified two types of legal research, doctrinal research and interdisciplinary (non-doctrinal) research. Doctrinal research is an investigation into the legal principles, rules and doctrines through an analysis of legislation and case law. Interdisciplinary or non-doctrinal research investigates the relationship of law with other behavioural sciences. In simple terms, non-doctrinal research is research 'about law' and doctrinal research is research 'in law'. The Arthurs Report (1983) identified a research structure in the form of a matrix (set out below) that legal researchers could use when conducting tax research.

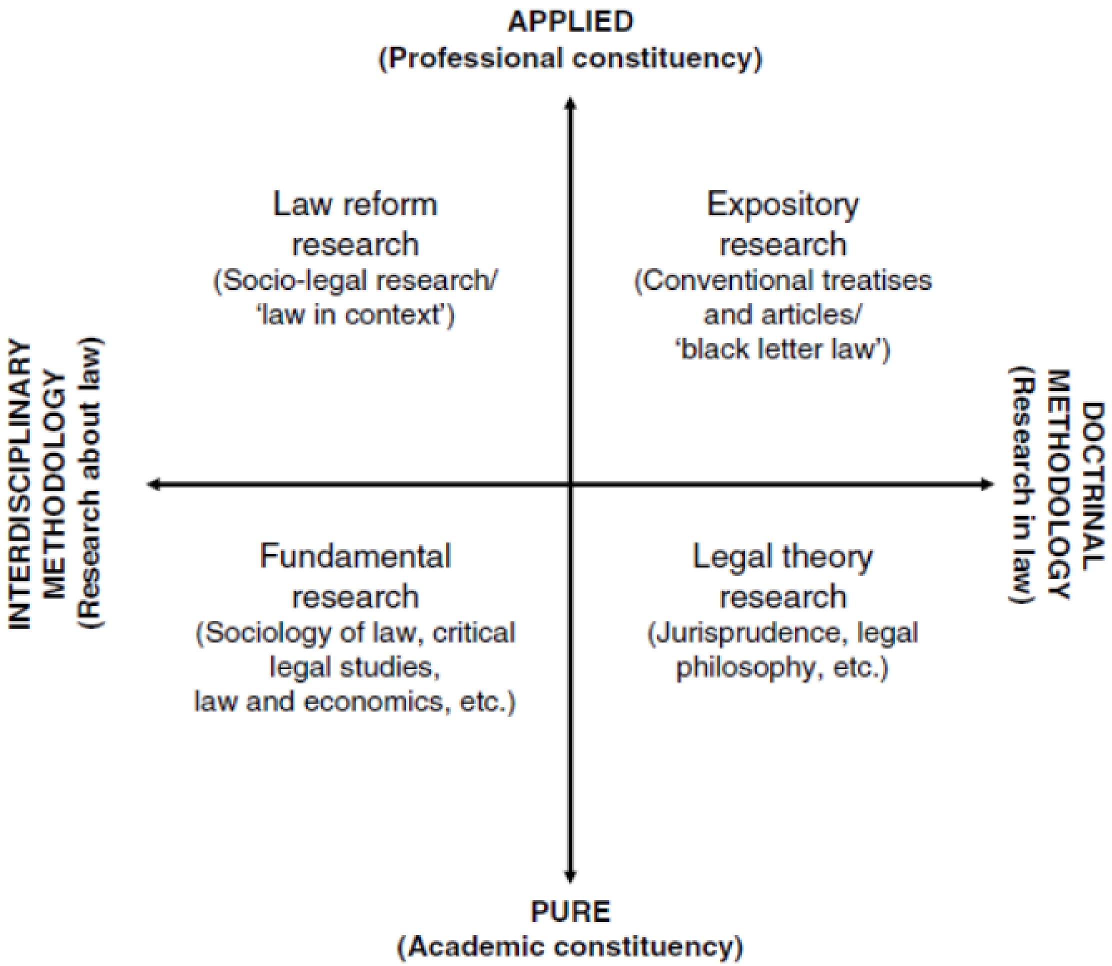

Figure 2.1: Legal research framework

(Arthurs, 1983)

The research methodology applied in this study can be described as a doctrinal research methodology, as it represents research *in law*. McKerchar (2008:18) describes doctrinal research as an established methodology that presents an orderly description of the rules directing a particular legal group. Doctrinal research requires an examination of the interactions among the rules; it clarifies matters of complexity, and is entirely based on textual documents. In the present study, the legal rules relating to corporate groups are analysed and the interaction among the rules are set out. The study furthermore attempts to clarify complex matters relating to the taxation of corporate groups.

Doctrinal research can take in a pure or applied orientation (Chynoweth, 2008:28-35). Whereas pure research is practically the same as theoretical research, applied research is the equivalent of practical research or expository research. In applying the doctrinal research methodologies, both the pure and applied orientations can be used in the same study. In theoretical research, the emphasis is on a more comprehensive perception of the theoretical foundation of rules and of the collective consequences of a series of laws and practices that affect a specific topic (Stack, 2012:16). By creating an understanding of international “best practice” in relation to corporate group tax systems in Chapter 3, a theoretical basis is established on which the remainder of the study is built. Formal group tax systems employed internationally are explored in detail in order to gain an understanding of the workings of these group tax regimes and the principles underlying these group tax systems. Immediately thereafter, also in Chapter 3, the theory is applied. The comparative analysis of international group tax systems in Chapter 3 is an application of the doctrinal research methodology. The legal regimes of different jurisdictions are compared in comparative law, which also falls into the doctrinal research methodology (Stack, 2012:17). In Chapter 3, the legal rules relating to group tax systems in countries economically important to South Africa are analysed and compared to identify the underlying similarities and differences between these different group tax regimes.

This pattern of first determining a theoretical foundation of rules and then applying the theoretical basis is repeated in this study. In Chapter 4, the policy objectives that have been taken into account by countries that have introduced formal group tax systems are identified and analysed. These policy objectives are then used to constitute a theoretical basis for evaluating the suitability of the current corporate restructuring regime as an ideal group tax system for South Africa in Chapter 5, and then to suggest a suitable group tax regime in the last part of the study. In Chapter 6 of this study, a basic framework of international group tax systems, developed according to their design, is examined in order to identify feasible options for designing a group tax system for the South African situation. This framework is then applied in the rest of the study in order to suggest a South African group tax design.

Reform-oriented research that evaluates the suitability of current rules and suggests changes where existing rules are found to be inadequate is also included within the doctrinal research methodology (Stack, 2012:17). In this study, the current group tax regime in South Africa and statutes relating to groups are criticised and evaluated. Following an assessment of the existing rules, changes are recommended to any rules found wanting.

Regardless of the research paradigm that is assumed, it is important that the research should have a clear purpose and that there is strong alignment between the purpose of the research and its design (McKerchar, 2008:21). The design used in this study can be associated with both the post-positivist paradigm and the doctrinal legal research paradigm, and was designed to answer the purpose of the study.

2.3 THE RESEARCH PROCESS

The framework developed in the Arthurs Report (1983) does not link the legal research methodologies to the general qualitative research paradigm. Nonetheless, because law is a social science, any research approach adopted by legal researchers could be classified within the ambit of general qualitative research. Williams (1998) is of the opinion that the general qualitative research design can be combined with the legal research design. This study uses a qualitative research design. A qualitative research design includes research that is subjective and uses natural language arguments, instead of numbers and figures (Williams, 1998). The research process is set out in the following table.

Table 2.1: The Research Process

Research process elements	Method
Research design	General qualitative research design combined with legal research design
Unit of analysis and selection process	Documents were collected via searches on databases, using various search terms
Method of analysis	Critical analysis of content using logic reasoning
Qualitative rigor	Use of primary data sources, reference to multiple sources and detailed descriptions of the processes followed. The rules of legal interpretation were strictly followed.
Ethical considerations	Avoidance of plagiarism

(Own construct)

2.3.1 <u>The research design</u>

The design used in this study can be associated with both the post-positivist paradigm and the doctrinal research paradigm. A qualitative research design is used in this study. It combines the general qualitative research design with the legal research design. The legal research approach, which is more specific than the general qualitative research approach is, includes qualitative methods such as identifying, analysing and interpreting the relevant law (Stack, 2012:14). Legal interpretative methods are used in understanding and describing data (Babbie & Mouton: 2009:430). In this study, legal interpretative methods are used to understand, describe and reflect on the economic reality of transactions occurring within economic units and group tax systems implemented internationally.

A general qualitative research approach explains how certain concepts are used to construct reality within the context of systems, in this instance, tax systems. Emphasis is placed on analysing how such reality has already been constructed in existing legal systems dealing with current group tax models, to construct a model of the current reality, or at least of the structural elements it consists of. The actual reality is then compared with the model reality, which serves as a standard against which the actual current reality can be tested. In this study, the current corporate restructuring regime of South Africa is evaluated against the tax objectives of a good tax system, and against the objectives of an ideal group tax regime. The attributes of the actual reality that fall short of this benchmark are reconstructed, by means of proposed reforms, in a manner that brings them closer to the ideal construction of reality, based upon the underlying principles of tax law that had been identified. Where the current corporate restructuring regime falls short, an appropriate group tax regime is proposed, based on the structural elements underlying international group tax regimes. The proposed regime should address the shortfalls of the current regime.

2.3.2 The unit of analysis and the selection process

This study was based entirely on a qualitative method that involves the analyses and interpretation of documentary data. This study is solely based on textual documents. The research is performed to gain a complete understanding of the key features underlying international groups and how the different group tax designs impact on the options elected by lawmakers in respect of each key feature when designing group tax regimes.

In order to analyse the taxation of corporate groups, the tax policy objectives considered by jurisdictions, international group tax systems, taxation principles, the single enterprise principle, South African tax legislation relating to corporate groups and information relating to the structural elements, and extracts from the following documentary data were analysed and interpreted:

- primary sources, particularly income tax legislation, the explanatory memoranda accompanying the income tax amendment bills, relevant case law, policy documents, reports, and interpretation notes, regulations and guides by tax authorities and governments on the topic; and
- secondary sources, including articles in accredited journals, textbooks and other writings of experts in the field.

To collect data, a systematic search was conducted on relevant academic databases throughout the years to collect documents by prominent institutions and authors. A search for grey literature was also conducted by searching resources such as Google. The reference lists of data collected were also examined in order to identify additional resources.

2.3.3 Method of analysis

In performing doctrinal research, the research methodology comprises the use of either inductive or deductive logic to provide an accurate analysis of the principles of the specific area of law relating to the research question. In the present study, the research was conducted in the form of a natural language argument, supported by documentary proof, using mainly deductive reasoning.

2.3.4 Qualitative rigour

In order for qualitative research to be trustworthy, a researcher must show that the research adheres to the following criteria: validity, reliability, confirmability and transferability (Babbie & Mouton, 2009). In the present study, the researcher adhered to these criteria by

- continuously validating the data collected for potential bias, neglect or lack of precision (data were drawn from a wide range of material – books, accredited articles, legislation, government domains and other credible domains, across several disciplines – taxation, economics and law, and several jurisdictions – the United States, the Netherlands, Australia and the United Kingdom, amongst others, to ensure that the various items of data are valid);
- referring to different sources in promoting reliability and confirmability (almost 250 credible references were used in this study, with the most recent sources being used, and references were compared and verified to ensure reliability);

- using primary data sources as often as possible (legislation and case law were used to interpret legislation and to confirm statements by experts); and

- providing detailed descriptions of the processes followed to ensure transferability (Thorough descriptions were provided of the processes followed to ensure the results can be transferred, for example, in the identification of group tax models applied in comparable jurisdictions economically important to South Africa in Chapter 3, the identification of the policy considerations underpinning group tax systems in Chapter 4, and the identification of the structural elements in Chapter 7).

The post-positivist approach strives for trustworthiness and credibility. The trustworthiness of the study and its findings were further enhanced by following the rules of legal interpretation as recognised in terms of statutes and common law. This entails putting more emphasis on primary data, such as statutes and case law that creates legal precedent, deliberating contrasting perspectives, and concluding based on a preponderance of credible evidence, the rigour of the arguments and the written opinions of acknowledged experts in the field.

2.3.5 <u>Ethical considerations</u>

All the data used for the purpose of the research are publicly available and no ethical considerations arise in relation to their use. This study was submitted for ethical clearance. Ethical clearance was granted, and no ethical issues were identified regarding the research conducted. All sources were fully and accurately referenced.

2.4 CONCLUSION

Several research paradigms along the continuum can be applied within the field of taxation, from the positivist pole to the interpretivist pole, including middle-ground paradigms like critical realism and the post-positivist paradigm. No one paradigm is necessarily better than another is, as each possesses strengths and weaknesses. Different paradigms are, however, capable of answering different kinds of research questions. While the assumptions underlying the present study have footprints of interpretivism, positivism and critical realism, this study mainly manifests the assumptions of the post-positivist paradigm. An alternative viewpoint is to regard legal research as a different paradigm altogether, existing outside the traditional research paradigm continuum. The Arthurs Report (1983) identified two types of legal research, doctrinal research and interdisciplinary (non-doctrinal) research. The research methodology applied in the present study can be described as a doctrinal research methodology as it represents research in law. In this study, a pure or theoretical orientation is employed in the earlier chapters to gain an understanding of the legal rules and principles of group tax systems. This is followed by an applied orientation where the legal rules currently used in South Africa are evaluated and recommendations for change suggested in the form of a proposed group tax system for South Africa. A reform-oriented research approach, which evaluates the adequacy of existing rules and recommends changes, is also included within the doctrinal research methodology and applied in this study.

Regardless of the research paradigm that is assumed, it is important that the research should have a clear purpose and that there is strong alignment between the purpose of the research and its design. The design used in this study can be associated with both the post-positivist paradigm and the doctrinal legal research paradigm but, most importantly, it was designed to answer the purpose of the study.

In the present study, a qualitative research design is used. It combines the general qualitative research design with the legal research design. Legal interpretative methods are used to understand, describe and reflect on the economic reality of transactions occurring within economic units and group tax systems implemented internationally. A general qualitative research approach is used to explain how certain concepts are used to construct reality within current group tax models, in other words, to construct an ideal or model reality. The actual reality of the South African system is then compared with the model reality. Where the current regime falls short, an appropriate group tax regime is proposed, based on the structural elements underlying international group tax regimes which meet recognised tax principles. The proposed regime should address any shortfalls of the current regime.

Before considering any shortfalls of the current regime and proposing an appropriate group tax system for South Africa, international best practice concerning corporate group tax systems needs to be investigated. This will be done in the next chapter.

CHAPTER 3: BEST PRACTICE CONCERNING FORMAL GROUP TAX SYSTEMS

3.1 INTRODUCTION

When considering an appropriate group tax system for South Africa, it is important to first understand international best practice in relation to corporate group tax systems. In this chapter, the different models of group tax systems employed internationally are analysed in order to determine the group tax model that is perceived to represent best practice. Thereafter, formal group tax systems that are employed in comparable tax jurisdictions which have economic ties to South Africa are compared in order to identify the group tax regime that is perceived to represent best practice in a South African context.

“Best practice” refers to a method or model that is officially accepted as being the best to use in particular field, usually prescribed formally and in detail (*Cambridge Online Dictionary*, 2016). According to the *Oxford Online Dictionary* (2016), best practice is defined as “commercial or professional procedures that are accepted or prescribed as being correct or most effective”. The interpretation of the term "best" can be very subjective, as the best practice in one jurisdiction does not necessarily mean the best practice in another. According to Kusserow (2012), best practice is a method that, through experience and evaluation, has proven to lead to an optimal result. The aim is to explore formal group tax systems employed internationally to gain an understanding of the workings of these group tax regimes and to compare the underlying similarities and differences between these different group tax regimes in order to understand best practice concerning corporate group taxation.

3.2 DEFINING A FORMAL GROUP TAX SYSTEM

According to the International Fiscal Association (2004:31) and the European Commission[25] (2006:§14), group taxation is based on the principle that each group constitutes an economic unit and should therefore be dealt with as a single enterprise. It was agreed at the 2004 International Fiscal Association conference (Masui, 2004:31) that a "group tax regime" refers to the *rules* that enable a group to compute its tax liability on a consolidated or combined basis. In order to qualify as a group tax regime, the rules must recognise the fact that the group operates as a single economic unit or enterprise. There are two objectives that the ideal group tax regime aims to achieve: firstly, the system must provide for the tax-free transfer of assets between the companies within a group, and secondly, the system must allow for set-off profits and losses within the companies in a group. "These two issues are central to the taxation of corporate groups" and indicate that a tax system recognises the group as a single enterprise (Masui, 2004:31; Ting, 2013b:32, 39).

The first objective (tax-free transfer of assets between group companies) presupposes that where capital assets that have appreciated in value are sold or transferred between group members in normal group transactions, taxation on the profit is deferred until the assets are disposed of to third parties outside the group (Masui, 2004:32).

The second objective (setting off profits and losses within the group) presupposes that where there is a profitable member and a loss-making member in one group, corporate tax rules in that jurisdiction allow the offset of the profitable member's profits against the losses of the loss-making member (Masui, 2004:31). There are various types of group tax regimes that meet either one or both of these objectives and therefore recognise the group as a single enterprise. It appears that these two objectives that are central to group tax systems can be considered the ideal objectives or functions that a group tax system can achieve but cannot be considered to be requirements of a group tax system (Ting, 2013b:38).[26] The conclusion can therefore be drawn that any set of rules that enables a group to compute its tax liability on a consolidated or combined basis and that contributes

25 The European Commission furthers the interests of the European Union by recommending and implementing legislation, as well as introducing policies. It consists of a group of Commissioners, one appointed by each European Union member country (European Commission, 2012:3-38).

26 Ting (2013b:38) adds that the objectives must be achieved without the need for a corporate restructure.

to economic unity by meeting either of these objectives, can be considered a group tax system.

During the 2004 International Fiscal Association Conference, 30 countries reported on their group tax regimes (20 of these 30 countries indicated that they had a group tax system in place, and ten countries indicated that they were considering the introduction of group tax regimes) (Masui, 2004:25). According to the 2004 International Fiscal Association Report on Group Taxation, more countries have group taxation rules providing for the offset of losses than for tax-free intragroup asset transfers (Masui, 2004:31). However, countries often enact separate statutes in order to provide for tax relief on intragroup asset transfers, thereby ensuring that both objectives are achieved, albeit in a more fragmented manner (Masui, 2004:33). Masui (2004:33) reports that taxpayers often resort to tax planning techniques in jurisdictions where only one of the objectives is provided for, and even more so in jurisdictions where neither of the objectives is provided for. From the survey carried out by the International Fiscal Association in 2004, Table 3.1 was drawn up in order to summarise how these two objectives are achieved. The table has been adapted and is current as at 31 December 2018.

Table 3.1: Group tax objectives comparison

Jurisdiction	Setting off profits and losses between group members	Tax-free intragroup transfer of assets
Argentina	No	No
Belgium	No	No
Canada	No	No
Czech Republic	No	No
Hungary	No	No
Peru	No	No
South Africa	No	No
Switzerland	No	No
Uruguay	No	No
India	No	Yes*
Austria	Yes	No
Denmark	Yes	No
Finland	Yes	No
Germany	Yes	No
Luxembourg	Yes	No
Mexico	Yes	No
Portugal	Yes	No
Singapore	Yes	No
Norway	Yes	Yes*
Sweden	Yes	Yes*
United Kingdom	Yes	Yes*
France	Yes	Yes#
Italy	Yes	Yes#
Japan	Yes	Yes#
Korea (South Korea)	Yes	Yes#
New Zealand	Yes	Yes#
Spain	Yes	Yes#
USA	Yes	Yes#
Australia	Yes	Yes
Netherlands	Yes	Yes

(Adapted from Masui, 2004:32; Footnotes added)

* Separate statutes provide for the deferral of gains on intragroup transfers of assets.

Although part of its group tax system, the deferral of gains on intragroup transfers of assets is limited.

From Table 3.1 above, it is clear that the two objectives are independent of each other. Both objectives can, however, be dealt with in a single regime, like those of the Netherlands and Australia. In fact, the group tax regimes of the Netherlands and Australia are the only group tax models that fully achieve both objectives through a single regime. In all other jurisdictions where both objectives are achieved, either two separate regimes are enacted or the objectives are only achieved on a limited basis.

According to Table 3.1, some countries (Argentina, Belgium,[27] Canada, the Czech Republic, Hungary, Peru, South Africa, Switzerland and Uruguay) have no group taxation regime and completely ignore the group tax concept. The domestic tax laws of these countries do not differentiate between a single company and a company that is part of a national or international group. Accordingly, no specific group taxation regime is provided for and taxable income is determined separately for each legal entity; each entity is therefore taxed as an independent company (Princen & Gérard, 2008:175).

Technically, tax rules dealing with the reorganisation of companies also fall within the definition of group tax regimes, as the companies engaging in the reorganisation process are usually treated on a unitary basis by providing for the tax-free transfer of assets. As these reorganisation tax relief rules often apply on a once-off basis, they are considered to be informal group tax systems. According to Nikolakakis (2008:31), some jurisdictions use formal group tax systems to provide for the deferral of gains from intragroup asset transfers, while other jurisdictions provide more informal relief measures. An example of such a jurisdiction is India, where there is no formal group tax regime, but relief measures provide for the non-recognition of income and gains or losses between the transferor and transferee in the case of intragroup asset transfers during corporate restructuring. South Africa can also be placed in this category (Nikolakakis, 2008:31). Certain intragroup asset transfers between group companies can be undertaken in South Africa without any immediate capital gains tax or income tax implications.[28] Consequently, assets can be

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27 Belgium does not apply any tax consolidation mechanism with respect to corporate tax (PricewaterhouseCoopers, 2016b). Notwithstanding the absence of a tax group, the Belgian tax regime has a tax-friendly dispensation for cross-border reorganisations involving resident companies and the permanent establishment of non-resident companies. Since 11 December 2008, both purely Belgian and cross-border reorganisations are eligible for tax-neutrality. However, tax-neutral treatment is not permitted where one of the main aims of the transaction is to avoid or evade taxation (KPMG, 2014).

28 In terms of sections 42 to 47 of the Income Tax Act, 58 of 1962, provided that the requirements of the applicable section are met.

transferred tax-free between group members in terms of qualifying corporate restructuring transactions. Profits and losses on assets are only realised once the asset is sold to a third party outside of the group. Clearly, the tax-free transfer of assets between group members adheres to the single enterprise principle of group taxation, albeit in limited circumstances.

Formal group tax systems, on the other hand, refer to group tax regimes that deal with the corporate group operations *on an ongoing basis* in calculating the taxable result of the group operations.[29] Formal group tax regimes[30] include not only comprehensive consolidation systems like the Australian group tax regime, but also systems that enable the transfer of losses or profits between members of a group in a more fragmented manner, without full consolidation, such as the United Kingdom's loss-transfer system. Today, more than two-thirds[31] of OECD countries, and more than half[32] of the member states of the European Union, have some type of formal group tax regime (Canada Department of Finance, 2010:29; Oestreicher *et al*., 2011:8). For the purposes of this study, the term "formal group tax regime" will be used when referring to any group tax regime that calculates the taxable result of the group's operations on an ongoing basis (not as a corporate restructuring regime) and that meets at least one of the objectives of transferring assets tax-free between the group members or setting off profits and losses within the group.

3.3 THE TYPOLOGY[33] OF FORMAL GROUP TAX MODELS

From the International Fiscal Association's survey of formal group taxation regimes, it appears that the structural elements underlying international group tax regimes have been transplanted from one jurisdiction to another by policy makers. For example, the main

29 Some of these formal group tax systems also allow for tax-free corporate reorganisations.

30 The terms "group tax regime" and "consolidation regime" are often used interchangeably to describe a formal group tax regime. According to Davids (2009:3), amended and adapted terms are often used internationally to cover virtually all forms of formal group tax regimes.

31 South Korea seems to be the only member country of the 34 OECD member countries to have introduced a formal group tax system after 2010. No data indicating otherwise could be found.

32 In 17 of the 28 member states of the European Union, group tax regimes are in place (Oestreicher *et al*., 2011:8). After the finalisation of Brexit (23 June 2016), a referendum in which the citizens of Britain voted to exit the European Union, there will be only 27 member states left in the European Union.

33 Typology refers to a system used for putting things into groups according to how they are similar (refer to the simple definition of "typology") (*Merriam-Webster*, 2016).

source of inspiration for Luxembourg's 1981 fiscal unity regime was the French regime (Masui, 2004:29). It has become apparent that some regimes have distinctively similar features, and different "families" (models) of formal group tax systems with similar features have been identified, namely the *Organschaft* model, the loss-transfer model, the group contribution model, and the consolidation model (Masui, 2004:29).

Lang (2008:214-215) has differentiated between three categories of formal group taxation systems: consolidation systems, where all intragroup transactions are eliminated; group contribution systems, where subsidiaries pay certain tax deductible contributions to other subsidiaries or group members that have suffered losses; and loss transfer models, where losses are transferred from a group company incurring losses to a profitable group company, thereby offsetting losses against group profits. According to Lang (2008:214-215), the German *Organschaft* concept does not fit exactly into any one of these categories, but it demonstrates elements of a consolidation system, as well as of a group contribution system.

According to the International Fiscal Association report (Masui, 2004:29), there are numerous reasons why common elements of group tax regimes could have been transplanted. Firstly, language may have been the reason why Austria and Germany, both German-speaking regions, employed the *Organschaft* model. The second reason why similar group tax systems were found was the fact that tax policies tend to spread more easily among countries with similar legal environments. The elements of the loss transfer model were identified predominately in common law jurisdictions such as the United Kingdom (Masui, 2004:29). The third possible reason for similar group tax models was probably due to the close proximity of countries, their similar taxing structures, and the number of cross-border transactions between them. This was probably the reason why the third group tax model, the group contribution model, developed. This model was found to be employed by the Nordic countries, namely Sweden, Finland, and Norway (Masui, 2004:29). All other regimes are somewhat broadly classified into a fourth model, referred to as the "consolidation" model, although the consolidation model has variations and is found in many jurisdictions around the world (Masui, 2004:29). According to Masui (2004:29), it is "difficult to establish an exact "family tree" of the group tax regime around the world. Lines are hard to draw. Exceptions abound."

Nikolakakis (2008:30), on the other hand, is of the opinion that there are no consistent tendencies among jurisdictions with respect to formal group tax regimes. Although similarities can be identified, the specific practices take on a variety of forms and rely on different standards. Nikolakakis (2008:30) argues that the four different group tax "families" identified in the International Fiscal Association report actually refer to four different "approaches" to group taxation. Nikolakakis (2008:30) nonetheless differentiated between five "approaches" of formal group tax regimes, as he split the consolidation "approach" (consolidation model) into two: the full consolidation approaches and the partial consolidation approaches.

Because of the large number of countries that participated in their survey, the identification by the International Fiscal Association of four main models or families of group tax regimes is followed in this study. Each of the four models achieves at least one of the two objectives (tax-free intragroup asset transfers or the offset of losses) and is not limited to restructuring transactions only. Therefore, the term "formal group tax regimes" will be used in this study to refer to these four group tax models. The four different models of group tax systems identified by the International Fiscal Association in its survey of all the group taxation models employed by national states are the *Organschaft* model, the loss-transfer model, the group contribution model, and the consolidation model (Masui, 2004:29). These four formal group tax models will now be discussed in detail in order to present a viewpoint as to which one of the group tax models appears to represent best practice.

3.3.1 The Organschaft model

The *Organschaft* model is the most longstanding of all the group tax models. It is an artificial commercial concept created by the courts and has spread to the German-speaking states of Germany[34] and Austria[35] (Masui, 2004:29). The *Organschaft* model developed as a consequence of the German commercial "law of concern" that is based on the assumption that when a company is controlled by another company, the controlled company then undergoes an underlying structural change, as it is no longer managed as

34 Germany's *Organschaft* system requires a majority shareholding (>50%) that must be maintained from the start of the subsidiary's accounting period onward (PricewaterhouseCoopers LLP, 2006:226).

35 Austria abandoned the *Organschaft* model in 2004.

an independent entity (Sargent, 1985:327-358). The subsidiaries forming part of the corporate group are accepted as legally separate entities (organs), but at the same time, these "organs" contribute to and are part of a bigger organism, namely the group (Skalet, 2010:9). Therefore, instead of acting independently, they are now subordinated to the interests of the group (Jens, 1993:143-145).

The dependent subsidiary, being under the complete authority of the dominant or parent company, then has to pay over all of its profits to the parent company,[36] where the profits are consolidated at the level of the parent (Sargent, 1985:327-358). Despite having to pay over its profits, the subsidiary remains liable to tax, showing a profit of nil. In fact, the tax balance of a subsidiary will always show a profit of nil, even if it incurs a tax loss, because the parent also has to reimburse any loss of a subsidiary by making a tax-deductible payment to the subsidiary (Lang, 2008:215). This result, in terms of which all subsidiary profits are paid over to the parent company and subsidiary losses are reimbursed by the parent company, is achieved by way of an agreement concluded with the parent company, called a *Gewinnabführungsvertrag.*[37] According to the *Gewinnabführungsvertrag*, the subsidiaries agree to pay their profits to the parent for at least five years[38] (Lang, 2008:215). Pre-incorporation losses of subsidiaries, arising prior to the *Organschaft* arrangement, are frozen[39] and can only be used once the subsidiary exits the group, while a parent's pre-incorporation losses can be used without restrictions (Lang, 2008:215).

Because the *Organschaft* model does not allow for the elimination of intragroup transactions, no tax relief is granted on intragroup asset transfers (Masui, 2004:33). Figure 3.1 below illustrates the working of profit and loss pooling within the *Organschaft* group (Masui, 2004:20). By way of an agreement, the *Gewinnabführungsvertrag*, concluded with the parent company (P), the subsidiaries (S1 and S2) are committed to assign their profits (+300 of Subsidiary 1) and losses (-200 of Subsidiary 2) to the parent company for both tax and commercial purposes. Subsidiary 1 (S1) therefore pays over its profit of +300 to the parent company (P), and P is then taxed on the profit of 300. The parent company (P) then reimburses Subsidiary 2 (S2) with the loss of 200 incurred by the subsidiary and

36 This transfer of profits is not treated as a distribution of dividends (Ault & Arnold, 2010: 401).

37 A *Gewinnabführungsvertrag* is only applied in Germany. It was subject to harsh criticism in both Austria and Germany and was abolished in Austria in 2004.

38 In terms of paragraphs 14-19 of the *Körperschaftsteuergesetz* (Corporate Income Taxation Act).

39 Cannot be used while the *Organschaft* arrangement is in effect.

claims the 200 as a tax-deductible payment. The subsidiaries (S1 and S2) are considered to have incurred neither profits nor losses, with both showing profits of nil.

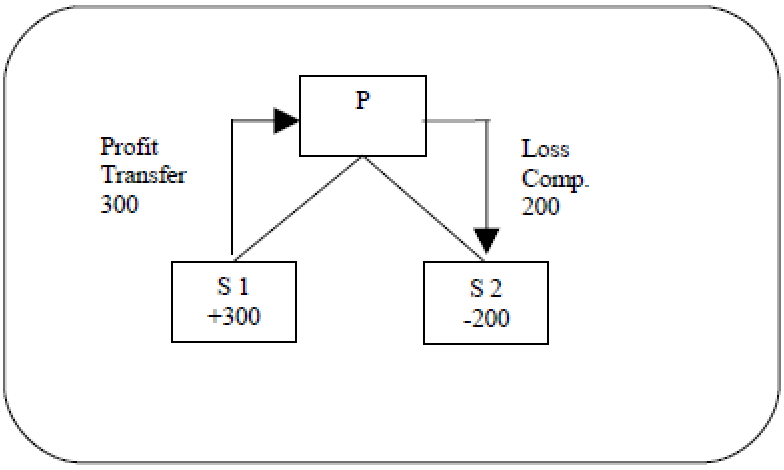

Figure 3.1: The Organschaft model

(International Fiscal Association, 2004:3)

The fact that the contract (*Gewinnabführungsvertrag*) is mandatory is often criticised as it means that the subsidiaries are obliged to pay all their profits to the parent, without eliminating intragroup profits. This is particularly unfair to the subsidiary's minority shareholders, as no dividends can be paid if no profits are left in the subsidiaries[40] (Lang, 2008:215-216). Two other criticisms of the *Organschaft* model are that this model does not allow for more than one group parent and that this model is restricted to domestic subsidiaries with their places of management in Germany and registered offices within the European Union or European Economic Area[41] (Deloitte, 2015:12-13; Lang, 2008:215-216). The *Organschaft* model is often viewed as a subset of the consolidation model (Masui, 2004:31). According to Lang (2008:214), the German concept of the *Organschaft* shows elements of a consolidation model, as well as of a group contribution model.

40 A majority shareholding of more than 50% is required. Dividend payments are normally made by the parent to minority shareholders to compensate them where the controlling company does not own all the share capital in the company (PricewaterhouseCoopers LLP, 2006:226).

41 The European Economic Area comprises the member countries of the European Union, including Iceland, Liechtenstein and Norway (Deloitte, 2015).

3.3.2 The group contribution model

The expression "formal transfer of profits" is used to describe the group contribution model whereby the profits of a group member (contribution) may be transferred to another group member, and as a consequence, the fiscal loss of the latter member may be utilised (Masui, 2004:29). Each group company is taxed separately. The actual transferral of profits is recorded in the financial statements, either by cash payment or being recorded against inter-company loan accounts, with the latter being the norm. The transferral of profits is not only permitted from the subsidiaries to their parent and vice versa, but also among the subsidiaries themselves.

According to the report by Masui (2004:29), in terms of the contribution model, each member company remains liable for submitting its own corporate tax return. Nikolakakis (2008:31) explains that each company determines its taxable profit or loss on a stand-alone basis, as if no group relationship exists. A profitmaking group member is allowed to create a tax-deductible payment (contribution) in favour of a lossmaking group member in order to utilise the loss of the latter (Nikolakakis, 2008:31). The tax-deductible payment (contribution) is limited to the business income of the profitmaking group member and no tax losses can be created. Contribution payments are not only used to utilise tax losses of a loss-making group member, but are also used for other purposes, for example to shift income between members in order to pay dividends.

The diagram that follows (see Figure 3.2) illustrates this model (Masui, 2004:20). The profit-making company, Subsidiary 1 (S1), can transfer ("contribute") some of its profit of +300 to a loss-making company, Subsidiary 2 (S2), which has a loss of -200. Subsidiary 1 (S1) contributes +200 of its profit to Subsidiary 2 (S2). The +200 is considered to be a tax-deductible payment for the contributing company, Subsidiary (S1), and can be deducted from its profits. Subsidiary 1 (S1) can offset the loss of -200 against its profit of +300 so as to be taxed on a reduced profit of +100 (+300 – 200 = +100), with Subsidiary 2 (S2) ending with a profit of nil (+200 – 200).

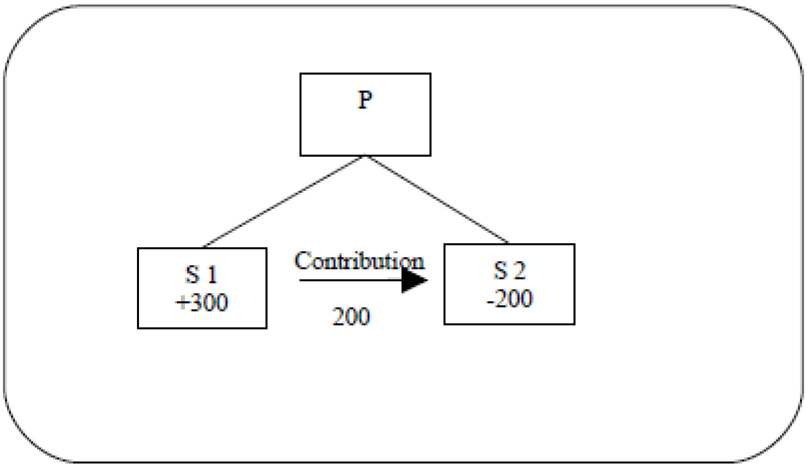

Figure 3.2: The group contribution model

(International Fiscal Association, 2004:3)

This model is applied in Scandinavian countries, Sweden, Finland, and Norway (Lermer & De Reus, 2009:10). In all three countries, group members must be part of a group where there is common ownership level (directly or indirectly held) of 90% or more, and all companies must be domestic residents for tax purposes, except for certain exceptions where foreign ownership[42] is allowed (PricewaterhouseCoopers, 2016b). Because the group contribution model does not provide for the elimination of intragroup transactions, no tax relief is granted on intragroup asset transfers (Masui, 2004:33). Separate statutes have to be enacted by a country using this model, if it wishes to provide for tax relief on intragroup asset transfers. Norway has enacted such statutes which allow for the transfer of assets[43] among group members equal to tax book value, in other words free of tax (PricewaterhouseCoopers, 2016b).

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42 The group contribution rules of Norway apply, under some circumstances, also to branches of foreign corporates resident within the European Economic Area (PricewaterhouseCoopers, 2016b). The Finnish group contribution rules allow the ownership chain to be located through foreign entities, if there is a double tax agreement between Finland and the resident country of the ultimate parent of the group (PricewaterhouseCoopers, 2016b). In terms of Swedish group contribution rules, European Economic Area companies are regarded as resident companies of Sweden, provided that the recipient is taxed in Sweden (PricewaterhouseCoopers, 2016b).

43 Surety in respect of the dormant tax relating to the unrealised profit must be provided, if requested by the tax authorities. If the transferee loses the affiliation with the tax group while still owning the transferred assets, the transferor will be taxed on the difference between the tax book value and the market value of the asset (PricewaterhouseCoopers, 2016b).

3.3.3 The loss-transfer model or group relief model

The loss-transfer model allows for only the transfer of losses within a group. This model is also known as the group relief model and mainly applies in countries where the common law system applies. In terms of the loss-transfer model, the tax loss of a group member may be surrendered for the use of another profit-making group member (Nikolakakis, 2008:30).

This model is similar to the group contribution model but differs as the loss-transfer model permits the transfer of only *losses* between the members in a group, where the group contribution model permits the transfer of only *profits* between the members in a group. Another difference is that no book entry in the financial records is required under the loss-transfer model. The result for tax purposes is nonetheless similar to that of the group contribution model (Masui, 2004:29-30).

Every group company remains liable for the submission of its own corporate return for tax purposes. Under this model, the loss-making company is able to *elect* to surrender its tax loss. By electing to surrender its tax loss, the tax loss is transferred to another group member. The loss-making company will subsequently find itself in a position where it is in a tax-neutral position, having a tax profit/loss of nil (Nikolakakis, 2008:30). The recipient company's taxable profit will be reduced by the transferred loss, and the company will therefore pay less tax than it would without the transfer of the loss (Tickle, 2009:2). Although no entry is made in the financial statements of the group members, in practice the recipient company sometimes makes a payment to compensate the loss-making company for the losses transferred. However, such a payment is not taxed as income in the loss-making company's hands (Nikolakakis, 2008:30).

The diagram below (Figure 3.3) illustrates how a tax loss from one member company is transferred to a profit-making member company (Masui, 2004:30). Under this model, the taxable profit/loss of every group company is firstly calculated on a stand-alone base (Nikolakakis, 2008:30). Thereafter, the loss-making (surrendering) company, Subsidiary 2 (S2), can surrender its tax loss of -200 to another company in the same group of companies, the profitmaking company (claimant), Subsidiary 1 (S1), which can offset the loss of -200 against its profit +300 so as to be taxed on a reduced profit of +100 (+300 – 200 = +100).

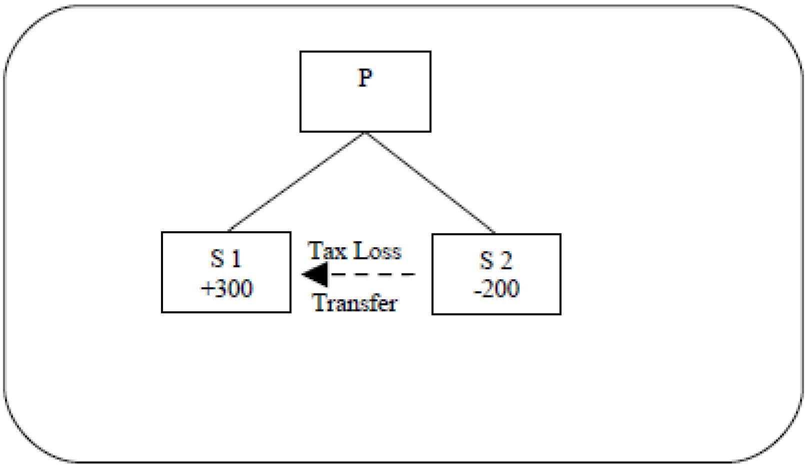

Figure 3.3: The loss-transfer (or group relief) model

(International Fiscal Association, 2004:3)

This model is currently applied in the United Kingdom,[44] Cyprus, Ireland and Malta, among other countries (Princen & Gérard, 2008:180). An advantage of the loss-transfer model is the simplicity of its administration and ease of compliance (Canada Department of Finance, 2010:7). The loss-transfer model does not allow for the transfer of capital losses, as only the transfer of trade losses is allowed among group members (Ault & Arnold, 2010:400). The loss-transfer model also does not allow for the elimination of intragroup transactions (Masui, 2004:33). Separate statutes have to be enacted for tax relief on intragroup asset transfers if a jurisdiction wishes to achieve this group tax objective as

44 To qualify for loss-transfer, companies must be part of the same group with a common ownership level (directly or indirectly held) of 75% or more, and both companies must be UK residents for tax purposes. These provisions are extended to foreign group members in two situations: Firstly, against the UK profits earned by a UK permanent establishment of a non-UK resident group member, and secondly, a group company that is resident in the UK is theoretically able to claim group relief in respect for losses of a subsidiary that is not a resident of the UK, provided that it is resident in the European Economic Area or has incurred its losses via a permanent establishment within the European Economic Area. Provided, furthermore, that all opportunities for claiming non-UK relief in respect of the losses have been utilised and any relief in respect of these losses in future years is not available. (PricewaterhouseCoopers, 2016b).

well. For example, in the United Kingdom, separate statutes were enacted in terms of which profits on intragroup asset transfers may be disregarded within a 75%-owned group, depending on the type of asset (appreciated or depreciated assets) and depending on whether these assets are being disposed of or replaced[45] (United Kingdom, 1992).[46]

New Zealand employs two formal group tax systems simultaneously, the consolidation model and the loss-transfer model. The loss-transfer model employed in New Zealand differs from the loss-transfer model employed in the United Kingdom and other countries. According to New Zealand's loss-transfer model, subvention payments need to be made by the profitable company wishing to utilise the tax loss. The subvention payment made by the profitable company to the loss-making company cannot exceed the amount of the loss incurred by the lossmaking company. The payment is deductible by the profitable company and assessable to the loss-making company (PricewaterhouseCoopers, 2016b).

3.3.4 The consolidation model

The meaning of the term "consolidation" for tax purposes should not be confused with its meaning for accounting purposes. The term "consolidation" is used for accounting purposes to refer to the combination of the separate financial statements of all group companies by eliminating all intragroup transactions affecting the profit and loss account (European Commission, 2006:§14). For tax purposes, intragroup transactions are not eliminated in the same manner when applying the consolidation model. Most jurisdictions using the consolidation model require that the entities in the group first calculate their profits and losses separately, taking into account all intragroup transactions.[47] Thereafter, when computing the consolidated taxable income of the corporate group, profits and

45 A "degrouping" charge is levied where the transferee company exits the group within a period of six years after the transfer (United Kingdom, 1992:s179).

46 Another example is Ireland, where separate statutes were enacted to provide for the non-recognition of profits or losses between group members on intragroup asset transfers provided that that company that acquires the asset does not exit the group within ten years after the transaction (PricewaterhouseCoopers, 2016b).

47 Some jurisdictions even have strict requirements regarding the use of the arm's length principle when the intragroup transaction occurs.

losses arising from intragroup transactions may be eliminated (permanently or provisionally[48]) or may not be eliminated.

The group of companies is then taxed as a single fiscal unit, with the parent company being the single taxpayer paying the tax of the entire group (Masui, 2004:30). Ultimately, all the group members are liable for *paying* the tax charge (Princen & Gérard, 2008:181).

The diagram below (Figure 3.4) illustrates how the taxable profit of Subsidiary 1 (S1) of +300 and the tax loss of Subsidiary 2 (S2) of -200 are combined and transferred to the parent company (P), which normally files one tax return for the whole group for income tax purposes and is taxed on the consolidated profits (+300 – 200 = +100), as if the group is a single taxpayer (Masui, 2004:30). (Assume in this example that the parent company has no taxable profit or loss.)

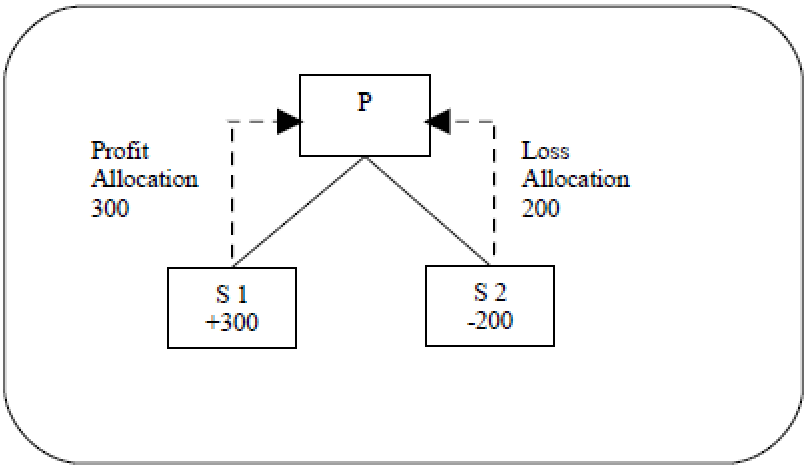

Figure 3.4: The consolidation model

(International Fiscal Association, 2004:3)

The consolidation model is the most frequently used, worldwide, and includes a variety of approaches that have been adopted in various countries (Masui, 2004:30-31). According

48 Provisionally means that aggregated profits and losses from intragroup transactions could be added back to the group's tax base in the event that the subsidiary exits the group (European Commission, 2006:§34).

to Nikolakakis (2008:30), the consolidation “approach” (consolidation model) can be split into two approaches: the full consolidation approach and the partial consolidation approach. These two approaches are also referred to in the International Fiscal Association report (Masui, 2004:31) as the full consolidation model and the partial consolidation model, known as the pooling system. Ting (2011:432) goes even further by splitting the full consolidation model into two approaches, the attribution approach and the absorption approach, thus identifying three variations of the consolidation model. These are pooling (a version of the consolidation model used in most European states, the United States and New Zealand, amongst others), attribution (the consolidation model used in the Netherlands), and absorption (the consolidation model used in Australia). According to Ting (2011:432), the variation in consolidation models is demonstrated by the extent to which the single enterprise principle is applied in consolidation regimes.

3.3.4.1 The pooling approach

According to Ting (2011:432), the pooling[49] approach represents the weakest application of the single enterprise principle of the three variations. In terms of the pooling approach applied in the European Union, the taxable profits and tax losses are first calculated *separately* for each group member, and the common taxable income is then computed by aggregating the group members’ taxable income and tax losses (Princen & Gérard, 2008:181). The tax bases for each group member are not necessarily adjusted for intragroup transactions (Princen & Gérard, 2008:181). The group taxable income is eventually attributed to the parent company, which is responsible for paying tax for the group (Princen & Gérard, 2008:181). The consolidated taxable income is determined independently from the consolidated accounting profit of the corporate group that is computed for accounting purposes. No accounting consolidation is therefore required to apply tax consolidation. The pooling method permits losses of one group member to be set off against profits of another group member, but as the elimination of intragroup transactions is not required, tax relief is not necessarily granted for profits on intragroup asset transfers.

49 The term “pooling” is used for combining the separate tax results of numerous group companies, without requiring the elimination of intragroup transactions as prerequisite (European Commission, 2006:§14).

The pooling approach is the consolidation model primarily used in the European Union (Masui, 2004:30). Variants of the pooling approach are also applied in United States[50] and New Zealand[51] (Ault & Arnold, 2010: 398). Other countries that use a pooling system as a group taxation regime include Austria (from 2005), Denmark, France, Italy (from 2008), Luxembourg, Poland, Portugal, Slovenia, Russia, Mexico, and Spain (PricewaterhouseCoopers, 2016b).

3.3.4.2 The attribution approach

According to Ting (2011:432), the attribution approach represents the second strongest version of the single enterprise principle. With the introduction of the attribution approach in 2003,[52] the Netherlands is now the only country applying the attribution approach, which

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50 According to the United States pooling method, every group member completes its tax return in terms of normal corporate tax principles, with the exception of certain items that have to be computed on a consolidated basis. The items that are normally computed on a combined basis comprise capital gains, certain net losses, deductions in respect of donations to charitable organisations, deductions in respect of net operating losses, and the deduction for dividends received (United States, Treasury, Regulations, para 26 1.1502-12). Thereafter, the group's consolidated taxable income is calculated by combining the separate taxable income of each member of the group and taking into account the consolidated items (United States, Treasury, Regulations, para 26 1.1502-11 to 28). The combined information is submitted in the form of a consolidated return that is formulated for the group, reporting each group member's income, expenses, and balance sheet items (Canada, Department of Finance, 2010:12). These rules are complex, based on comprehensive statutory approval, and are contained in a complex set of administrative regulations (United States, Treasury, Regulations, ss 1.1502-1 to 1.1502-100, as authorised by para 26 USC 1502). The United States pooling approach can be considered a hybrid method as it recognises the separate entity principle based on the rules normally used by separate companies, while taxing the corporate group as single enterprise by consolidating the tax results of group companies (Canada, Department of Finance, 2010:12).

51 New Zealand employs two formal group tax systems simultaneously. First, the consolidation model that allows qualifying corporate groups to file a consolidated tax return (resident companies and their wholly owned resident subsidiaries may elect to submit a single tax return) (PricewaterhouseCoopers, 2016b). Second, the loss-transfer model that allows the offset of losses of one group member against the profits of another group member (PricewaterhouseCoopers, 2016b). A qualifying corporate group can only elect to apply one of the group tax models at a time (PricewaterhouseCoopers, 2016b). Under New Zealand's consolidation model, taxable income is first calculated per group member (subject to certain adjustments). Thereafter, the sum of the group members' taxable income is added to certain consolidated items in order to calculate the consolidated taxable income of the corporate group (Ting, 2013b: 190). In this regard, it appears to be similar to the United States pooling method. The system furthermore does not specifically provide for the tax deferral of gains on asset transfers on internal restructuring transactions, because New Zealand does not have a capital gains tax system (Ting, 2013b: 190). However, because certain items are eliminated at separate entity level and later consolidated at corporate group level, the system does provide for tax deferral on the gains of certain asset transfers.

52 The Netherlands previously used the "absorption approach".

is referred to as "fiscal unity" ("fiscale eenheid") (Masui, 2004:43). A resident parent company may elect to file a consolidated tax return with its subsidiaries[53] (Ault & Arnold, 2010:400). All assets, liabilities and activities of subsidiaries are attributed to the parent company[54] for income tax purposes. This means that the income and expenditure of the subsidiaries are considered to be those of the parent, therefore aggregating all taxable profits and losses of subsidiaries in the hands of the parent company (Ault & Arnold, 2010: 400). The attribution approach functions much like the consolidation of financial statements for accounting purposes. In other words, within the fiscal unity, the losses of a lossmaking member can be set off against profits of a profitmaking member. Intragroup transactions, including property transfers, are generally eliminated. Therefore, most intragroup reorganisations will not trigger taxation, except when the fiscal unity between the transferor member and transferee member is terminated.[55] A crucial aspect relating to this approach is that the separate entity treatment of group companies continues in the application of double tax agreements for income tax purposes[56] (Ting, 2011:433; Masui, 2004:43).

3.3.4.3 The absorption approach

According to Ting (2013b:285), the absorption approach represents the strongest version of the single enterprise principle. Australia is presently the only jurisdiction that uses the absorption approach. In terms of the single enterprise principle, consolidated subsidiaries are considered to become divisions of the parent company. For income tax purposes, it is considered that they have ended their existence as separate companies. This is known as

53 Any domestic parent company that holds at least 95%, directly or indirectly, of a domestic subsidiary throughout the consolidation period can elect to be treated as a fiscal unity. Foreign subsidiaries with a permanent establishment in the Netherlands can under specific circumstances become part of a fiscal unity, as well. (Ault & Arnold, 2010: 400). In October 2015, a legislative proposal was published that would allow a fiscal unity between Dutch entities that are linked through a European Union / European Economic Area entity. It is unclear when the legislative proposal will become effective. However, it is already possible to request such a fiscal unity based, on a Decree by the State Secretary for Finance, issued in December 2014 (PricewaterhouseCoopers, 2016b).

54 Netherlands, *Wet op de Vennootschapsbelasting 1969* Art. 15 – 15d.

55 Generally, a "de-grouping" charge that is provided for (Ault & Arnold, 2010: 400).

56 In terms of the Model Convention of the OECD which was drafted in 1963, the parent company and the subsidiary company are treated as totally distinct taxpayers. There is normally less recognition of corporate groups in tax treaties than under the domestic laws of countries (Ault & Sasseville, 2010).

the “single entity rule”. The parent company is deemed to be the owner of all the assets of the subsidiaries. Any transfers of assets between group members are totally disregarded. This treatment of intragroup transfers differs from the treatment of intragroup transfers in most other consolidation regimes. Apart from having no tax implications, it also means that group members are not required to track asset transfers or to keep record of any deferred gains or losses. It furthermore means that gains or losses are not recaptured when either the transferor company or the transferee company exits the group (Ting, 2011:434).

In terms of the full consolidation systems (absorption and attribution approaches), the legal *persona* of every group company is ignored for income tax purposes, adhering to the single enterprise principle. A corporate group is considered to be a fiscal unit, with one set of accounts aggregating the results, as well as all the assets and liabilities of the group members (Princen & Gérard, 2008:181). It appears that a third objective is achieved by the absorption and attribution approaches, and that is the elimination of all intragroup transactions. Transactions between the separate entities in a corporate group are eliminated and do not lead to profit realisation, indicating a stronger application of the single enterprise principle. A tax charge is effectively only triggered on transactions with outside parties (non-group entities). In achieving the first two objectives (the offset of losses within the group and tax-free intragroup asset transfers), this “third objective” is automatically achieved (Masui, 2004:33). The elimination of intragroup transactions is not achieved in terms of the pooling approach. It is clear from the pooling method applied by most European countries that there is no elimination of intragroup transactions. However, under the pooling methods applied by New Zealand and the United States, some specific items are eliminated at the separate entity level and are later combined on a corporate group level. It seems, therefore, that with regard to these specific items, the elimination of some intragroup transactions does occur. Nonetheless, for purposes of this study, only the first two objectives will be referred to as objectives that the ideal group tax regime aims to achieve.

3.3.5 <u>The ideal group tax system demonstrating "best practice"</u>

Theoretically, the ideal group tax system is one that achieves both the offset of losses within groups and tax-free intragroup asset transfers, but "best practice" may suggest differently. The group tax families identified by the International Fiscal Association in its survey of all the group taxation models employed by national states, and considered to be the four "formal group tax regimes", are the *Organschaft* model, the loss-transfer model, the group contribution model, and the consolidation model (using either the pooling method, attribution method or absorption method). The question is, which of these four group tax models,[57] described in detail in this chapter, represents the ideal group tax model that demonstrates best practice? Numerous studies have compared the different group tax models in order to identify best practice with regard to the different group tax models (Masui, 2004; Lermer and De Reus, 2009; Canada, Department of Finance, 2010; Ting, 2013b).

Lermer and De Reus (2009:8) categorised the four group tax models or families into two principal models and two crystallised models. The two principal models are the consolidation model and the loss transfer model (Lermer & de Reus, 2009:8). Other families of group tax regimes are crystallised models that have attributes of one or both of these principal models (Lermer & De Reus, 2009:8). The Canadian Department of Finance (2010:11-13) suggested that this continuum[58] begins at the one end with the full consolidation models (absorption and attribution approaches), which perceive the group as a single taxpayer, permitting the setting off of losses within the group and allowing for intragroup asset transfers that is free of any tax effects (Canada, Department of Finance, 2010:11-13). The "loss-transfer model" is found at the other end of the continuum, allowing only the offset of losses between group members, while group members remain separate taxpayers (Canada, Department of Finance, 2010:11-13). The continuum therefore ends with a weaker application of the single enterprise principle (Princen & Gérard, 2008:180). All other models are situated between these two extremes, depending on the degree to which the single enterprise principle is applied (Canadian Bankers Association, 2011:6).

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57 The International Fiscal Association's typology of the various group tax regimes.
58 This can also be seen as a theoretical framework.

This continuum of formal group tax models, with the full consolidation model at the one extreme, the loss-transfer model at the other, and all other models in between, is illustrated in Figure 3.5 below.

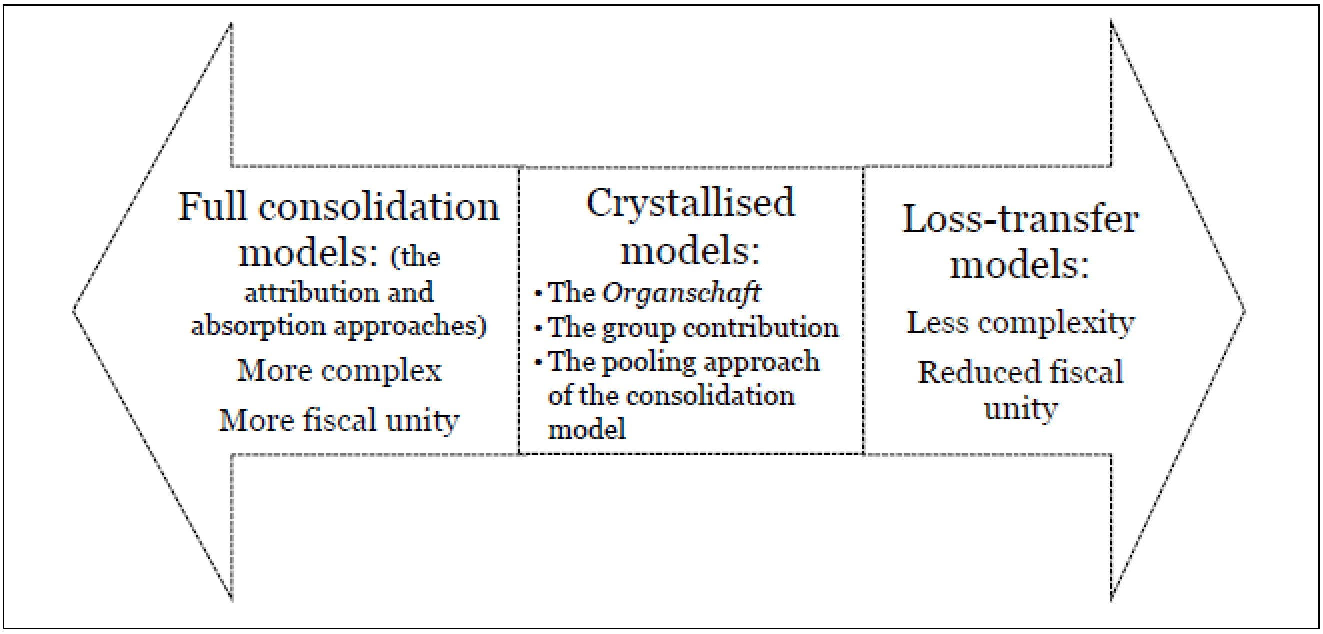

Figure 3.5: Families of formal group tax regimes presented on a continuum[59]

(Own formulation of the spectrum of group tax regimes suggested in the International Fiscal Association's report in 2004)

In his study, Ting (2013b:39) also presented the group tax regimes on a continuum but expanded on the continuum reflected in Figure 3.5 by including informal group tax regimes and jurisdictions with no group tax systems. According to Ting (2011:432), the variation in group tax models is demonstrated by the extent to which the single enterprise principle is applied. Ting's continuum starts at the one end with the strongest application of the single enterprise principle, represented by full consolidation models (absorption approach and attribution approach), which allow for both objectives: loss offset and tax-free intragroup asset transfers in one regime. Ting's continuum (2013b:39) ends at the other end with the weakest application of the single enterprise principle, represented by countries with no

59 Because South Africa's tax system does not include a formal "group tax system", it cannot be placed on this continuum of formal group tax systems. It follows, then, that according to the report of the International Fiscal Association, South Africa has no formal group tax system in place (Masui, 2004:32).

group tax regime. Between these extremes, Ting (2013b:39) added regimes that allow for either loss offset or tax-free intragroup transfers, like the *Organschaft* model that only allows for the offset of losses, not the tax-free transfer of assets. Because South Africa's corporate restructuring regime allows for the tax-free movement of assets in certain restructuring transactions, South Africa's informal group tax regime could also be fitted onto Ting's continuum of group tax regimes (see Figure 3.6). Apart from countries with no group tax regimes, the corporate restructuring regimes of South Africa[60] and India represent the weakest application of economic unity on Ting's continuum (see Figure 3.6). Like the continuum in Figure 3.5, Ting's continuum in Figure 3.6 also begins at the one end with the full consolidation model (absorption and attribution approaches) because it represents the strongest application of economic unity by meeting both objectives (see Figure 3.6) (Ting, 2013b:39).

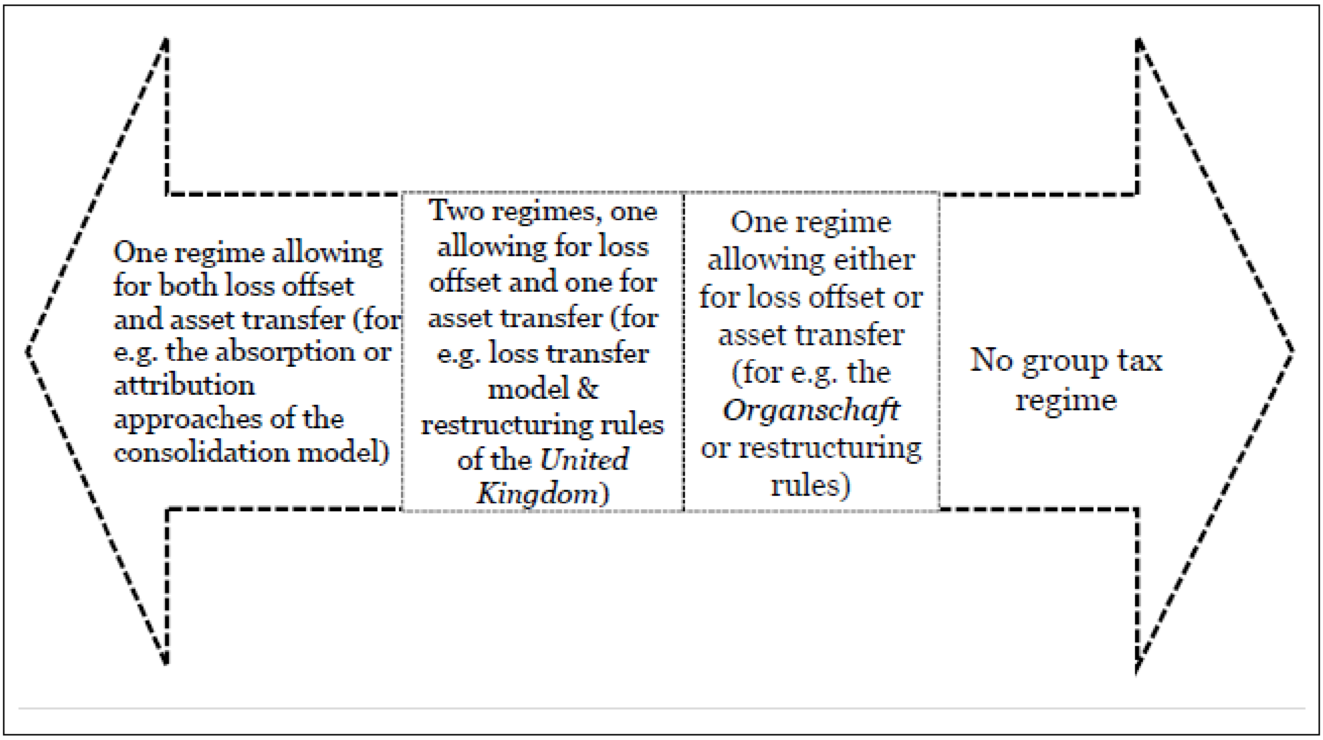

Figure 3.6: Group tax regimes presented on Ting's continuum

(Own formulation of Ting's continuum (2013b:39))

60 Although South Africa's corporate restructuring regime fits onto the continuum of group tax regimes, as suggested by Ting (2013b:39), South Africa's corporate restructuring regime is not a formal group tax regime.

The consolidation model is preferred by most countries when introducing a group tax regime (Ting, 2013b:6). Even countries that have had a different group tax model for many decades have adopted the consolidation model over the past two and a half decades. Australia (2002) and New Zealand (1993) have also introduced the consolidation regime, despite having a loss-transfer model (Ting, 2013b:7). Ting (2013b:7) suspects that some countries, which are already equipped with other group tax systems, may also decide to introduce a consolidation regime. Countries that have introduced a consolidation model include Japan in 2002, Italy in 2004, Austria in 2005, and South Korea in 2010 (PricewaterhouseCoopers, 2016b). Ting (2013b:7) furthermore believes that, as more countries introduce the consolidation model, more countries will be pressured[61] to harmonise their systems by also introducing the consolidation model. It therefore appears that the consolidation model represents best practice.[62]

The majority of countries that have introduced the consolidation model as a group tax system apply the pooling approach of consolidation (Canada, Department of Finance, 2010). However, when comparing the full consolidation models, i.e. the attribution approach and the absorption approach, to the other group tax models on a continuum, it is clear that the single enterprise principle is applied much more strongly in the full consolidation models (Ting, 2013b:285-286). From the analysis of all three approaches to the consolidation model, it is clear that the absorption approach represents the strongest version of the single enterprise principle (Canadian Bankers Association, 2011:6). Unfortunately, it contains rules that are extremely complex and problematic, and because of the elimination of intragroup transactions, it adds considerable administrative complexity to the corporate tax system (Canada, Department of Finance, 2010:7). According to Ting (2011:434), the price to pay for employing the strongest version of the single enterprise principle is high.[63] Ting (2013b:293) is of the opinion that a stronger application of the enterprise principle does not imply a better group tax system.

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61 Promoting competitiveness was the policy objective for both South Korea and Japan with the introduction of their consolidation models (Ting, 2013b:7).

62 Although the consolidation model comes at the cost of legislative and administrative simplicity, Ting (2013b:293) is of the opinion that the complexities of the consolidation model are manageable, to a certain extent.

63 Upon entering consolidation, problematic and extremely complicated rules, referred to as the “tax-cost-setting” rules, are used to determine the cost bases of assets and intragroup share interests in respect of the subsidiary. An additional challenge created by adhering to the single enterprise principle is the

It is evident from the detailed discussion of all four formal group tax models that the consolidation model is the one that best applies the enterprise principle. Unfortunately, the consolidation model is also the most complex of the four group tax models. In the end, it appears that not one of the group tax models can be deemed an ideal model, as all group tax models are afflicted with problems. Ultimately, these four formal group tax models need to be considered in a South African context in order to determine which of the group tax models represents best practice for South Africa.

3.4 GROUP TAX MODELS APPLIED IN COMPARABLE JURISDICTIONS ECONOMICALLY IMPORTANT TO SOUTH AFRICA

In order to determine which of the group tax models represents best practice for South Africa, the group tax models employed in comparable jurisdictions that have important economic ties to South Africa need to be considered. South Africa is integrated into the global economy and is a member of the BRICS countries[64] (Brazil, Russia, India, China and South Africa), as well as a member of the African Union [65] (with its 54 member-countries in Africa). South Africa is also one of 53 members of the Commonwealth[66] and a member of the United Nations. Sectors in the South African economy, such as mining, services, manufacturing, tourism and agriculture, rival similar sectors in countries in the developed world, like Australia (The Heritage Foundation, 2016).[67]

Important export partners of South Africa are China (9% of total exports), the United States (8%), Germany (6.5%), Botswana (5.1%), Namibia (5.1%) and Japan (4.9%). Other

difficult interactions created between the consolidation system and other parts of the income tax system that is still grounded in the separate entity principle (Ting, 2011:434). In Ting's analysis of the Australian consolidation regime, he concluded that the absorption approach has many problems and complexities, and that the Australian regime would *not* be an attractive model for other countries (Ting, 2010:193).

64 The acronym BRICS was originally created by Jim O'Neill from Goldman Sachs Investment Bank in 2001 in a paper entitled "Building Better Global Economic BRICs" and refers to the apparent shift in global economic power away from the developed economies, towards the developing world (O'Neill, 2001).

65 One of the initiatives of the African Union, is the NEPAD (New Partnership for Africa's Development) programme adopted in 2001 by African leaders, with the important aims of poverty abolition, elevation of maintainable growth and advancement, and the emancipation of women, via the construction of real partnerships between jurisdictions at national and international levels (African Union, 2016).

66 The Commonwealth is an intergovernmental organisation of 53 member-states of which most were territories of the former British Empire (Commonwealth, 2016).

67 2016 Index of Economic Freedom (The Heritage Foundation, 2016).

important export partners of South Africa include the United Kingdom, India, Belgium, Zambia and the Netherlands. South Africa's main trading partners with regard to imports are China (18%), Germany (11%), the United States (7%), India (5%), Nigeria (4%) and Saudi Arabia (3%). Other important import trading partners of South Africa include the United Kingdom, Thailand and Angola (tradingeconomics.com, 2016; SARS Customs & Excise, 2016[68]). Besides trading with other African countries, South Africa has important free trade agreements with the United States, the European Union, the European Free Trade Association (EFTA) (which includes Iceland, Liechtenstein, Norway and Switzerland) and preferential trade agreements with Argentina, Brazil, Paraguay and Uruguay (South Africa, 2016).

Some of the countries with which South Africa has economic ties have no group tax systems at all: Belgium, Brazil, China, Thailand, Switzerland, Nigeria, Egypt, Argentina and Senegal. Of the BRICS countries, Russia did have a group tax system (consolidation model, a pooling approach for resident corporate group members under common ownership of at least 90%), but a one-year suspension was imposed on the formation of consolidated groups in 2015. The suspension was extended until 2018 (PricewaterhouseCoopers, 2016b; BDO, 2017:22). Because of the uncertainty regarding the moratorium on the Russian group tax system, it should not be considered in the comparison. The only other member of the BRICS countries that employs a group tax system is India. India applies an informal group tax system that provides for the deferral of tax when transferring assets between companies in a corporate group. Because only formal group tax systems are considered in the comparison, the Indian informal tax system should be excluded. Nonetheless, an informal group tax system can be used as an alternative to a formal group tax system in a South African context. This issue will be considered later in this study.[69] The only trading partner in Africa with group tax rules is Botswana, where limited group tax rules are in place.[70] These rules are, however, extremely limited and cannot be considered in a comparison of formal group tax systems.

68 Export and import statistics for the year up and to June 2016 were retrieved on 13 July 2016.

69 In Chapter 5 of this study, the suitability of an informal group tax system in a South African context will be explored further.

70 The tax losses suffered by a wholly owned subsidiary of the Botswana Development Corporation Limited are allowed to be set off (in full or in part) against another wholly owned subsidiary's taxable profits, if a written communication of the election is delivered to the Commissioner General (PricewaterhouseCoopers, 2017a).

As a further criterion for selecting countries to compare, only one country per formal group tax model was selected. In addition, only one country per consolidation model approach was selected. Where more than one country used the same group tax model or consolidation model approach, the selection fell on the country economically most important to South Africa.

In order to present the comparison of the different formal group tax regimes applied in comparable jurisdictions with which South Africa has economic ties in the form of a table, the following jurisdictions were selected per model (the reasons for comparability or economic importance to South Africa are given in brackets):

- The absorption approach of the consolidation model: Australia (the only country applying this approach; comparable with South Africa’s economy as the country is trading in sectors similar to the South African economy).

- The attribution approach of the consolidation model: the Netherlands (the only country applying this approach; one of South Africa’s important trading partners and as part of the European Union, the country has a free trade agreement with the South African Customs Union to which South Africa is a party).

- The pooling approach of the consolidation model: the United States (economically more important to South Africa than Japan, which also applies the pooling approach; an important import and export trading partner, and the country has a non-reciprocal trade agreement to which South Africa is a party).

- The group contribution model: Norway (economically more important to South Africa than Iceland that applies the same model; one of four European States of the EFTA that holds a free trade agreement with the South African Customs Union to which South Africa is a party).

- The *Organschaft* model: Germany (only country considered that applies this model; important import and export trading partner).

- The loss transfer model: The United Kingdom (economically more important to South Africa than Liechtenstein that applies the same model; one of South Africa’s important trading partners and elements of English law have been incorporated into South Africa's hybrid legal system[71]).

When comparing the formal group tax regimes applied in different jurisdictions, it becomes clear that there are certain common features contained in most formal group tax regimes. These common features are used in Table 3.2 below to compare the formal group tax systems in countries that are economically important to South Africa (see the first column in Table 3.2). The common features can be grouped together into the following five groups:

- Firstly, the rules that enable the jurisdiction to compute the tax base of a qualifying group on a combined basis. These relate directly to the typology of the various group tax systems employed by the specific jurisdictions, as described in detail in this chapter (the consolidation models, the group contribution model, the *Organschaft* model and the loss-transfer model). This group also relates to the objectives that the ideal group tax regime aims to achieve, namely the tax-free transfer of assets from one group member to another and setting off losses within the group. The larger the number of objectives achieved in a group tax regime are, the stronger the application of the single enterprise principle in that group tax regime will be. (see Features 1 – 4).

- Secondly, the eligibility requirements, which refer to the requirements that group entities need to meet to qualify for inclusion in the group. Normally, a specific degree of common ownership is required, but eligibility requirements also refer to the type of entities eligible to participate.[72] Another consideration when determining the qualifying group is whether non-resident companies (as parent company or as subsidiary) are allowed to be part of the group. (see Features 5 – 7).

- Thirdly, whether participation is compulsory or voluntary, and whether it applies for a minimum period or not. Participation can furthermore apply to all entities that qualify, or only to specific entities as chosen by the group. (see Features 8 – 10).

71 South Africa uses a "mixed" legal system, established by the intertwining of a few legal systems. Although South African law is based on a Roman-Dutch common law system, elements of English law have been incorporated into South African law (History of South African Law).

72 As this study is limited to corporate groups, only groups that include companies will be reported on.

- Fourthly, the treatment of members' unused tax attributes. Unused tax attributes refer to tax attributes not yet utilised, for example the balance of assessed losses not yet set-off, and the tax cost of assets transferred but not yet claimed for tax purposes.[73] (see Features 2 & 4).

- The last group of common features relates to practical considerations, for example whether members are jointly liable for the taxation of the group. It also relates to the submission of the consolidated returns, whether one return is submitted by the parent or whether each member is liable to submit a tax return. (see Features 11 – 12).

It is evident that these common features are addressed in formal group tax regimes internationally and that these common features can be considered the structural elements of international group tax regimes. Differences were found when comparing the common features (structural elements) of formal group tax systems employed in comparable jurisdictions that have economic ties with South Africa. Table 3.2 illustrates the differences in the structural elements and is current as at 31 December 2018.

73 This includes the treatment of tax attributes accumulated prior to participation upon entering into the group, as well as the treatment of tax attributes accumulated during participation and upon exiting the group. Although the treatments of unused tax attributes are not compared in detail in Table 3.2, the details are discussed in Chapter 7.

Table 3.2: Comparison of formal group tax models in comparable and economically important jurisdictions

	Australia	The Netherlands	The United States	Norway	Germany	The United Kingdom
Formal Group Tax Model employed:	Consolidation: Absorption	Consolidation: Attribution	Consolidation: Pooling	Group contribution	Organschaft	Loss-transfer
1. Full consolidation system	Yes	Yes	No	No	No	No
2. Offset of losses (tax attributes)	Yes	Yes	Yes	Yes	Yes	Yes
3. Elimination of intragroup transactions	Yes	Yes	Yes, but only certain transactions	No	No	No
4. Tax-free asset transfers	Yes	Yes	Yes	Yes, separate statutes	No	Yes, separate statutes
5. Ownership requirements	100%	≥95%	≥80%	>90%	>50%	≥75%
6. Non-res. allowed as parent company?	No	No[74]	No	No[75]	No[76]	No
- **Exception**		EU/EEA company		PE of EEA company	PE[77] of foreign company	PE of foreign company
7. Non-res. allowed as subsidiary?	No	No[78]	No[79]	No	No	No[80]
- **Exception**		PE of foreign company	Canadian/ Mexican co.	PE of EEA company		PE of EEA /foreign co.
8. Elective/ compulsory	Elective	Elective	Elective	Elective	Elective	Elective
9. Minimum term	Permanent	None	Permanent	Annual option	5 years	None
10. Compulsory for all subsidiaries	No	No	Yes	No*	No	No*
11. Joint liability to pay group tax	Yes	Yes	Yes	No	Yes	No
12. Filing of returns	Only parent	Only parent^	Only parent^	Each company	Each company	Each company

(Own formulation)

74 An amendment to the income tax law in 2015 permits fiscal unity among entities of the Netherlands that are connected via an intermediary holding or parent company of the European Union (EU) / European Economic Area (EEA) (PricewaterhouseCoopers, 2018).
75 A permanent establishment of foreign corporates resident within the European Economic Area (EEA) is allowed (PricewaterhouseCoopers, 2018).
76 A German-registered permanent establishment (branch) of a foreign company is allowed (PricewaterhouseCoopers, 2018).
77 Permanent establishment.
78 Only if a foreign company has a PE in the Netherlands (PricewaterhouseCoopers, 2018).
79 Only Canadian and Mexican subsidiaries are allowed (PricewaterhouseCoopers, 2018).
80 Extended to UK permanent establishments of non-UK companies and non-UK subsidiaries in the European Economic Area (EEA) in some situations (PricewaterhouseCoopers, 2018).
* Only the two participating companies need to comply.
^ Each company is still considered a separate tax entity although only the parent submits a tax return.

From the comparison set out in Table 3.2, the following conclusions can be drawn:

- The consolidation models represent the strongest application of the single enterprise principle. The group tax regimes in the three jurisdictions employing the consolidation model (pooling, attribution and absorption approach) address the majority of structural elements that indicate the presence of a strong single enterprise principle in these jurisdictions (Features 1 – 4).

- The full group tax models that allow for full consolidation and elimination of intragroup transactions are found in the Netherlands (attribution approach) and Australia (absorption approach). These jurisdictions' ownership requirements are significantly higher (Australia, 100% and the Netherlands, ≥95%), yet more objectives are achieved in these jurisdictions: the offset of losses, the elimination of intragroup transactions, and the deferral of gains on intragroup asset transfers (Features 2 – 4). To compensate for the high ownership requirements, the Netherlands allows individual subsidiaries to choose not to consolidate.

- The rules for computing the tax base of a qualifying group on a combined basis are similar for the contribution model and the loss-transfer model. These models allow for the transfer of either losses or profits within the group, which ultimately achieves the same net result: the offset of losses within the group. The contribution model of Norway and the loss-transfer model of the United Kingdom allow for the offset of losses (Feature 2). In both countries, separate statutes were enacted to allow for the deferral of gains on asset transfers in the case of internal restructuring (Feature 4).

- Provided the minimum ownership requirements are met (Feature 5), all formal group tax systems indicated on Table 3.2 allow for 100% offset of losses, 100% elimination of intragroup transactions (where applicable), and 100% deferral of gains on intragroup asset transfers (where applicable). This clearly has implications for minority shareholders where the minimum ownership requirement is less than 100%.

- Although Germany's *Organschaft* system is less restrictive than the group tax systems of the other jurisdictions, as it requires only a majority shareholding (>50%), the acceptance of a profit-and-loss pooling agreement poses a significant barrier. The pooling agreement has to be notarised by a public notary and entered into the German business register prior to the last day of the subsidiary's first *Organschaft* financial year-end. It is furthermore enforceable for a five-year term (PricewaterhouseCoopers LLP, 2006:226).

- All formal group tax systems in Table 3.2 are elective for the corporate group (Feature 8). It is assumed that the group tax system will only be selected by groups of companies in instances where group taxes are reduced. It is submitted that the introduction of a group tax system can lead to a reduction in tax revenue, at least initially. However, by attracting multi-national groups, the introduction of a formal group tax system may ultimately lead to an increase in tax revenue.[81]

- With some exceptions, all jurisdictions in Table 3.2 only allow resident companies to be part of the tax group, whether as parent company or as a subsidiary (Features 6 and 7). During recent years, however, several jurisdictions have amended their group tax laws to include permanent establishments of non-resident companies as group members (Germany, the Netherlands, the United Kingdom and Norway).

It is obvious that there are several differences in how the structural elements of the formal group tax regimes are employed internationally in comparable countries. These differences are the result of the varying policy objectives and legal systems applying in these countries. It therefore appears almost impossible to determine best practice for a jurisdiction with regard to any specific group tax model, based purely on the comparison in Table 3.2, without considering the jurisdiction's tax policies with regard to each of the common features (structural elements). From Table 3.2, it is clear that South Africa's legal system and South Africa's tax policy objectives need to be considered to identify the group tax regime that would be most effective in a South African context.

According to Ting (2013b:293), the actual group tax regime adopted in a jurisdiction, in the end, is the product of difficult compromises and adjustments. It is therefore suggested that ascertaining the best practice lies in analysing the structural elements of formal group tax regimes (the common features identified in this chapter) in detail. The structural elements should then be adjusted to suit the policy objectives of South Africa to find the ideal group tax model for South Africa. It is submitted that by applying this method, it will ensure that

81 It is, therefore, doubtful whether tax authorities would be eager to introduce a group tax system unless there is another strong motive, such as long-term growth, for introducing it.

the final product is better and more efficient than the current regime or any alternative group tax regime.

3.5 CONCLUSION

In this chapter best practice in relation to corporate group taxation was considered. Firstly, a literature review was conducted to understand and analyse how economic unity is recognised in formal group tax regimes internationally and to differentiate between the group tax models employed worldwide. It was concluded that "formal" group tax regimes refer to group tax regimes that achieve at least one of the two ideal objectives,[82] the tax-free intragroup transfer of assets and the set-off of losses between group members, and are not limited to specific restructuring transactions. Although South Africa's corporate restructuring regime fits onto the extended continuum of group tax regimes as suggested by some researchers, South Africa's corporate restructuring regime is not a "formal" group tax regime. However, separate statutes and other informal systems of group tax, like South Africa's corporate restructuring regime, contribute to economic unity and need to be considered when determining an ideal group tax system for South Africa. International group tax families were considered and the following formal group tax models were identified: the *Organschaft* model, the loss-transfer model, the group contribution model, and the consolidation model (using either the pooling method, attribution method or absorption method). When considering best practice with regard to the different formal group tax models, it was found that, of all four the group tax models, the consolidation model represents the strongest application of the enterprise principle. The full consolidation model (absorption and attribution approaches) is the only formal group tax model that achieves both ideal objectives:[83] firstly, to allow for the set-off of losses within the group; and secondly, to provide for the tax-free intragroup transfer of assets. Unfortunately, the consolidation model also has problems as it contains rules that are

82 It appears that a third objective, the elimination of all intragroup transactions, is achieved by *full* consolidation models, like the absorption and attribution models. In achieving the first two objectives (the offset of losses within the group and tax-free intragroup asset transfers), this "third objective" is achieved in most instances. For purposes of this study, only the first two objectives will be referred to as objectives that the ideal group tax regime aims to achieve.

83 As these two ideal objectives refer to the purpose for which group tax systems are designed, it would also be correct to refer to the two *functions* of group tax systems.

extremely complex. It was concluded that none of the formal group tax models can be considered an ideal model or best practice, as all formal group tax models are accompanied by problems.

Secondly, formal group tax regimes employed in comparable tax jurisdictions were compared in order to identify the group tax regime that is perceived to represent best practice in a South African context. When comparing the formal group tax systems applied in comparable jurisdictions, it became clear that there are certain common features addressed in these jurisdictions' group tax statutes. The following common features were identified and grouped together: the rules that enable the jurisdiction to compute the tax base of a qualifying group on a combined basis (including the proportion of the member's taxable income or loss to be included in the combined tax base); the definition of the group of companies (including common ownership requirements and eligibility requirements); the participation rules (whether involvement in the group tax regime is compulsory or voluntary, whether revocable following a certain period, and whether involvement applies to all qualifying entities); the treatment of tax attributes and the balance of unused tax attributes (upon entering the group, during the group tax period, and upon exiting the group); and other practical considerations (joint liability and filing of returns). Clearly, these features are shared by group tax regimes and can be considered the structural elements underlying international group tax regimes.

From the comparison of formal group tax systems employed in comparable jurisdictions that have economic ties to South Africa, it is evident that that there are numerous differences between the group tax models employed. It is submitted that the different policy objectives[84] and legal systems pertaining to the different jurisdictions have caused these differences. As such, it is evident that no specific jurisdiction's group tax regime can be considered better and more effective than any alternative jurisdiction's group tax system. To take another jurisdiction's group tax regime as it is and employ it as part of the South African tax system, would mean that South Africa accepts that foreign jurisdiction's tax policy objectives as its own. It appears that no jurisdiction's group tax regime can be considered best practice in a South African context.

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84 Different tax policy objectives were identified with regard to adhering to the single enterprise doctrine, competitiveness, simplicity, protection of minority shareholder groups (fairness), efficiency (revenue protection), and relief to non-resident companies (cross-border neutrality).

The actual group tax regime adopted in a specific jurisdiction is ultimately the result of difficult concessions and adjustments. It requires adjusting the structural elements of group tax regimes according to the policy objectives of a specific jurisdiction, and the restrictions that exist in that jurisdiction. It is therefore suggested that best practice in a South African context can be achieved by following certain steps. First, the structural elements (common features) underlying formal group tax regimes should be analysed in detail. The structural elements should then be adjusted to suit the policy objectives of South Africa in order to find the ideal group tax model for South Africa. Best practice will be achieved if the final product is better and more efficient than the current regime or any alternative group tax regime. Before attempting this process, it is necessary to understand how policy considerations influence the design and implementation of group tax regimes, internationally. In the next chapter, the policy considerations taken into account by countries that have considered the introduction of formal group tax systems are identified and evaluated in terms of the recognised principles of a good tax system.

CHAPTER 4: POLICY CONSIDERATIONS UNDERPINNING GROUP TAX SYSTEMS

4.1 INTRODUCTION

With the appearance of the multinational corporate group as an entity form, it has become important that the corporate group be taxed as a single enterprise which, it is submitted, can be achieved by implementing a formal group tax system. An appropriate group tax system not only needs to be in line with South Africa's policy objectives, but also needs to be in line with the recognised principles of a good tax system. The aim of this chapter is, firstly, to identify the stated policy considerations of countries that have considered introducing formal group tax regimes that recognise the single enterprise principle, and secondly, to evaluate whether the policy considerations adopted by countries that have employed formal group tax systems internationally meet the recognised principles of a good tax system.

4.2 POLICY OBJECTIVES AND PRINCIPLES CONSIDERED

The actual group tax regime adopted in a jurisdiction is normally the result of difficult compromises made between conflicting policy objectives and limitations existing in tax regimes (Ting, 2013b:293). A jurisdiction's specific circumstances, policy objectives and limitations should, therefore, be considered when introducing a group tax regime.

Governments often adopt a number of policy objectives, simultaneously. When considering the tax objectives of a jurisdiction's tax system, decision makers need to ask what the citizens of the country need the tax system to achieve (Davis Tax Committee, 2016b:4). Normally, citizens around the world have more or less the same needs, and the following objectives are generally pursued by governments:

- to raise revenue to fund state expenditure (normally, this is the primary objective);
- to redistribute resources to promote social objectives, nation building and social cohesion;

- to correct failures in the market by applying (for example) a tax on the production of products that lead to pollution, or a tax on the consumption of harmful products;
- to influence behavioural adjustments by supporting specific actions, for example investments, and opposing other actions, for example sugar consumption;
- to support increased levels of savings to accelerate economic growth; and
- to encourage international competitiveness through innovation, productivity and minimising the cost of doing business, while guarding against international competitiveness as the main driver of the tax system.

(Davis Tax Committee, 2016b:4).

These objectives exist for the tax system as a whole, which means that not all taxes need to address all objectives, as long as the objectives are met overall (Mirrlees, Adam, Besley, Blundell, Bond, Chote, Gammie, Johnson, Miles & Poterba, 2011:333). It is important to understand that a jurisdiction's tax objectives influence its citizens' social welfare and impact on their financial well-being. The challenge for a jurisdiction's tax system is therefore to minimise the negative effects for its citizens, while still meeting its tax objectives (Mirrlees, 2011:22).

A tax system should be judged against the principles or canons of a good tax system, which constitute *guidelines* against which to evaluate a tax system, instead of *objectives* (Mirrlees *et al*., 2011:332). The OECD (2014) proposed that the principles of a "good" tax system in the modern electronic age constitute neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility. The Davis Tax Committee (2016b:13) recently assessed the South African tax system against these principles of a good tax system. In its report, the Davis Tax Committee (2016b:6) links the principle of revenue buoyancy with the principle of flexibility. Revenue buoyancy refers to a government's ability to raise revenue during all phases of the business cycle, whether the economy is in a downward phase or an upward phase. The Davis Tax Committee furthermore (2016b:5) links transparency with the principle of certainty, which implies that a tax system that people can understand is better than one that is complex and not clear. In general, it means that the:

- calculations should be clear;
- the time and manner of collection should be known and accepted;

- tax reform must follow a review process;
- the system must be easy to comprehend and administratively convenient;
- the system must minimise the resources needed to handle tax matters; and
- the system must be fair to all, and also be perceived as fair to all, as those who are not as well-off cannot afford expensive tax consultants.

(Davis Tax Committee; 2016b:5).

These principles of a good income tax system should be used to evaluate the alternative policy options adopted internationally in group tax systems. A suitable group tax system should adhere to these general canons. Certain tensions may, however, exist between the various principles of optimal tax design, which may necessitate trade-offs. In order to adhere to fairness, for example, simplicity may be compromised.

Certain countries claim to have applied certain policy considerations to justify their decisions to either:

- introduce a group tax regime (Australia, the United Kingdom, Spain, France and Japan);
- recommend the introduction of a multilateral corporate group tax system (the European Union); or
- abolish the introduction of a group tax regime (Canada[85])

It is submitted that these policy considerations should therefore be carefully weighed up when introducing a group tax regime in South Africa.

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85 Canada investigated the introduction of a group tax system after their Minister of Finance released a consultation paper in November 2010. The previous attempt to introduce a corporate group tax system was in 1985. However, in 1985, after submitting a discussion paper and draft legislation, Parliament voted against the introduction of a group tax system. The Canadian Government felt obliged to investigate the introduction of such a system again in 2010, as Canada was the only country of the G-7 member countries (the seven major industrialised countries: the United States, Canada, the United Kingdom, Germany, France, Italy and Japan) with no formal group tax system (Canada Department of Finance, 2010). From 2010 to 2012, the Canadian Government conducted a thorough investigation, which included extensive consultations with government officials and businesses. On 21 March 2013, the Minister of Finance confirmed during the 2013 Budget Speech that the government had completed its investigation into a group tax system and that moving to a formal system of corporate group taxation was not a priority at that time (Canada Department of Finance, 2013).

Only four of the seven policy considerations claimed to have been applied by jurisdictions that have considered group tax systems are *principles* of a good tax system (simplicity,[86] fairness,[87] neutrality[88] and efficiency[89]). The other three policy considerations are merely policy *objectives* (competitiveness,[90] single enterprise principle[91] and anti-avoidance[92]).[93] In the discussion that follows, the three policy objectives are explored first. These policy objectives are also considered in terms of the principles of a good tax system. Thereafter, the discussion examines the rest of the seven policy considerations, namely the four principles. Each of the seven policy considerations is also considered from a South African viewpoint.

4.2.1 **Single enterprise principle[94]**

The international shift from the separate legal entity principle to the single enterprise principle demands that authorities seek to achieve the single enterprise principle when introducing new corporate tax systems. During the life cycle of a corporate group, there are three occasions where the single enterprise principle needs to be considered when introducing tax legislation: firstly, at incorporation (the formation of the company and the

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86 Claimed by the European Union as the rationale for introducing the CCCTB (European Commission, 2011b), and provided as reason by Canada for not introducing a formal group tax system (see Section 4.2.4 of Chapter 4).

87 Claimed by the United Kingdom, France and the European Union as the rationale (see Section 4.2.5 of Chapter 4).

88 Considered amongst others by Canada, the European Union, New Zealand and the United Kingdom (see Section 4.2.6 of Chapter 4).

89 Claimed by the European Union as the rationale for introducing the CCCTB (European Commission, 2015).

90 Considered amongst others by Spain, Canada, the European Union, France, Japan, South Korea and the United Kingdom (see Section 4.2.2 of Chapter 4).

91 Considered amongst others by Canada, the United States, the Netherlands, France, New Zealand, Australia and South Korea (see Section 4.2.1 of Chapter 4).

92 Claimed by Australia and the European Union as the rationale (see Section 4.2.3 of Chapter 4).

93 Ting (2013b:97-98) confirms in his comparative analysis of eight countries that these three policy objectives have been the main drivers for introducing a consolidation tax system in eight countries. According to Ting (2013b:97), two policy objectives, competitiveness and applying the enterprise principle, have been claimed by most countries as their rationale, with competitiveness being the main policy objective, either stated explicitly or indirectly as being the reason for the introduction of the consolidation system in the eight countries. The reason why competitiveness is claimed by most countries as a policy rationale is because the application of the policy objective of the single enterprise principle automatically leads to achieving the policy objective of competitiveness, but the same reasoning does not necessarily apply in reverse (Ting, 2013b:97-98).

94 Also referred to as the “single entity doctrine” by some.

transfer of the existing unincorporated business to the company); secondly, when corporate groups are formed and reorganised (when acquisitions and mergers take place); and lastly, on an on-going basis after the corporate group has been formed and normal trade operations are conducted.

During the last few decades, a number of jurisdictions, including South Africa, the United States and Canada, have introduced tax legislation that provides for the formation of a company by a controlling shareholder, as a non-taxable event (Ault & Arnold, 2010:342). With regard to the formation and reorganisation of a corporate group, a number of jurisdictions, including South Africa, India, the United Kingdom and Norway, have introduced tax legislation that provides for the tax-deferred treatment of corporate reorganisations, which include corporate mergers and acquisitions, changes in capital structure, and other similar rearrangements of corporate affairs (Ault & Arnold, 2010:375-376). The tax statutes that provide for tax-deferred treatment in the case of corporate reorganisations apply on a once-off basis when the reorganisation transaction takes place.

Lastly, to account for the group operations on an on-going basis, tax rules are needed that take into account the overall economic result of all group transactions within the single enterprise, and not only specific reorganisation transactions. These tax rules treat each company as a division of a single enterprise, the corporate group (Ault & Arnold, 2010:396). The techniques may differ, but normally no gain or loss is realised on inter-company transactions, and profits and losses are only realised on transactions with third parties outside of the group (Ault & Arnold, 2010:396). These rules expand on the deferred tax rules that recognise economic unity on the reorganisation of companies, as it applies on a continuous basis by taking into account all transactions of the corporate group on a combined basis. This is referred to as consolidated corporate taxation or group taxation and accords fiscal recognition to the fact that a group of companies acts as a single economic unit.

It is submitted that the single enterprise principle is a core objective, as it also relates to the objectives that the ideal group tax regime aims to achieve, namely the tax-free intragroup transfer of assets and the set-off of losses within the corporate group. In his comparative study of eight countries, Ting (2013b:97) finds that the policy objective of applying the single enterprise principle was one of the main drivers for introducing a consolidation tax system in six countries (the United States, the Netherlands, France, New Zealand, Australia and South Korea).

The application of the single enterprise principle to the taxation of corporate groups could, furthermore, be justified by the neutrality principle, which converges with the principle of efficiency, both being principles of a good tax system. This viewpoint is also upheld by Ting (2013b:26). With regard to corporate groups, effectiveness and neutrality is promoted when the tax unit more closely harmonises with the economic reality of a group of companies that acts as a single economic unit (Canada, 2010:2). Therefore, where a corporate tax system adheres to the single enterprise principle, the tax system will adhere to the canons of a good tax system. It is therefore submitted that in an integrated modern corporate tax system, the single enterprise principle should be one of the primary policy objectives when contemplating the implementation of a group tax system, and it should also be one of the main policy objectives considered by South Africa.

4.2.2 Competitiveness

According to the World Economic Forum (2015), competitiveness (which includes *tax* competitiveness) is defined as "the set of institutions, policies, and factors that determine the level of productivity of a country." The level of efficiency of a country determines the level of prosperity of that country and sets the rates of return obtained by investors in an economy. These are the factors that would ultimately lead to growth in a country's economy (World Economic Forum, 2015). Competitiveness is a much wider policy objective than tax competition.

Tax competition, on the other hand, refers to the idea that countries compete to attract the capital (investment) and mobile economic activity (business) of multinational companies. By attracting these activities, a country is able to collect greater tax revenues (European Commission, 2011c). The attractiveness of a tax system can be increased by applying comprehensive measures, such as a reduction of the company income tax rate, or by applying targeted measures, such as offering attractive incentives. An example of a targeted measure is the introduction of a special tax incentive for research and development activities (European Commission, 2011c). Today, multinational corporate groups trade in a global market place, rather than in a national market place. International tax issues have become increasingly important to multinational corporate groups when deciding where to allocate their resources. Resources, like services, goods, and capital, are becoming progressively more flexible, thus allowing the location of multinational companies to be driven by considerations like taxation (Dorsey, 2006).

Where a country lowers corporate tax rates to attract multinational corporate groups, it does not automatically result in economic growth or efficiency in employing its resources (Devereux & Sørensen, 2006:3-6). It merely means that corporate entities situated in that jurisdiction experience a rise in their after-tax profits. Jurisdictions that appeal to multinational corporate groups because they offer lower tax rates are not necessarily more competitive than jurisdictions with high tax rates are. In fact, a decrease in taxation rates is often considered the most important reason for profit shifting,[95] which results in greater numbers of mobile multinational corporate groups becoming more profitable. Anti-avoidance measures are essentially the result of base erosion and profit-shifting activities of multinational companies. It appears, therefore, that tax competition and anti-avoidance are contradictory policy objectives, and the pursuit of tax competition as a tax objective is considered a harmful tax policy (Devereux, Griffith & Klemm, 2002:487-488).

A tax system's competitiveness cannot merely be judged by its taxation rates, the tax relief offered by the tax regime, or even by referring to its complete tax burden (European Commission, 2011c). In order to have a taxation policy that truly furthers competitiveness in the economy, it is also important to concentrate on the quality of the taxation system by guaranteeing that tax avoidance and tax evasion are minimised, and that the canons of efficiency and neutrality are promoted (European Commission, 2011c). By improving the effectiveness of the tax system, which includes the tax treatment of corporate groups, a viable economic environment is created, thereby improving the country's competitiveness (Canada, 2010:2).

95 Allowances play a relatively minor role in determining multinational companies' tax burdens (Devereux, Griffith & Klemm, 2002:465).

The absence of a group tax system poses a competitive disadvantage for a jurisdiction. According to Andersson (2007:98), the lack of a cross-border group tax system is a major barrier in the competitiveness of a jurisdiction and also links with the lack of neutrality, specifically in an international context. While the principles of competitiveness and neutrality are interrelated, competitiveness is a more proactive concept, as it suggests that a tax system should take an active role to promote economic growth (Ting, 2013b:21).

Competitiveness was also one of the policy objectives that moved the Canadian government to explore the introduction of a group tax regime. The Canadian government felt compelled to examine the introduction of such a system (for the second time) in 2010 (Canada, Department of Finance, 2010). Competitiveness and fairness are the two main objectives of the United Kingdom's corporate tax system, with its loss-transfer model as group tax system (Collier, & Maffini, 2015:2).

Competitiveness has also been claimed as one of the reasons for introducing a consolidation group tax system in France (Knoepfler & Anderson: 1988:171). It was identified as the same policy objective when a group tax system was introduced in Japan to "revive" the economy (Komamiya, 2004:393). While the Japanese Government does not appear to support an overly "competitive" tax regime, which might lead to harmful tax competition, it does seek to ensure that its corporate tax system remains competitive on a global basis in order to enhance the competitiveness of Japanese companies doing business worldwide (Chambers & Partners, 2016). Another example is South Korea, which introduced its consolidation model in order to promote competitiveness (Ting, 2013b:7).

In his comparative study of eight countries, Ting (2013b:97) finds that, apart from the policy objective of applying the enterprise principle, competitiveness was the other dominant policy objective for introducing a consolidation tax system. The policy objective of competitiveness is furthermore consistent with the application of the enterprise principle (Ting, 2013b:97). In its report, the Davis Tax Committee (2016a:14) recognises international competitiveness as a policy objective, but warns that in maintaining South Africa's competitive position, a "race to the bottom" should be avoided.

It is clear that competitiveness is one of the dominant policy objectives aimed at by most countries that have recently[96] implemented, or considered implementing, a group tax system, and it should therefore be one of the policy objectives considered by South Africa.

4.2.3 Anti-Avoidance

Anti-avoidance relates to the fairness and equity principles of a good tax system (OECD, 2015). When taxpayers (including ordinary individuals) see multinational companies legally avoiding income tax, it undermines voluntary compliance by *all* taxpayers (OECD, 2015). Fairness in a tax system suggests that the possibility for avoiding tax should be minimised (OECD, 2014:30). According to the European Commission (2016), differences in tax structures comprise one of the reasons why multinational corporate groups attempt tax-planning techniques that often evolve into aggressive tax avoidance schemes.

From a survey undertaken in 2004 by the International Fiscal Association, it became clear that corporate groups resort to tax-planning techniques to achieve the objectives of a group tax system in countries without a relevant regime or separate statutes to meet these objectives (Masui, 2004:33). These tax-planning techniques often involve using non-arm's length transfer prices to shift profits to loss-making entities.[97] The occurrences of these tax planning techniques have increased in intensity over the years (OECD, 2015). It is submitted that these planning techniques can be considered to comprise one of the reasons for the aggressive tax schemes engaged in by multinational corporations, as identified by the OECD in 2015.[98] The aim of the Base Erosion and Profit Shifting (BEPS) measures introduced by the OECD is to "realign taxation with economic substance and value creation, while preventing double taxation". This aim corresponds with the single enterprise principle, which implies that the solution might be found in introducing a group tax system. Furthermore, the new tax issues that have emerged with the development of multinational corporate tax groups have necessitated the introduction of more refined

96 Up and until December 2018.

97 This is referred to as base erosion and profit shifting (BEPS).

98 The prevention of aggressive tax schemes undertaken by multinational corporate groups is one of the objectives of the OECD/G20 BEPS project, launched in 2015. All OECD and G20 countries have committed to the OECD/G20 BEPS project. This project aims to prevent double tax treaty shopping, to promote country-by-country reporting, to fight harmful tax practices, and to improve dispute resolution, internationally (OECD, 2015).

group tax regimes. Obsolete corporate tax systems create opportunities for multinational corporate groups to use complex tax-planning schemes to escape taxes. In January 2016, the European Commission re-launched its proposal for a multilateral corporate tax system as a holistic solution to corporate tax reform in the European Union. According to the European Commission, a uniform, multilateral corporate tax system in the form of the CCCTB (Common Consolidated Corporate Tax Base)[99] is the only way to solve the current BEPS[100] problems in corporate tax (European Commission, 2016). The European Commission[101] believes that the harmonisation of group tax systems, in line with international tax systems, will inevitably lead to more transparency, better coherence, a clearer understanding of tax systems between countries, and ultimately, more effective anti-avoidance (European Commission, 2016).

Ting (2013b:64) finds, in his comparative study of eight countries, that Australia is the only country of the eight countries that had included the countering of avoidance schemes as one of its most important policy objectives when introducing its group tax regime. On the introduction of the consolidation regime, it was stated that government intended to address double taxation and tax avoidance through intragroup dealings[102] (Australian Government, 2002:§1.9). According to the Income Tax Assessment Act 1997,[103] the objectives of the

99 In October 2001, the European Commission announced its intention to introduce a multilateral group tax system across Europe, known as the CCCTB, where multinational corporate groups would be able to file a single consolidated tax return of all their profits earned and losses suffered across the European Union. The Common Consolidated Corporate Tax Base (CCCTB) defines the tax base as the sum of the taxable income and losses of group companies in the European Union, calculated according to the rules of the CCCTB. The corporate group, as taxable unit, will file a single return to report the taxable income or loss of the group. Thereafter, the consolidated taxable profits of the group would be divided so that each European Union member country can tax the profits at their applicable tax rate. The European Commission (2004) believes that a consolidated corporate tax base is the only way to address the tax obstacles that exist for multinational corporate groups. Although the European Commission proposed in 2011 that the CCCTB should be introduced (International Tax Review, 2014), the CCCTB had not yet been introduced as at the date of writing (2018).

100 According to the OECD, profit shifting is the reason why some multinational corporate groups earn enormous profits but pay little or no tax. Profit-shifting leads to considerable income losses for most governments, a substantial tax burden for residents, and competitive disadvantages for businesses that continue to pay their just share of tax (OECD, 2015).

101 The European Commission endorses the overall interest of the European Union by suggesting and implementing legislation, as well as policies. It consists of a team of Commissioners, one from each European Union member country.

102 In general, corporate groups regard tax as a cost, and if given the choice, it is accepted that corporate groups would revert to the option with the lowest tax cost.

103 Section 700-10 of the Australian Assessment Act 1997.

Australian group tax regime are “to prevent double taxation of the same economic gain realised by a consolidated group; and to prevent a double tax benefit being obtained from an economic loss realised by a consolidated group; and to provide a systematic solution to the prevention of such double taxation and double tax benefits…”. Furthermore, because *all* intragroup transactions are eliminated in a consolidation group tax regime, there is no need for transfer pricing scrutiny within the corporate group, which effectively means that the consolidation system itself can be considered an anti-avoidance measure. Nevertheless, because Australia’s consolidation regime is an *elective* regime, which has been immensely popular among corporate groups, it is uncertain whether the consolidation regime has been effective as anti-avoidance measure (Ting, 2013b:64).

While it is doubtful whether an *elective* group tax regime, like that of Australia, could effectively combat avoidance schemes, it is possible that a *compulsory* group tax regime, like the amended CCCTB project suggested by the European Commission (2015), might create more transparency and lead to a fairer tax system. Combatting anti-avoidance should be one of the policy objectives considered when designing a group tax system for South Africa.

4.2.4 Simplicity

Simplicity implies that the tax system should employ a simple methodology, and the rules should be clear so that taxpayers know where they stand (OECD, 2014:30). Simplicity is an attractive quality of any good tax system. Unfortunately, each time there is a trade-off between simplicity and another canon, such as fairness, simplicity is normally compromised (James, Sawyer & Budak, 2016:27).

The principle of simplicity is linked with the principle of certainty. Where companies understand their burdens and privileges, they are equipped to select the optimum choice and to react to proposed policy choices (OECD, 2014:30). According to the Davis Tax Committee’s report on the South African Tax System (Davis Tax Committee, 2016b:7), a simple tax system is normally a good tax system because a simple tax system is expected to be understandable and involve low administrative expenses (Davis Tax Committee, 2016b:7).

Group tax regimes are recognised as being complex tax systems (Farenfeld, 2007:258). The reason for the complexity of group tax regimes seems to lie in the fundamental inconsistency between the enterprise principle and the traditional principle of separate entities that, despite everything, exists in countless tax and legal systems. An example of this is the treatment of groups in a group tax system where double tax agreements[104] apply. In general, double tax agreements still adhere to the traditional principle of separate entities. Therefore, even though a company is recognised as part of a group in terms of the local jurisdiction's group tax system, it will still be regarded as a separate entity for purposes of a double tax agreement[105] (Sasseville, 2008:130). This creates mismatches between the two systems, which may lead to tax planning opportunities. For example, a subsidiary that forms part of a group in terms of a jurisdiction's group tax system may qualify for tax benefits in terms of a double tax agreement, which recognises the subsidiary as separate company. The subsidiary may, therefore, qualify for double relief in terms of the double tax agreement and in terms of the jurisdiction's group tax system.

Conflict also arises where parts of a specific tax system were drawn up according to the traditional separate entity principle, and another part of the system provides for the consolidation of groups of companies, adhering to the newer single enterprise principle[106] (Schulman, 2010:36). Jurisdictions[107] with group tax regimes have to implement

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104 A double tax agreement is an agreement between two or more countries that provides tax relief, ensuring that the same amount of income is not taxed twice. Tax relief is provided for by stating which jurisdiction has the sole right to tax the income or by limiting the rights of one of the countries where more than one country has such rights. Other ways to avoid taxation on the same amount of income are achieved through a jurisdiction's domestic tax laws, by granting exemption on foreign income, or a tax credit for foreign tax paid (Chartered Institute of Taxation, 2016).

105 The overall principle of the OECD Model Convention (a model double tax agreement used by most countries, worldwide) is clearly the separate entity, and recognition of groups of companies is rare. For double tax agreement purposes, a subsidiary and its parent are seen as totally distinct taxpayers (Sasseville, 2008:130).

106 This is demonstrated by the two foreign income relief regimes designed to avoid the potential double taxation of income from a foreign source: the foreign income exemption method and the foreign tax credit method (Schulman, 2010:36). In the Netherlands, for example, the foreign income exemption provision (known as the *Besluit voorkoming dubbele belasting* (*Bvdb*)) produces a different result if applied by two companies on a stand-alone basis, as compared with the result if applied by the consolidated group (of which the two companies are members), as the exemption applies to the consolidated group as if it is a single taxpayer (Müller, 2008: §8.1.3).

107 An example is France, where anti-avoidance measures (specifically article 223B) had to be introduced to prohibit the deduction of interest where one group member was not consolidated and the difference

complicated anti-avoidance rules in order to prevent this conflict. This, in turn, complicates the tax system even more. It is clear that the stronger the application of the enterprise principle is, the more tension there is between the separate entity principle and the single enterprise principle, and the more complex the group tax system will be. The Australian regime, with its numerous anti-avoidance rules and particularly complex consolidation model, illustrates this point clearly (Ting, 2013b:23).

This tension between the separate entity principle and the single enterprise principle can also be found in the taxation of cross-border transactions. Simplicity has been claimed as one of the reasons for suggesting a CCCTB in the European Union (European Commission, 2011b). A common consolidated corporate tax base avoids the tension because all jurisdictions follow one set of rules when computing their taxable income, thus removing mismatches between tax systems within the European Union. This multilateral corporate group tax system provides the prospect of simplifying or removing the complex rules currently dealing with transfer pricing[108] and double taxation, as well as the possibility of reducing the compliance costs for companies operating within the European Union (Farenfeld, 2007:258). The CCCTB may, however, also create new complexities, especially in apportioning the common profit between member states (Farenfeld, 2007:258).

According to Farenfeld (2007:258), the perceived simplicity of the application of the single enterprise principle in group tax regimes seems to be deceptive, as experiences of group tax regimes suggest that they are complex tax regimes. In 2013, the Canadian Minister of Finance declared that their government had taken the decision to abandon the implementation of a formal group tax system. The apparent complexities of a formal group

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in tax treatment between the consolidated group and the unconsolidated group member was exploited (the scheme is known as *"l'amendement Charasse"*) (Jervis, Jones & Van den Brande, 2014:16).

108 Transfer pricing is the term used generally for determining prices in cross-border, intragroup transactions which occur between parties connected to each other. These transactions are "controlled" transactions and should be distinguished from transactions between parties that operate on an "arm's length" basis. It is necessary to set such prices as part of the normal rules under which multinational corporations operate. "Transfer pricing" itself does not evoke tax avoidance. However, when goods or services are transferred across national borders within the networks of a multinational corporate group, a transfer price must be calculated for tax reasons, because in situations where the tax rates of two countries differ, the multinational corporate group has an incentive to set its prices in a way that reduces its overall tax liability by declaring higher profits in the country with the lower tax burden (United Nations, 2012).

tax system were presented as the main reason for not introducing a group tax regime in Canada (Canada, Department of Finance, 2013).

Like Canada, the South African Government will have to consider the objective of simplicity when designing a formal group tax system. Simplicity was adopted by the Davis Tax Committee (2016b:7) as design guideline, and in terms of its report, any outcome that will lead to even more complexity in the South African tax system must be "strongly justified by irrefutable evidence, given that administration and compliance costs matter a great deal and impose significant limitations on tax design". If simplicity is sacrificed, the South African tax authorities would only introduce such a formal group tax system if the other objectives it achieves weigh more heavily than abandoning the objective of simplicity.

4.2.5 Fairness

Achieving fairness in the tax system has become increasingly complex. In the late 1700s, when Adam Smith authored the Wealth of Nations, fairness in a tax system was achieved where the citizens "contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state" (Smith, 1776:1043). In the present global age, however, where capital is highly mobile and multinational companies trade in the international market without necessarily having a home country, fairness must be viewed from a different perspective. The fact that countries compete against each other to attract foreign investments, and the need to consider the political issues when determining who should carry the tax burden in a fair and just tax system, complicate the issue of fairness even more. It is therefore clear that as the business world is changing, the issue of fairness is continually becoming more complex.

According to the OECD (2014:30), fairness implies that the correct amount of tax should be levied at the correct time, while avoiding both the double taxation and non-taxation of amounts. A tax should be seen as just in its effect on all persons, which implies equity.

Equity, from a tax perspective, means that taxpayers with equal ability must contribute equally (OECD, 2014:31). Equity, from a tax perspective, has two dimensions:[109]

- vertical equity (different levels of income should be taxed differently – taxpayers with a higher level of economic well-being should bear a greater tax burden); and
- horizontal equity (the same level of income should bear the same amount of tax – taxpayers in a similar economic position should bear an equal tax burden).

(OECD, 1998).[110]

Although the fairness principle originally only applied in the context of individuals,[111] there are now many countries that also apply the fairness principle to companies. In the consultation paper issued by the Canadian Government in 2010, reference was made to fairness in relation to a group of companies. According to the consultation paper, fairness implies that groups of companies with comparable or the same structures should be taxed alike (horizontal equity), whilst the tax system should still provide for smaller groups with dissimilar demands and fewer resources to manage their tax liabilities (vertical equity) (Canada, Department of Finance, 2010:3).

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109 In this submission, the two dimensions of vertical and horizontal equity are referred to, while acknowledging that the American Institute of Certified Public Accountants identifies seven aspects that should be taken into account when assessing tax fairness:

1. *Exchanged Fairness* – Over a long period, taxpayers receive proper value for the taxes they pay.
2. *Procedural Fairness* – Taxpayers have a fair opportunity to object to assessments, are given reasonable opportunity to make presentation, and are treated respectfully by tax administrators.
3. *Horizontal Fairness* – Taxpayers in the same situations are treated similarly.
4. *Vertical Fairness* – Tax systems are adjusted to provide for tax burdens in line with the taxpayer's ability to pay.
5. *Time-Related Fairness* – Taxes adjust to situations where income or wealth levels fluctuate over time.
6. *Inter-Group Fairness* – No group of taxpayers is favoured to the disadvantage of another group without good reason.
7. *Compliance Fairness* – All taxpayers pay their taxes.

(American Institute of Certified Public Accountants (AICPA), 2007:3).

110 "Fairness" or "equity" was reconsidered and restated as a canon of taxation in 1998 by the OECD as being applicable in the modern electronic era.

111 The main reason why fairness traditionally only applied to individuals is because, in terms of established economic belief, corporates do not carry the tax burden; instead, the burden of taxes is forwarded to the shareholders and other individuals like employees, directors and customers (Leape, 2008:18). Today, companies are used in nearly every region internationally, and have become an accessible taxing point, which means that companies have a convincing argument in demanding a fair taxation regime (Leape, 2008:19).

Fairness is compromised in a group tax context where group tax systems provide for ownership requirements that are less than 100%, but allow for 100% offset of losses. This clearly has implications for the minority shareholders, influencing their right to claim the tax losses. In terms of the fairness principle, fairness to minority groups can be seen as one of the dimensions of fairness identified by the American Institute of Certified Public Accountants. According to the dimension, “Inter-Group Equity and Fairness”, one group of taxpayers should not receive preferential treatment to the disadvantage of another group of taxpayers, without good reason (American Institute of Certified Public Accountants (AICPA), 2007:3).

In the United Kingdom, “fairness” is one of the two main objectives of the United Kingdom’s corporate tax system (Collier & Maffini, 2015:2). Fairness also suggests that the probability that taxation might be evaded or avoided should be minimised (OECD, 2014:30). This fact was more recently emphasised by the Financial Secretary to the United Kingdom Treasury (Gauke, 2015) when he stressed that the United Kingdom will persist in leading global efforts to ensure that companies, worldwide, pay an adequate portion of tax. This was said with reference to the OECD’s project to fight BEPS[112] avoidance schemes. Gauke (2015) confirmed that although the government of the United Kingdom sees the tax system as an important instrument for promoting business activities, it is equally important that actions are taken to ensure a “fairer” business environment.

When dealing with group tax, the principle of fairness should also be considered in relation to cross-border transactions. This is referred to as “inter-nation equity”, which relates to the apportionment of profits and losses realised in cross-border transactions. Fairness requires that each country receives an equitable share of tax revenues[113] from cross-border transactions (OECD, 2014:31).

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112 BEPS schemes concerns tax planning schemes that abuse and misuse openings and discrepancies in taxation laws. The aim of these strategies is the “disappearance” of taxable income for taxation purposes or the shifting of profits to places where there is barely any actual activity, but the tax burdens are small, with the effect that low or no company tax is incurred. Although some of these strategies are illegal, most are not (OECD, 2015).

113 An equitable share of tax revenue is determined by considering both the taxing rights of the countries involved and a just allocation of the taxation basis between the jurisdictions that have a connection to a particular gain (Brooks, 2009:472-493).

In France, it was claimed that fairness was one of the reasons for introducing a consolidation group tax system (Knoepfler & Anderson: 1988:171). Fairness links with the anti-avoidance objective and has been stated as being one of the objectives of the re-launch of The CCCTB. The CCCTB lies at the heart of the European Union's "Action Plan for a Fairer and Efficient Corporate Tax System",[114] as it would lead to a fair distribution of the tax burden among taxpayers in the European Union (European Commission, 2016).

Fairness is a policy objective adopted by some of the countries that have introduced a formal group tax system. This, together with the increased demand for fairer tax regulations for multinational corporate groups, suggests that "fairness" should also be a dominant policy objective to consider when designing a group tax system for South Africa.

4.2.6 Neutrality

The taxation regime should be impartial in respect of the choice between diverse forms of business activities. A neutral or unbiased tax system is a tax system that treats the same economic activities in comparable ways for taxation purposes, to ensure that choices are grounded in business values and not based on taxation consequences (OECD, 2014:30). Neutrality is important in diminishing the unintended and negative effects of taxation on decisions such as the allocation of resources (Scottish Government, 2013:57). With regard to a group of companies, it implies that the group should be permitted to manage its resources in the most favourable way.

A tax system that is neutral should be simple to navigate and should aim to avoid unjustifiable discrimination between people and economic activities, and help to minimise economic distortions and behaviour changes (Mirrlees, 2011:333). If a tax system for corporate groups treats similar corporate structures differently, economic distortions could arise (Canada, Department of Finance, 2010:2). According to Masui (2004:34), the neutrality argument specifically focuses on two specific corporate structures: divisions (or branches) and subsidiaries. This is illustrated in Figure 4.1 below, where Masui (2004:34)

114 On 17 June 2015, the European Commission published an Action Plan for a Fairer and Efficient Corporate Tax System, showing its strong commitment to fairer corporate taxation in the European Union (European Commission, 2016).

uses the example of a hypothetical company (TaxCo), which has two lines of business: research and publishing (see Figure 4.1).

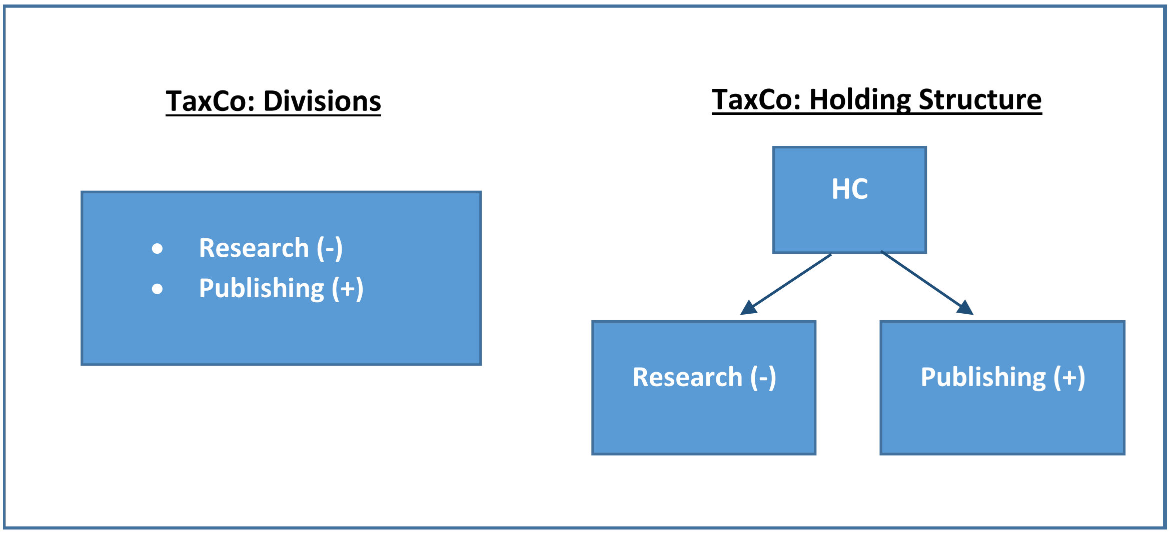

Figure 4.1: Neutrality argument of divisions versus subsidiaries (Source: Masui, 2004:34)

In the first case, on the left, both businesses are conducted as internal divisions of TaxCo. Since both divisions are parts of one single corporation, the losses arising from its research activities are set off against the profits made by the publishing operation. The transfer of assets from one division to another is also ignored for tax purposes, because the transfer is merely an asset relocation within one company, with no legal result in respect of any third party outside the company.

In the second case, on the right, TaxCo restructures its organisational form and adopts a structure where the research business is run by a separate subsidiary (Research), and the publishing operation is carried on by another subsidiary (Publishing). A parent company (HC) owns all the shares issued by Research and by Publishing. The tax consequences of this structure, in the absence of a group taxation regime, are that:

- the losses of Research cannot be set off against the profits of Publishing, because the two corporations are independent taxpayers; and

- any transfer of assets between Research and Publishing is generally considered to be a taxable event and is often accompanied by a careful scrutiny of whether the consideration paid reflects the fair market value of the transferred asset.

It is clear that not having a group tax regime differentiates between the tax treatment of divisions or branches versus the tax treatment of subsidiaries. A group tax system is therefore a more neutral system, as subsidiaries are taxed in a way similar to divisions. A group tax regime therefore minimises the discrimination in favour of, or against, a specific business form (OECD, 2014:30). Tax should not influence a decision to choose between divisions (or branches) and subsidiaries. The neutrality argument should thus be regarded as a policy objective in establishing a group tax regime.

According to Masui (2004:34), this argument is not that straightforward, as the two corporate structures do not represent exactly the same economic situation. The second structure (parent company and subsidiaries) also offers limited liability protection against creditors, promotes decentralised decision-making opportunities at subsidiary level, and provides better incentives for the disclosure of financial information based on separate accounting. None of these features exists where a business is operated within a single company (Masui, 2004:35). Princen and Gérard (2008:175) are also of the view that, despite the various group tax regimes employed in member states, tax neutrality is a utopian objective in the European Union, as these two corporate structures (divisions and subsidiaries) are not totally identical in economic terms, in any of the member states of the European Union.

Princen and Gérard (2008:174) are of the opinion that neutrality, from a group taxation perspective, should be viewed in both a national context (which implies that any decision regarding the corporate structure should not be influenced by taxation) and in an international context (which implies that choices relating to the distribution of group entities geographically should be neutral). Neutrality in an international group tax context should, furthermore, be considered from two contrasting viewpoints, namely capital export neutrality and capital import neutrality (Oestreicher *et al*., 2011:15). Capital export neutrality[115] implies that taxation should not influence a domestic investor when deciding whether to invest domestically or abroad (Katz Commission, 1995:§3.1.2.2). Capital import neutrality,[116] on the other hand, demands that all investments within a jurisdiction faces a similar tax burden, irrespective of whether they are owned by a local or an overseas investor (Katz Commission, 1995:§3.1.2.2). Clearly, unless all tax rates and all tax bases are calculated in the same way globally, attaining both capital export and capital import neutrality at the same time is not achievable. Normally, countries need to choose between these competing two neutralities (Weisbach, 2014:4).

Neutrality in an international context is one of the objectives of the CCCTB. This objective of the CCCTB is to achieve cross-border neutrality by providing for the consolidation of profits and losses when computing the European-wide taxable bases of European multinational corporate groups (European Commission, 2011b). When proposing the CCCTB, the European Commission (2011b) announced their intention to improve tax neutral environments, specifically between local and cross-border activities, in order to improve the potential of the European Single Market.[117] Because total neutrality in an international tax context requires both the tax base and the tax rate to be neutral where corporate groups engage in cross-border activities, the CCCTB would only be able to achieve partial international tax neutrality (Princen & Gérard, 2008:184). This is because, in terms of the CCCTB, each Member State would retain the right to decide on its corporate income tax rate, according to its budgetary needs. Complete neutrality appears to be a difficult objective to achieve.

Moreover, the fact that most jurisdictions in the European Union that employ group tax systems, but which only allow resident companies to be part of the tax group, is an

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115 Capital export neutrality is achieved in worldwide systems of taxation by providing for foreign tax credits. It guarantees that the taxpayer who invests will incur the same amount of tax, whether he receives his investment income from overseas sources or from local sources (Katz Commission, 1995:§3.1.2.2).

116 Capital import neutrality is achieved by applying a source-based tax system or introducing a tax system in which foreign income is exempt. It ensures that numerous jurisdictions compete on similar footings in the capital market (Katz Commission, 1995:§3.1.2.2).

117 Also referred to as the "Internal Market". The Single Market refers to the European Union as a single region with no internal borders or any further controlling hindrances, ensuring the unrestricted movement of goods and services. The European Commission is of the opinion that it would stimulate competition and trade, improve efficiency, raise quality, and would help to cut prices in Europe (European Commission, 2016).

infringement of the freedom of establishment principle[118] as provided for in terms of the European Commission Treaty.[119] The freedom of establishment principle was agreed upon to ensure tax neutrality in the European Union (European Parliament, 2011:20). The freedom of establishment principle has, however, been challenged in numerous cases heard in the European Court of Justice.[120] Amongst the most recent of these cases, a case was heard on 16 June 2014 by the European Court of Justice which ruled that the fiscal unity regime of the Netherlands infringes on the freedom of establishment principle of European Union law (PricewaterhouseCoopers, 2016b). In October 2015, an amendment to the law was announced that allows fiscal unity between entities in the Netherlands that are linked through an entity in the European Union, or the European Economic Area (PricewaterhouseCoopers, 2016b). This and other decisions by the European Court of Justice regarding the infringement of the freedom of establishment principle[121] have persuaded many countries in the European Union to amend their group tax laws to include permanent establishments of non-resident companies as group members (Austria, Denmark, Germany, Italy, Luxembourg, Spain and the United Kingdom) (PricewaterhouseCoopers, 2016b). Most European countries, however, still only allow

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118 The freedom of establishment principle, as set out in Articles 43 to 48 of the European Commission Treaty, enables nationals of European Union member states and companies incorporated in the European Union to pursue economic activities in a stable and continuous way in one or more member states, without being discriminated against by those member states based on their nationality or their mode of incorporation (Craig & De Burca, 2003:772).

119 The European Commission Treaty (also known as the Treaty of Lisbon) is an international agreement that forms the constitutional basis of the European Union. It amends the Treaty on the European Union (2007) (previously known as the Maastricht Treaty (1993)), and the Treaty on the Functioning of the European Union (2007) (previously known as the Treaty of Rome (1958)). It was signed by the EU member states on 13 December 2007 and applies from 1 December 2009. (Foundation for EU Democracy, 2008:3).

The European Commission Treaty lays down several freedoms, ensuring that nationals can trade and move within the European Union, without the impediment of national boundaries:

- Freedom of movement with regard to goods (Articles 23 to 31 EC);
- Freedom of movement with regard to workers (Articles 39 to 42 EC);
- Freedom of establishment (Articles 43 to 48 EC);
- Freedom in relation to the provision of services (Articles 49 to 55 EC); and
- Freedom of movement with regard to capital (Articles 56 to 60 EC)

(Heusser, 2009:1).

120 The European Court of Justice is the highest court in the European Union in matters of European Union law. It ensures that every European Union member country abides by European Union law and that European Union law is interpreted and applied in the same way in every European Union member country (Court of Justice of the European Union, 2016). .

121 Experts on European tax law are of the opinion that tax neutrality should continue to play a major role in the decisions of the European Courts (Amatucci, Gonzàlez & Trzaskalik, 2006:280).

resident companies to enjoy their group tax relief measures, emphasising the fact that complete tax neutrality is difficult to achieve.

Despite being difficult to adhere to fully, tax neutrality is a core aspect of New Zealand's general approach to taxation (New Zealand Inland Revenue, 2016). It was also stated to be one of the tax objectives of introducing a consolidation regime in New Zealand (Plunket & McKinley, 2004:506). It is similarly one of the aims[122] in the United Kingdom with its loss-transfer group tax model, as it ensures fiscal neutrality in a group of companies (Walton & Stone, 2005).

Like simplicity, complete tax neutrality is difficult to achieve in any group tax system. Nonetheless, neutrality is consistent with taxing the group of companies as a single unit. It should, therefore, be one of the policy objectives that policy makers need to consider when introducing a group tax system in South Africa.

4.2.7 Efficiency

Efficiency in a system of taxation suggests that the tax system is devised with the intention of collecting revenues in the most effective way without causing harm to the economic efficiency and productivity of a country (Canada, Department of Finance, 2010:2). Efficiency should be viewed from the perspective of the taxpayer (businesses) as well as the perspective of the *fiscus*. For the taxpayer, this means that the cost of complying with tax laws should be reduced to a feasible extent, with minimal wastage of economic resources. For the fiscus, it means that losses in the tax system should be reduced as far as possible (OECD, 2014:30). The principle of efficiency is linked with the principle of neutrality.[123] A system of taxation should allow for the allocation of resources to their most productive usages, without the distortion of the decision-making process (OECD, 2014:30). Clearly, a tax system that is neutral would most probably also be more efficient.

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122 Although neutrality was one of the objectives, the main objectives for introducing the loss-transfer system in the United Kingdom were fairness and competitiveness (Collier & Maffini, 2015:2).

123 While a system of taxation should demand the allocation of resources to their most productive usages, with minimal wastage, neutrality entails that discrimination in favour of, or against, any particular economic choice is minimised (OECD, 2014:30). Where a tax system is not neutral, "taxpayers have an incentive to devote socially wasteful effort to reducing their tax payments by changing the form or substance of their activities" (Mirrlees *et al*., 2011:657).

On the re-launch of the CCCTB in 2015, the European Commission (2015) predicted that the implementation of such a group tax system would enhance the efficiency of corporate tax systems in the European Union[124] (European Commission, 2015).

It is evident that the introduction of a formal group tax regime can increase the general efficiency of a system of taxation. However, if a group tax system is too complex, it may increase compliance cost for both the *fiscus* and the taxpayer and ultimately compromise the overall efficiency. It is suggested that efficiency should, therefore, be one of the policy objectives considered by South Africa.

4.2.8 Compromising conflicting objectives

According to Masui (2004:37), the policy matters that should be considered when adopting a formal group tax system in a jurisdiction should include broad considerations, taking into account the impact on the efficiency of resource allocation and the fairness of income distribution, as well as the canons of a good tax system. Policy makers should understand that a group tax regime is most often introduced where a compromise is reached between contradictory policy objectives, with simplicity as a tax principle often being sacrificed in the case of group taxation. It appears that the art lies in the policy makers' ability to determine which policy option would best suit their particular jurisdiction. Furthermore, where trade-offs exist, the best "second-best" option, used in optimal tax theory, can be applied to determine which policy option would be most efficient.[125]

124 According to the European Commission (2015), it would lead to an overall saving of €0.7 billion per year in compliance costs for multinational companies operating the European Union.

125 The "second-best" option (one of the features of optimal tax theory) addresses how a government can best raise revenues in a distorted economy. Of course, the "first-best" option would be where optimum revenues can be raised and no distortions exist – the economic nirvana. The "first-best" option is, however, seldom achievable in the real world. Policy options that are less efficient in raising revenue than the "first-best" option have to be identified for the distorted economy. They are referred to as "second-best" policies. The "second-best" options would be the more economically efficient policy options that best improve national welfare and utility. The *best* of the "second-best" policy options would most likely be the "second-best" option that raises most revenue and would therefore rank first (Boadway, 2012:7-27).

It seems that the principle of simplicity has often been sacrificed for the sake of the single enterprise principle in jurisdictions that have introduced group tax regimes. This is because of the inherent conflict that exists between the single enterprise principle and the traditional principle of separate entities, which still exist in tax and legal systems. Ting (2013b:26) suggests that simplicity is often mooted as one of the policy objectives for introducing a group tax regime but is difficult to achieve in practice. An example of where the policy makers considered introducing a group tax system, but decided against it, is Canada. The following policy objectives and guidelines were considered: anti-avoidance, competitiveness, efficiency, simplicity, and compliance. According to O'Brien (2013:25), conflicting policy objectives caused the real tension in Canada. The Canadian Government was of the opinion that an appropriate group tax model should be fairly straightforward and adaptable and should encourage corporate groups to comply with tax laws. Such a system should also prevent inappropriate tax avoidance and (interprovincial) profit shifting. In the end, Canada, with its federal system of government, did not introduce a formal group tax system due to contradictory policy objectives – achieving efficiency, anti-avoidance and competitiveness on the one hand, versus simplicity on the other (O'Brien, 2013:25).

Although the Davis Tax Committee (2016b:7) considers simplicity to be one of the tax principles of the South African tax system, the Committee did report that more complex provisions would be considered, but only if they are "strongly justified by irrefutable evidence". Only then, can simplicity be sacrificed. It appears, therefore, that simplicity should be considered as a tax objective by South Africa when designing a group tax system, and that when choosing between two design options, the simpler option should prevail. But, if a trade-off is required, where other objectives achieved by a design option weigh more heavily than simplicity, and it is convincingly justifiable, then the objective of simplicity could be sacrificed.

4.3 CONCLUSION

In this chapter, policy considerations that are essential when contemplating a formal group tax regime were examined. There are various policy objectives and guidelines that should be considered by the South African tax authorities when introducing a formal group tax regime. In this chapter, seven policy objectives were found to have been considered by various jurisdictions when contemplating group tax systems: four are also considered canons (principles) of a good tax system, while three are merely policy objectives. With regard to the three policy objectives (competitiveness, the single enterprise principle, and anti-avoidance), the single enterprise principle stands out as the core policy objective that the South African Government needs to consider, as it promotes the taxation of multinational corporate groups in line with economic reality, while preventing double taxation. Competitiveness[126] is also considered to be a dominant policy objective, while anti-avoidance needs to be considered, although it is of lesser importance.[127] These three objectives, furthermore, promote the canons of a good tax system, specifically neutrality, efficiency and fairness.

With regard to the tax principles, one principle stands out as being difficult, if not impossible, to achieve, namely simplicity. It is submitted that this principle would probably be compromised. It also seems that although neutrality has been claimed as a rationale by most countries that have implemented a group tax system, neutrality is difficult to achieve fully. International neutrality would probably be compromised. With pressures mounting for a fairer international tax dispensation for multinational corporate groups, it is suggested that “fairness”, as a policy guideline, is becoming increasingly important to consider when designing a group tax system. From the discussion of the tax principles, it appears therefore that fairness, efficiency, neutrality and simplicity (in this order of importance) stand out as important to consider when introducing a formal group tax regime in South Africa, with fairness as the dominant objective. Furthermore, the South African tax authorities will have to ensure that the objectives achieved by introducing a formal group tax system weigh more heavily than surrendering the principle of simplicity, as simplicity would probably be compromised. South African policy makers should also take these considerations into account when designing an appropriate group tax regime for South Africa.

Finally, the following policy considerations were identified: the single enterprise principle, competitiveness, anti-avoidance, fairness, efficiency, neutrality, and simplicity, with the single enterprise principle, competitiveness and fairness as the dominant objectives, while

126 Bearing in mind that international competitiveness should not be the main driver of the South African tax system.

127 The anti-avoidance objective also links with fairness (as a tax principle).

the single enterprise principle is considered as the core of all objectives. These policy objectives will help to identify the policy options available when considering the structural elements of formal group tax regimes, internationally. As these policy objectives also meet the requirements of a good tax system, they will be used to evaluate the appropriateness of the current taxation provisions regarding corporate groups in South Africa in the next chapter.

CHAPTER 5: AN EVALUATION OF THE CURRENT GROUP TAX PROVISIONS IN SOUTH AFRICA

5.1 INTRODUCTION

This chapter evaluates the current tax system dealing with corporate groups in South Africa. The aim of this chapter is to evaluate the suitability of the current corporate restructuring regime as an appropriate group tax system for South Africa, in adhering to the single enterprise principle. The current tax provisions applying to corporate groups in South Africa are evaluated against the policy objectives identified in Chapter 4 as being important when considering a group tax regime. These objectives are in line with the recognised principles of a good tax system. In addition, the current tax provisions are evaluated against the objectives that the ideal group tax regime aims to achieve, namely the tax-free intragroup transfer of assets and the set-off of losses within the group. These two objectives ultimately satisfy the single enterprise principle – taxation of multinational corporate groups in terms of economic reality.

Currently, South Africa has no formal group taxation system. Each company in a corporate group is taxed as a separate taxpayer. Because South African tax law consists of a combination of legislation and case law, the courts are often called upon to clarify legislation. Over time, several court decisions have illustrated the challenges posed by the absence of a formal group tax system in South Africa (Stack, *et al*., 2015:139-160).[128]

128 Three court cases were analysed in the study by Stack, *et al*. (2015:139-160): In the first court case, *CIR v Niko, 1940 (AD) 416 (11 SATC 124)*, the taxpayer was treated unfairly when assets and liabilities were moved from one entity to another owned by the same taxpayer. In reality, no profit or loss is realised in such an instance, as the taxpayer represents both the seller and the buyer, in essence one economic unit. Yet, it is evident from the *Niko* case that the taxpayer, Mr Niko, had to extract funds from his capital to pay the tax on the transfer of assets within the single economic unit. Clearly, this is an example of an unjust situation. Following the decision of the *Niko* case, it has become even more essential to recognise the economic unity of groups, as trade within a group of companies, an example of an economic unit, has increased remarkably since then. Two more recent cases were analysed to further illustrate the challenges created by a tax system that does not recognise the single enterprise principle. In *CSARS v Wooltru Property Holdings (Pty) Ltd*, the *fiscus* lost tax revenue because the group, as single enterprise, was not fully recognised in the formal group tax system in South Africa. In *Ackermans Ltd. v CSARS, 2010, 73 SATC 1*, the court had to unnecessarily consider the tax

From the viewpoint of Kruger, Stein, Dachs and Davey (2012:11), “South African courts and law makers have obstinately refused to recognise the existence of ‘groups’ of companies for tax purposes”.[129]

Nonetheless, the introduction of group taxation has been considered in South Africa and some corporate group relief provisions have been implemented. Three work groups appointed by the South African Government have investigated the viability of a formal group tax system for South Africa: the Margo Commission (1987), the Katz Commission (1995), and the Davis Tax Committee (being a tax review committee) (2018). To provide background to group tax in South Africa, this chapter starts with a brief discussion of the findings of the commissions of inquiry and the tax review committee, as well as the statutes introduced over the years to provide relief relevant to the taxation of corporate groups, before evaluating the current situation.

5.2 THE COMMISSIONS OF INQUIRY AND THE TAX REVIEW COMMITTEE

5.2.1 The Margo Commission

The implementation of a formal group tax system in South Africa was initially considered by the Margo Commission[130] in 1986. The Margo Commission conducted its work during the era of apartheid, at a time when South Africa was faced with increasing isolation from global markets and had been subject to severe economic and political sanctions imposed

implications stemming from the transfer of contingent liabilities between group companies because the economic reality, that groups operate as single economic units, is not recognised in the South African judicial system.

129 According to Kruger, *et al*. (2012:11) numerous court cases illustrate instances where the members of a corporate group, acting as one economic unit, had incurred expenditure that benefited other group members in the same group. Notwithstanding the fact that the expenditure was incurred in producing income for the group as single economic unit, the expenditure was disallowed because it was not regarded to be in the production of that specific taxpayer’s income. The court cases referred to by Kruger, *et al* (2012) are: *ITC 1124, 31 SATC 53, Solaglass Finance Company (Pty) Ltd v Commissioner for Inland Revenue, 1991 SA 257 (A), 53 SATC 1,* and *Commissioner for Inland Revenue v Sunnyside Centre (Pty) Ltd, 1997 SA 68(A), 58 SATC 319.*

130 The Margo Commission was appointed in terms of Government Gazette 201 of 20 November 1984 to enquire into the tax structure of South Africa. The Margo Commission completed its work on 20 November 1986, with the final report being issued during 1987. The role of taxation in the South African economy had to be reconsidered by the Margo Commission, particularly whether the tax system adhered to the principles of simplicity and fairness, eliminated revenue erosion and promoted economic growth in South Africa (Mitchell, Stein & Silke, 1987:191).

by countries internationally, which resulted in extensive disinvestment from South Africa (Omar, 2009:23-24). The reforms recommended by the Margo Commission are therefore considered against this background.

The Margo Commission acknowledged that South Africa taxes each company as a separate taxpayer, which was not then the general tendency in tax jurisdictions internationally (Margo Commission, 1987:§10.94). Most of the important groups and professional bodies that made presentations to the Margo Commission petitioned convincingly in favour of a group tax system[131] (Margo Commission, 1987:§10.95). According to representations made to the Margo Commission, the consolidation model and the loss-transfer model were considered as possible alternatives[132] (Margo Commission, 1987:§10.102). The Margo Commission (1987:§10.102) concluded that the claim that the loss-transfer model was a simpler system than the consolidation system held true only at a conceptual level.[133] In as far as the consolidation regime was concerned, most members of the Margo Commission were of the view that, whilst the consolidation regime, *prima facie,* appears to be more complex, it in fact represents a simpler and a more sound approach to group taxation. The Margo Commission considered the consolidation model to be more suited to the South African context, provided anti-avoidance legislation is introduced to prevent trading in assessed losses and the ring-fencing of pre-consolidation assessed losses (Margo Commission, 1987:§10.103).

In the end, the members of the Margo Commission (1987:§10.104) could not reach consensus on the issue of group taxation. The minority of the Margo Commission recommended that group taxation should be introduced, provided that certain conditions were met[134] (Margo Commission, 1987:§10.108). The majority of the Margo Commission

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131 The Margo Commission recognised that the reason for this might be that group taxation is a concession granted to provide tax relief, and taxpayers in general may therefore favour a group tax system (Margo Commission, 1987:§10.95).

132 More groups favoured the loss-transfer model than the consolidation model (Margo Commission, 1987:§10.102).

133 The Commission were of the opinion that the loss-transfer regime caused more uncertainty and delays, in comparison with the consolidation regime. They based their view on the fact that loss transfers have implications for both transferor and transferee companies (intragroup transactions are not eliminated). Also, because of the period during which an election could be made, various permutations and combinations are brought into the equation (Margo Commission, 1987:§10.102).

134 A 100% ownership requirement; limitation of losses to the consolidation period, and anti-avoidance legislation to prevent trading in assessed-loss companies (Margo Commission, 1987:§10.108). The minority of the Margo Commission argued that not having a group tax system would act as a

was nonetheless of the view that the objective of the implementation of group taxation was to provide relief from taxation, and considered group taxation to be a form of tax avoidance that would eventually lead to substantial revenue losses for the South African Government (Margo Commission, 1987:§10.104). The majority argued that the company, and not the group, must continue to be the taxable unit in South Africa's corporate tax system (Margo Commission, 1987:§10.107). This argument directly opposes the newer, single enterprise principle and reverts to the traditional principle of separate entities.

Despite the Margo Commission's decision to recommend that a formal group tax system should not be implemented, most of the professional bodies and major companies nonetheless continued to lobby for a group tax system (South African Chamber of Commerce, 1996). Some of the reasons[135] given by the Margo Commission regarding why a group tax system should not be employed were that a group tax system would cause a loss of significant revenue to the state, it would increase the administrative burden of the State because of its complexity, and it would furthermore be unfair to minority shareholders (Margo Commission, 1987:§10.105). The Margo Commission concluded that the time was not "ripe" for group taxation in South Africa. The Margo Commission did, however, recommend that wider powers should be granted to the Commissioner to cater for instances where the strategic interest of South Africa is at stake (1987:§10.107). The corporate group relief regime provided at that stage to the shipping industry[136] was given

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disincentive to investing in South Africa and would give rise to large, divisionalised companies, while the adoption of a group tax regime would comply with trends in other tax jurisdictions and would also adhere to the principle of tax neutrality (Margo Commission, 1987:§10.108).

135 Other reasons included the expiry of valuable licence rights held by individual companies, non-compliance with certain regulatory requirements in specific industries, and violation of agreements in the names of the individual companies (Margo Commission, 1987:§10.98). It appears that these reasons should be revaluated, as individual companies would still be able to retain their separate existence within a group tax system, especially with regard to specific rights or licences and agreements held by those member companies. Some commentators speculate that the Margo Commission did not fully understand the implications of a group tax system (Davids, 2009:39; Kantor, 1988:115). Even the Katz Commission (1995:§10.98) stated that some of these reasons had "doubtful validity in the first place".

136 This regime was contained in section 14(1A) - (1D) of the Income Tax Act, 58 of 1962. This regime applied to transactions concluded between holding companies and their subsidiaries within the shipping industry on or before 12 March 1997. The Margo Commission (1987:§10.107) considered South Africa's interest in the shipping industry to be strategic to the economy of the country. Furthermore, governments are often compelled to offer competitive tax regimes to attract taxpayers in the shipping industry due to the highly mobile nature of the industry (National Treasury, 2013a:74). It is submitted that competitiveness must have been the reason why government permitted a group tax regime for the shipping industry. This regime was repealed by section 49 of Act No 31 of 2013. A new internationally

as an example of group relief measures granted to a strategic industry that should be introduced on a wider basis. These measures, legislated as part of the South African Income Tax Act, permitted a form of group taxation[137] and allowed for the transfer of a subsidiary's assessed loss to its parent company.[138] It also allowed a subsidiary to claim allowances on ships which it acquired from its parent company.[139] It furthermore provided that where any subsidiary operates a business as the proprietor of any ship, its parent company may elect[140] that the parent and subsidiary be deemed to be one and the same company for tax purposes.[141] This regime was exceptional as it was the only provision in South African tax legislation that also provided for the transfer of assessed losses between group companies, which is one of the objectives of the ideal group tax system. The Margo Commission (1987:§10.107) recommended that group tax provisions similar to those of the shipping industry should be extended in legislation to include other strategic industries in South Africa. This recommendation was never implemented. This recommendation does, however, provide an indication of the type of group tax regime the Margo Commission had in mind.[142]

In retrospect, the work done by the Margo Commission with regard to group taxation were not in vain. The most important contributions made by the Margo Commission were, firstly, to acknowledge the fact that South Africa's tax system regarding corporate groups is not in line with international systems, and secondly, that it considered arguments for and against

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competitive shipping regime was introduced, which grants exemptions to international shipping companies from normal tax (which includes capital gains tax), dividends tax, and withholding tax on interest. The new regime came into effect on 1 April 2014 and applied for tax years beginning on or after that date. (Section 12Q of the Income Tax Act, 58 of 1962.).

137 For the regime to apply, the following requirements had to be met: the parent company had to manage and control the subsidiary, the parent company had to be the sole beneficial shareholder of the subsidiary (100% holding); and the parent company had to be incorporated in South Africa (section 14(2) of the Income Tax Act, 58 of 1962).

138 Section 14(1A) of the Income Tax Act, 58 of 1962.

139 Section 14(1B) of the Income Tax Act, 58 of 1962.

140 According to section 14(1D)(b) of the Income Tax Act, 58 of 1962, the election was binding on all companies in the tax year when the election was made and in all tax years after that. The election could therefore only be reversed with the consent of the Commissioner.

141 Section 14(1D) of the Income Tax Act, 58 of 1962.

142 The regime only provided relief for shipping companies incorporated in South African and subsidiaries managed and controlled in South Africa, which is a clear indication of the intention of the legislature to benefit only domestic groups. The regime was elective and could only be reversed with the consent of the Commissioner. Because any group tax regime provides for a tax concession or a tax relief, it is submitted that such a regime should be elective and not mandatory. Also, once such a regime is opted for, the decision should not be reversed without the consent of the Commissioner.

the suitability of adopting a group tax system in South Africa. In this way, the Margo Commission opened the debate on the introduction of a group tax system in a South African context. After the Margo Commission's report, the Tax Advisory Committee of the Minister of Finance (1990:322) identified group taxation as a future area for research, as "international trends recognize a group as a single entity for tax purposes".

5.2.2 **The Katz Commission**

In 1995, the Katz Commission[143] re-investigated the matter. Unlike the Margo Commission, the Katz Commission was appointed during the post-apartheid era. South Africa was re-entering the international arena after years of isolation, and the South African Government was eager to attract multinational corporate groups back into the country. The main aims of the Katz Commission were to establish comprehensive tax reform that would contribute to robust and sustainable economic growth, the mitigation of poverty, and an increase in international economic competitiveness, while remaining true to the principles considered necessary for a good tax system (Joint Standing Committee on Finance, 1996:2). The Katz Commission (1995:§10.1.2) was, nonetheless, aware that group taxation was not a priority of all parties at that stage.

The Katz Commission (1995:§10.1.2) regarded the fact that no group tax system had been implemented by that time (1995) as a fundamental flaw in the South African tax system, and that "South Africa could no longer refuse the cogent arguments which favour movement to a group system". The Katz Commission (1995:§10.1.2) recommended that the transition to a group basis of taxation should commence immediately, and as experience would be gained in the process, further refinements to the group tax system could be effected (Katz Commission, 1995:§10.1.2). In response, the business community in South Africa, represented by the South African Chamber of Business,[144] reacted positively by declaring that a group tax regime would represent a move towards better fiscal management, reduce some financial distortions, and would align South Africa's tax treatment of companies with the tax treatment of companies in developed economies

143 The Katz Commission's findings on group taxation were reported on in the "Third Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa 1995".

144 Presently known as the South African Chamber of Commerce and Industry (SACCI).

(South African Chamber of Business, 1996:4-5). Taking into consideration the changed economic, global and political environment at the time of the Katz Commission, it is not surprising that the Katz Commission favoured the adoption of a group tax system, as compared with the Margo Commission that had reported during a challenging period. Any tax relief measure or tax concession, such as a system of group taxation, is arguably considered more favourable during periods of economic growth, when outlooks are optimistic.

Although the Katz Commission (1995:§10.6.1) recommended the introduction of a group tax system, it proposed a "gradual approach" to the implementation, beginning with "a simplified consolidation method"[145] and progressing towards a "full consolidation system".[146] According to the Katz Commission (1995:§10.6.4), the reason for recommending this gradual approach was to enable SARS to first evaluate the implication of the move to group taxation on tax offices in order to identify and address initial administrative problems, before moving to a fully-fledged consolidation system. The Katz Commission (1995:§10.5.4) was of the opinion that this gradual method of implementing group tax would reduce the effect that the complexity of such a system has, as well as the cost. The Katz Commission (1995:§10.2.10) also recognised that these difficulties were the same difficulties identified by the Margo Commission.

In response to the Katz Commission Report, the Joint Standing Committee on Finance (1996:25) requested that the characteristics of the different group tax methods be explained by comparing the characteristics of the consolidation method with the characteristics of the loss-transfer method. This indicates the view of the Joint Standing

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145 According to the Katz Commission, the initial group tax system should *not* be a "full consolidation model". The Katz Commission (1995:§10.2.1) recommended that the initial "compromised form of group taxation" should not be too complex or costly, and should be capable of evolving into a "fully fledged group taxation regime".

146 It is also not certain exactly which consolidation model the Katz Commission had in mind when they referred to a "full consolidation model". It can be assumed that the Katz Commission referred to the absorption approach of the consolidation model, because this is the only system where all "intragroup transactions would be eliminated" and the "tax result for the group would be identical to that which would have arisen if the subsidiaries had been divisions of the parent company" (Katz Commission, 1995:§10.5.22). At the time of the Katz Commission report, the Netherlands was the only country applying the absorption approach consolidation model. The Netherlands, however, later replaced it with the attribution model in 2003 (de Vries, 2004). When the Katz Commission reported on group tax in 1995, Australia was still applying the loss-transfer model. Australia only started applying the absorption method of the consolidation model in 2002.

Committee on Finance that the loss-transfer model was the simpler method referred to by the Katz Commission.[147] Nevertheless, from the step-by-step consolidation method suggested by the Katz Commission (1995:§10.5.27-33) and the examples set out in Appendix 1 of the third report of the Katz Commission, it appears that the "simplified consolidation method" referred to in the report refers to the pooling method of the consolidation model, rather than to the loss-transfer model.[148]

Like the opinion expressed by the Margo Commission, the Katz Commission (1995:§10.3.2) also expressed its preference for the consolidation group taxation regime, as opposed to the loss-transfer regime. The Katz Commission (1995:§10.3.2) noted that the loss-transfer regime "does very little about recognising the economic unity of a group", and potentially creates an environment for the manipulation of intragroup transactions, engineering of timing differences, manipulation of cost bases, and exploiting of capital/revenue mismatches. According to the Katz Commission (1995:§10.3.2), the loss-transfer system is more complex and prone to misuse than the consolidation model, due to the difficulties created by the time span involved in making an election in terms of the loss transfer model and the manner and degree of consolidation. Although the Katz Commission made several recommendations regarding group tax,[149] it is submitted that the most important contribution by the Katz Commission lies in the step-by-step consolidation mechanism it proposed.[150]

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147 According to the Joint Standing Committee on Finance (1996:24), the Katz Commission's recommendation in this regard was that, initially, the consolidated tax burden of the economic unit should be determined from returns submitted by each separate company, in which its normal taxable income is calculated by applying current legislation, except for a few proposed amendments.

148 It seems, according to the analysis of the structural elements of group tax regimes in Chapter 7, that the rules of the pooling consolidation model fit this description of the initial "simplified consolidation method". The rules of the simplified consolidation method suggested by the Katz Commission to calculate the group's tax base are analysed in detail in Chapter 8 of this study.

149 The Katz Commission (1995:§10.6.2) also suggested that, in accordance with the minority submission of the Margo Commission, a group should be defined as a parent company and wholly owned subsidiaries. The Katz Commission also proposed that group taxation should be voluntary and that any pre-consolidation losses of group members should be excluded. In general, the Joint Standing Committee on Finance (1996:24-25) supported these recommendations of the Katz Commission, but in addition, they suggested that anti-avoidance provisions should be drafted, the definition of a group be clarified, and the potential loss of revenue to the state be investigated.

150 The particulars of this consolidation mechanism are discussed in more detail in Chapter 8 where the structural elements of a suitable group tax regime for South Africa are considered.

Despite the fact that the recommendations of the Katz Commission were accepted in principle (Joint Standing Committee on Finance, 1996:25), the Department of Finance has only once since 1995 (during the Budget Review in 1996) referred to a group tax system. In the 1996 Budget Review, the Minister of Finance declared that the introduction of group taxation would place severe stress on the government's tax administration (Department of Finance, 1996). The Minister announced that the Katz Commission's recommendation of introducing a simplified consolidation model would have to be postponed until SARS became fully functioning (Department of Finance, 1996). It is submitted that SARS has had ample time since 1996 to become more efficient and that the efficiency of its systems can no longer be offered as an excuse for not introducing a group tax system. The shipping group tax regime, furthermore, provides insight into the ability of the revenue services in South Africa to deal with a group tax system. This shipping industry's group tax regime was in operation for over 20 years, and the working and application of this regime was widely understood and managed by SARS. It suggests that SARS is able to deal with a group tax system and its implementation, indicating that the government's reasons for not implementing a group tax regime in accordance with the Katz Commission's recommendations in 1996 appear no longer to be valid.

5.2.3 Davis Tax Committee

In the 2013 Budget, the then Minister of Finance[151] announced that the Davis Tax Committee would conduct a South African tax review to assess South Africa's tax policy framework (National Treasury, 2013b). Part of the Davis Tax Committee's terms of reference was to review the corporate tax system of South Africa. The Davis Tax Committee (2018:6) first assessed the current corporate restructuring rules and found the rules to be complex and not user friendly. In addressing the problem the Davis Tax Committee (2018:7-8) firstly recommended that the current corporate restructuring regime should be revised and refined. The Davis Tax Committee (2018:8) further recommended that a formal group tax system should be introduced.

151 Mr Pravin Gordhan.

A formal group tax regime could, however, only be considered once SARS had adequate resources to handle group tax and the economy was strong enough, which was not the case at the time of the report (Davis Tax Committee, 2018:8). The recommendations made by the Davis Tax Committee (2018:8) therefore did not include the introduction of a formal group tax system at that point in time.

In recommending a formal group tax regime, the Davis Tax Committee (2018:7) stated its preference for the loss-transfer model as initial regime, opposed to the consolidation model. Their reason for choosing the loss-transfer model appears to be simplicity: “the addition of the set off of assessed losses to the corporate rules” would “thus largely be a simple adjustment to what South Africa currently has” (Davis Tax Committee, 2018:7). According to the Davis Tax Committee (2018:7), South Africa should retain the group tax elements it currently has in place, i.e. the current corporate restructuring regime which allows “the tax-free transfer of assets between group members”, but should continue to refine these rules. The introduction of a loss-transfer model is therefore seen as an uncomplicated addition to South Africa’s current group tax provisions (the corporate restructuring regime).

In its report, the Davis Tax Committee (2018:83) rejects the consolidation models implemented by Australia and the United States because of their complexity and the vastness of their rules. According to the Davis Tax Committee (2018:83) the consolidation models implemented by Australia and the United States would only add complexity to the tax system and cannot be considered suitable in the South African context. The consolidation model of the Netherlands, on the other hand, is seen as an easier approach, and is recommended as a final stage group tax system (Davis Tax Committee, 2018:79).

5.2.4 Comparison of the findings

The Margo Commission, the Katz Commission, and the Davis Tax Committee considered arguments for and against the suitability for adopting a group tax system in South Africa. They all acknowledged the fact that South Africa’s tax system, with regard to corporate groups, is not in line with international systems. Furthermore, they agreed that cost and complexity are the two most important obstacles to introducing a group tax system in

South Africa. For the type of group tax model suitable in a South African context, both the Margo Commission and the Katz Commission agreed that the consolidation model and the loss transfer model are the two potential alternatives to consider. Both commissions were of the view that, *prima facie,* the consolidation model appears to be more complex, but according to the commissions, it represents a simpler and a sounder approach to group taxation and the single enterprise principle. Their viewpoints are in sharp contrast to that of the Davis Tax Committee (2018:7) that recommended that a loss-transfer model should be introduced as a simple and trouble-free supplement to the current corporate restructuring regime South Africa already has in place.

The Margo Commission decided against the introduction of a formal group tax regime in South Africa, whereas the Katz Commission decided in favour of the immediate introduction of a formal group tax system in South Africa. The Katz Commission proposed that a group tax model that is simple and straightforward should be introduced at first and then, after evaluating the effect of the initial simpler group tax system, a more comprehensive group tax model[152] should be introduced. The Davis Tax Committee (2018:8) recommended that a formal group tax system should only be implemented once the economic environment in South Africa is more positive, which was not the case at the time of their report. All the recommendations must, however, be considered against the economic backdrop of South Africa during the respective times of their reports. The Katz Commission, which reported during a time of great economic prospects, favoured the immediate introduction of a group tax system. By contrast, the Margo Commission, reporting during an exceptionally difficult period at the end of the apartheid era, rejected the introduction of a group tax system. The Davis Tax Committee that also reported during difficult economic times in South Africa decided in favour of a group tax system but only at a later stage when the economy is strong enough to "withstand such a change". It is apparent that the implementation of a formal group tax regime is viewed more optimistically during times of economic growth and positive expectations.

152 It is, however, uncertain whether it is possible to commence with a simpler group tax system and, through amendments to the original set of statutes, introduce a fully comprehensive group tax regime. This issue, and the details of the initial group tax model ("compromised form of group taxation") as suggested by the Katz Commission, are analysed further in the next chapter of this study.

5.3 PROVISIONS PROVIDING RELIEF TO CORPORATE GROUPS

Over the years, two separate sets of provisions have been introduced to provide tax relief for corporate groups. Although not formal group tax models, these sections provide relief similar to a group tax regime. The first set of provisions, the rationalisation relief rules, provided only temporary relief and was substituted by the corporate restructuring rules, which currently apply. In addition to these provisions, the South African tax legislation includes other provisions that have elements of group taxation, which will also be discussed in this chapter.

5.3.1 Rationalisation Relief Rules

The first tax regime introduced in South Africa that more broadly acknowledged the reality of economic units in South Africa comprised rationalisation relief provisions, introduced as a consequence of the Margo Commission's report.[153] In terms of these provisions, the rationalisation relief[154] was temporary, allowed during two separate phases each with its own set of tax relief measures. The provisions for the first phase of rationalisation relief were introduced in 1988.[155] It offered relief where a group of companies underwent restructuring during the period 17 June 1988 until 30 June 1991. These relief measures were only available to a group of companies that met the requirements and where the group opted that the rationalisation relief measures[156] would apply. If the Commissioner agreed to the rationalisation relief,[157] the intragroup transfer of assets constituting part of the deal could occur without any negative tax consequences for the parties involved. The parent company would file an income tax return consolidating the results for the group

153 It was found that some companies, due to the nature of their assets and liabilities and their tax positions, could rationalize their business structures inexpensively, while others had to incur enormous tax costs to restructure their businesses (Margo Commission, 1987:§10.102). Following the Margo Commission Report, Parliament debated the issue and decided to introduce temporary rationalisation relief measures to assist corporate groups wishing to rationalise their business structures (Ernst & Whinney, 1988:1).

154 The initial set of rationalisation relief measures of 1988 were later replaced by a new set of rationalisation relief measures in 1994.

155 Section 48 of the Taxation of Laws Amendment Act, 87 of 1988.

156 The taxpayer applied in writing in terms of section 48 of the Taxation of Laws Amendment Act, 87 of 1988.

157 The agreement was referred to as an "extra-statutory arrangement" between the Commissioner and the taxpayer.

companies that had elected to participate in the rationalisation process. Any profits or losses on the transfer of assets between group companies that formed part of the rationalisation would be eliminated in the consolidated return and effectively not be taxed. After the rationalisation process, each member company would continue as separate taxpayer. The intention was that the profits on any asset disposed of to an outside person after the rationalisation process would be subject to tax.

The problem with the rationalisation group tax relief measures applicable during the first phase was illustrated in the *Wooltru Property Holdings* case. Disparities arose because the group of companies were treated as separate and distinct taxpayers prior to the rationalisation agreement, and later as a single taxpayer for purposes of the rationalisation process, only to be treated as separate and distinct taxpayers again, following the rationalisation.[158] The rationalisation rules did not provide for rollover or similar measures which are normally provided for in formal group tax systems.[159] It is evident that introducing separate statutes that adhere to the single enterprise principle in a tax system, which was traditionally designed to apply the separate entity principle, created mismatches that should have been managed, specifically upon a company entering into the system and upon exiting. By providing for rollover provisions in the second phase of rationalisation

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158 The deductions (lease premiums in respect of leased property and leasehold improvements in respect of leased property) claimed by the subsidiaries in respect of certain leasehold assets were claimed while they were still treated as separate entities for tax purposes (under sections 11(*f*) and 11(*g*) of the Income Tax Act (South Africa, 1962). These leasehold rights were then transferred tax free from the subsidiary companies to the parent company at the time that they were treated as single economic unit in terms of the temporary rationalisation relief measures. After the rationalisation process, the group members continued as separate taxpayers again. It was at this stage that the parent company sold the rationalisation assets (leasehold rights) to an outsider. The Commissioner assessed the parent company on the recoupment of the allowances deducted in previous years of assessment by the subsidiaries. In the decisions of both the Special Court and a full bench of the Cape Provincial Division, it was accepted that the deductions previously claimed could not be taxed as a recoupment in Wooltru Property Holdings' hands, as the deductions had not been claimed by Wooltru Property Holdings. Wooltru Property Holdings, as parent company, merely presented the consolidated tax returns of the corporate group to the Commissioner as an administrative arrangement and part of the rationalisation relief regime permitted by SARS at that stage. The submission of consolidated returns by Wooltru Property Holdings by no means implied that the allowances were claimed by the parent company. The recoupment of the allowances can, therefore, not be taxed in the hands of the parent company. The *Wooltru Property Holdings* case illustrates how the South African government lost tax revenue due to the fact that the economic unity of the group was only partially recognised (Stack *et al*., 2015).

159 In terms of a group tax system, there are various options in respect of the treatment of assets (other than intragroup shares) upon entry and exit: quarantine treatment, deemed sale treatment, rollover treatment, and cost base reset treatment. For a detailed discussion of the methods applied in formal group tax regimes upon the entering and exiting a group tax regime, see Chapter 7, Section 7.7.

relief, most of the complications experienced with the rationalisation rules during the first phase, upon entering and exiting the system, were eliminated.

With the second phase rationalisation rules,[160] transferor and transferee companies were treated as one and the same company for income tax purposes,[161] thereby facilitating the rollover measures. The second phase rationalisation relief measures, introduced in 1994,[162] contained relief provisions similar to those contained in the rationalisation relief measures of the first phased introduced in 1988. It enabled companies to rationalise their affairs without incurring tax consequences on the transfer of shares or assets between companies within a group[163] and without incurring taxes on dividends distributed as part of the rationalisation scheme.[164] Notwithstanding the relief provided by the second phase rationalisation rules, assessed losses could not be passed from the transferor to the transferee and had to be sacrificed permanently.[165] The second phase rationalisation relief measures were, however, more limited than the rationalisation relief measures of the first phase. Initially, only a listed company[166] could qualify as a controlling company[167] of a

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160 In order to qualify for the rationalisation relief, a written agreement for the implementation of the rationalisation scheme had to be entered into on or after 4 November 1994. This meant that the group of companies applying for the tax relief had to be in existence on 4 November 1994, the date of the agreement. (This date was later extended to 19 June 1995 (section 7 of Taxation Laws Amendment Act, 37 of 1995). In 1997, the date of 19 June 1995 was amended again by replacing with the words "the date of the agreement" (section 56 of Taxation Laws Amendment Act, 27 of 1997)). Initially this rationalisation scheme did not have an expiry date. However, when the rationalisation scheme was replaced with the corporate restructuring regime, the final expiry date that an agreement in respect of a rationalisation scheme had to be submitted to the Commissioner was decreed as 1 March 2002 (section 178 of the Second Revenue Laws Amendment Act, 60 of 2001).

161 Section 39(2)(b), read together with section 39(6), of the Taxation Laws Amendment Act, 20 of 1994.

162 Section 39 of the Taxation Laws Amendment Act, 20 of 1994. Application for the second set of rationalisation relief measures had to be made to the Commissioner (section 39(3) of the Taxation Laws Amendment Act, 20 of 1994). The application had to be made in a written statement setting out details of the scheme and any subsequent variations, together with mandates from each controlled company, supported by resolutions of the directors or shareholders of those companies. The Commissioner then certified that stamp duty and transfer duty were not chargeable on the transfers concerned, but these exemptions lapsed if the transfers were not affected within six months after the date the certificate was issued.

163 Section 39(2)(c) of the Taxation Laws Amendment Act, 20 of 1994.

164 Section 39(2)(a) of the Taxation Laws Amendment Act, 20 of 1994.

165 Section 39(6)(c)(ii) of the Taxation Laws Amendment Act, 20 of 1994.

166 An amendment was introduced in 1995 to also allow unlisted companies with interests in the former Transkei, Bophuthatswana, Venda and Ciskei to partake in the rationalisation scheme (section 7 of Taxation Laws Amendment Act, 37 of 1995). Another amending provision in 1997 included groups not listed if the share capital of the parent is in excess of R250 million (section 56 of Taxation Laws Amendment Act, 27 of 1997). This limit of R250 million was amended in 1999 to reduce it to R75 million (section 108 of Revenue Laws Amendment Act, 53 of 1999).

group. Furthermore, in order to qualify as "rationalisation scheme"[168] the only or most important reason[169] must have been to acquire substantial and enduring savings or administrative benefits for the group of companies, to promote some or all of the group's trading activities, which must have already been carried on before the rationalisation scheme, or to effect a qualifying unbundling transaction.[170] [171]

Yet, despite its limitations, groups regularly made use of the rationalisation relief measures and government was pressured to continue providing restructuring relief measures to corporate groups on a more permanent and common basis (Ernst & Young, 1995:133; Feinstein, 1997:391; Karro, 2000:791). In 2001, the second phase rationalisation relief measures[172] were replaced by the corporate restructuring regime.[173]

5.3.2 Corporate Restructuring Rules

The second set of legislation that deals with corporate group relief in South Africa was introduced in 2001.[174] These rules were introduced to ensure tax neutrality in the case of the restructuring of corporate groups[175] in South Africa and are known as the corporate

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167 In order to qualify as a controlled company within the group, ≥ 75% of the share capital had to be held directly or indirectly (through other companies) by the controlling company (section 39 of the Taxation Laws Amendment Act, 20 of 1994).

168 Definition of "rationalisation scheme" in section 39(1) of the Taxation Laws Amendment Act, 20 of 1994.

169 According to section 39(7) of the Taxation Laws Amendment Act, 20 of 1994, the rationalisation relief would not be granted if the key purpose or one of the most important purposes of rationalisation had been to avoid, postpone or reduce of the tax liability that otherwise would have been payable.

170 In order to qualify for tax relief, the unbundling transaction had to conform with the prerequisites of section 60 of Act, 113 of 1996, which provided certain concessions in respect of normal tax and exemption from stamp duty. This unbundling provision enabled listed companies to make *in specie* distributions to their shareholders of distributable shares which it held in other listed companies. The proposed unbundling transaction had to be approved by the Commissioner.

171 The rationalisation rules were considered too limited to be of practical use to corporate groups in general (Karro, 2000:791).

172 It includes the unbundling relief rules.

173 Specific cut-off dates were announced, after which the previous unbundling and rationalisation rules ceased to apply. The final cut-off date for applying for an unbundling transaction was 1 December 2001, and for applying to a rationalisation scheme, this was 1 March 2002 (section 178 of the Second Revenue Laws Amendment Act, 60 of 2001).

174 Second Revenue Laws Amendment Act, 60 of 2001. .

175 Corporate restructuring involves a reformation of the ownership of a company; a restructuring of assets, trade operations, or purposes within a corporate group; the reorganisation of liabilities within a corporate group and a financial rearrangement (Haupt, 2016:521).

restructuring rules or corporate rules.[176] The corporate restructuring rules introduced in 2001 still apply today. The corporate restructuring rules offer relief in respect of intragroup transactions and between founding owners and their companies (National Treasury, 2001:6). These measures are mostly grounded on the basis that where the corporate group or the founding holders retain a significant ownership share in the asset disposed of, it is fitting that the transfer of assets should occur free of tax to a company where the assets can most effectively be applied for trade purposes[177] (National Treasury, 2001:6). The corporate restructuring rules offer relief that is in line with the relief offered by international formal group tax regimes by allowing for tax-free intragroup asset transfers by deferring the tax incidence until the assets are sold to an outside person (National Treasury, 2007:11[178]).

The main policy objective for introducing the corporate restructuring rules was to facilitate competitiveness. Worldwide, corporate restructuring tax relief rules are applied as a recognised method to minimise the cascading consequences of taxing capital gains on the sale of assets in multi-tiered corporate units.[179] To maintain its competitive edge, South Africa had to make sure that groups of companies on the JSE are offered benefits[180] equal to the benefits enjoyed by groups on the stock exchanges of New York, London and other countries (The Parliamentary Monitoring Group, 2001). The corporate restructuring rules, therefore, had to be introduced together with the introduction of capital gains tax (1 October 2001), if South Africa wished to remain competitive (Finance Standing Committee, 2001).[181]

Clearly, upon introduction of the restructuring rules in 2001, the legislator's main intention was simply to offer relief to corporate groups in South Africa in respect of the taxation of capital gains that is comparable to the relief measures offered by international tax systems

176 Sections 42–47 of the Income Tax Act, 58 of 1962.
177 This policy objective adheres to the neutrality canon.
178 Explanatory Memorandum on the Revenue Laws Amendment Bill, 2007.
179 Refer to the discussion of the cascading concept in Chapter 7, Section 7.8.
180 The introduction of the corporate restructuring rules also coincided with the introduction of the residence base tax system in South Africa, which represents a more acceptable basis internationally of taxing the residents of a country.
181 The Finance Standing Committee of South Africa held a meeting on 17 October 2001 on the Second Revenue Laws Amendment Bill (Parliamentary Monitoring Group, 2001).

when corporate groups undertake restructuring transactions in their jurisdictions[182] (National Treasury, 2001:6). While the original intention was to provide for capital gains tax relief, the corporate restructuring regime goes well beyond capital gains tax relief, as it also deals with relief from income tax, dividends tax, tax on donations, transfer duty, securities transfer tax, and value-added tax. It is consequently a system that offers integrated and comprehensive relief (National Treasury, 2001).

5.4 CORPORATE RESTRUCTURING RULES

Currently, the corporate restructuring rules offer the following tax relief:[183]

- section 42 in the case of asset-for-share transactions;
- section 43 where share-for-share transactions occur;
- section 44 in amalgamation transactions;
- section 45 where assets are transferred in intragroup transactions;
- section 46 provides for relief in unbundling transactions, and section 46A deals with the restriction of expenses claimed in respect of shares owned in an unbundling company; and

182 The South African tax system should provide tax relief to cater for the “combinations and flows” (mergers, acquisitions and unbundling transactions) naturally occurring within corporate groups.

183 The original provisions introduced in 2001, in Part III of the Income Tax Act, were contained in sections 41 to 46, with section 41 stipulating the pertinent definitions. The original corporate restructuring rules covered corporate formation transactions (section 42), share-for-share transactions (section 43), intragroup asset transfers (section 44), unbundling transactions (section 45) and corporate liquidations, winding-up and de-registrations (section 46). The original provisions did not allow for relief in the case of mergers. In 2002, a vast quantity of amendments was introduced to improve the 2001 provisions, to streamline their application, and to make sure that the measures plainly reflect the reason for their introduction (National Treasury 2002:18). New sections were introduced to offer relief in respect of the merging, amalgamation, takeover or occurrence of any similar restructuring deal between resident companies (National Treasury 2002:18-19). Sections 41 to 46 were replaced with sections 41 to 47 (Revenue Laws Amendment Act, 74 of 2002). In 2007, section 43 was repealed and the provisions incorporated in section 42 (Revenue Laws Amendment Act, 35 of 2007). In 2012, a new section 43 was introduced to deal with substitutive share-for-share transactions Revenue Laws Amendment Act, 22 of 2012, with effect from 1 January 2013 (Revenue Laws Amendment Act, 22 of 2012, with effect from 1 January 2013).

- section 47 offers relief when liquidating, winding-up or deregistering a company.

One of the two objectives or functions a formal group tax regime aims to achieve is to offer tax relief in respect of the intragroup transfer of assets. Section 45, dealing with intragroup transactions, was introduced to comply with this objective. According to National Treasury (2001:10), an intragroup transaction refers to the transfer of assets from one company to another company within the same group of companies. In terms of the restructuring rules, asset transfers between group members are entitled to rollover tax relief. According to National Treasury (2007:22), the aim of the relief offered by corporate restructuring rules is *"to place a single group of companies on par with a single company containing multiple branch operations. The transfer of assets between two branches of a single company should be a non-event for tax purposes. This also applies to the transfer of assets between two companies within the same group.*" This clearly indicates that government's intention with the introduction of intragroup relief (section 45 specifically) was to achieve neutrality in a corporate group context. Of all the corporate restructuring rules, this section most closely represents a group tax system. Section 45 is, furthermore, the most commonly used corporate restructuring relief measure (Deetlefs, 2014:16). The focus in this chapter will therefore be on the corporate restructuring relief provided in respect of intragroup transactions in section 45 of the corporate restructuring rules.

5.4.1 Intragroup relief in terms of section 45 of the corporate restructuring rules

In the case of "intragroup transactions",[184] the corporate restructuring rules[185] provide relief by allowing for the intragroup transfer of assets between members of the same group of companies,[186] free of tax. The relief is achieved by permitting the transferor company[187] to sell its assets or shares for a selling price equivalent to the base cost of the asset in the

184 An "intragroup transaction" is defined in section 45(1) of the Income Tax Act, 58 of 1962.

185 Section 45 of the Income Tax Act, 58 of 1962, provides rollover relief in respect of intragroup transferrals.

186 A minimum shareholding of 70% is required to qualify as a group of companies in order to become eligible for this relief in the case of the intragroup transfers under section 45 (section 41(1) of the Income Tax Act, 58 of 1962).

187 According to the definition of an "intragroup transaction" (section 45(1)(a) of the Income Tax Act, 58 of 1962) the transferor company can either be a resident or not. Under the definition of a "group of companies" (section 41(1)), only a non-resident company that is effectively managed in South Africa will qualify.

hands of the transferee, another qualifying group member.[188] Consequently, there are no gains realised when disposing of an asset to another member in the same group of companies.[189] The effect of rolling over the base cost is that the capital gain is only taxed once the asset is disposed of by the transferee to a third party.[190] Apart from the rollover of the base cost, the transferor and the transferee are seen to be "one and the same person". It is deemed that the transferee company has stepped into the shoes of the transferor company in respect of all aspects of tax.[191]

As the members are considered one and the same taxpayer, allowances in respect of allowance assets[192] deducted for taxation purposes by the transferor will only be taxed as a recoupment in the hands of the transferee when it is disposed of to an outside person.[193] Inventory transferred between group members is treated in the same way and it is deemed that the transferor has disposed of the inventory at tax cost to the transferee.[194] The tax cost of the inventory is simply passed on to the transferee, without any tax consequences for the transferor. It is furthermore deemed that the transferee steps into the shoes of the transferor in relation to specific contracts passed on between them.[195] It is obvious that by

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188 In terms of section 45(1)(a) of the Income Tax Act, 58 of 1962, the transferee company must be a resident company.

189 Section 45(1)(a) of the Income Tax Act, 58 of 1962, provides that both companies must form part of the same group of companies at "the end of the day" of the transaction.

190 Section 45(2)(a) of the Income Tax Act, 58 of 1962, in respect of capital assets and section 45(3)(a) of the Income Tax Act, 58 of 1962, in the case of allowance assets. This relief is not applicable where a transferor disposes of equity shares in a foreign company to a transferee, unless certain requirements are met (see section 45(1)(*b*) of the Income Tax Act, 58 of 1962).

191 The transferee acquires the same acquisition date, cost and valuation date value in respect of the asset where a pre-valuation date asset is acquired (section 45(2)(a) of the Income Tax Act, 58 of 1962).

192 "Allowance assets" are defined in section 41(1) of the Income Tax Act, 58 of 1962. An "allowance asset" is a capital asset, and therefore the rules pertaining to the roll-over of base cost for capital gains tax purposes also applies to it.

193 Section 45(3)(*a*) of the Income Tax Act, 58 of 1962. In the meantime, the transferee company will continue to claim deductions and allowances on the tax cost of the asset. This relief does not apply where a transferor company disposes of equity shares in a foreign company to a transferee company.

194 Section 45(2)(*b*) of the Income Tax Act, 58 of 1962. This relief does not apply where a transferor company disposes of equity shares in a foreign company to a transferee company.

195 Section 45(3)(*b*) of the Income Tax Act, 58 of 1962. Any section 24 allowance or section 24C allowance claimed by the transferor in the previous year of assessment is not added back in the hands of the transferor in the current year of assessment but is added back in the hands of the transferee. The transferee will then claim the new section 24 or 24C allowance in the current year of assessment. This relief does not apply where a transferor company disposes of equity shares in a foreign company to a transferee company.

providing for rollover provisions in the corporate restructuring rules, the complications suffered under the previous rationalisation regime are avoided.[196]

Although the corporate restructuring rule provides for the transfer of the asset at base cost or tax cost for tax purposes, the actual transfer amount can be different, and market values are often used. Where the asset is transferred at a value lower than market value, there will be no donations tax, provided that the transferee is a South African resident.[197] It is also required that the asset is retains its nature in the hands of the transferee; if the asset was held as a capital asset in hands of transferor, the asset must be held as a capital asset by the transferee. If the asset was held as inventory by the transferor, it must be held as inventory by the transferee.[198] Where the asset held by the transferor constitutes an *equity share in a foreign company*, corporate rollover relief will only be allowed if it is held as a *capital asset* by both group members, and if the asset is disposed of in exchange for the issue of debt or shares *other than equity shares* in the transferee.[199]

The section 45 intragroup corporate restructuring relief measure applies to the transfer of assets between any members in a group of companies, the parent company included.[200] This corporate restructuring rule applies automatically and all parties involved have to agree in writing if the corporate restructuring rule is *not* to apply.[201] This election can be

196 As will be discussed later, there are other serious problems with the corporate restructuring regime.

197 In terms of section 56(1)(*r*) of the Income Tax Act, 58 of 1962, transfers between group companies are exempt from donations tax.

198 Section 45(1)(*a*) of the Income Tax Act, 58 of 1962.

199 In addition to this, the transferor and transferee company must form part of the same group of companies as defined in section 1(1) of the Income Tax Act, 58 of 1962, and both companies must be resident companies, or a controlled foreign company in relation to one or more residents that form part of the above group of companies (section 45(1)(*b*) of the Income Tax Act, 58 of 1962).

200 There are certain exceptions, as set out in section 45(6) of the Income Tax Act, 58 of 1962, when the roll-over relief will not be applicable. For instance, where the asset consists of a share in the transferee, this roll-over relief will not apply (section 45(6)(*f*) of the Income Tax Act, 58 of 1962). Also, where the transferee's income is exempt from tax, the roll-over relief provided in section 45 will not apply (section 45(6)(*b*) of the Income Tax Act, 58 of 1962). The roll-over relief is also not available in respect of transferrals between controlled foreign companies which are part of an offshore group of companies, except for the transfer of equity shares held in foreign companies as capital assets (see section 45(1)(b) of the Income Tax Act, 58 of 1962).

201 Section 45(6)(*g*) of the Income Tax Act, 58 of 1962. Before 1 January 2009, section 45 was an optional provision, allowing group members to elect whether to partake in the tax relief relating to intragroup transfers. From 1 January 2009, this provision, and also its deferral, applies automatically. The transferor and the transferee are, nonetheless, allowed to elect together that section 45 should not apply, for instance if they wish to utilise an assessed loss, an assessed capital loss, or a scrapping allowance (Hunter, 2010).

made on an asset-by-asset basis; the group can elect that certain assets are transferred without this corporate rule applying. This allows companies a freedom of choice, as companies may not always wish to elect to apply these rollover provisions. For example, where the transferor company has an assessed capital loss, it may prefer to utilise the loss immediately. Another important consequence of this corporate restructuring rule is that it applies to the transfer of assets from one member to another member within the same corporate group, even if it is due to normal operational requirements that may not necessarily be considered to constitute corporate restructuring transactions (see section 45 of the Income Tax Act, 58 of 1962). This section, therefore, allows qualifying intragroup transactions to be protected from the tax consequences[202] which would typically apply to such transactions, with the tax effects "rolled-over" to a later date when the relevant asset is disposed of to a party outside the group of companies.

5.4.2 Anti-avoidance in terms of section 45 of the corporate restructuring rules

Past experience in other countries that have introduced similar measures showed that corporate restructuring measures which provide intragroup relief are often used to avoid tax. With the introduction of the corporate restructuring rules, National Treasury (2001:6)[203] was aware of the importance of introducing anti-avoidance measures, which were introduced at the outset to provide for any potential tax loopholes unintentionally created by the corporate restructuring rules. As avoidance schemes afterwards appeared, these original anti-avoidance provisions had to be replaced, and amended anti-avoidance provisions had to be implemented.

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202 There is no capital gains tax, no income tax, no dividends tax (sections 64F(1)(*a*) and (*b*) of the Income Tax Act, 58 of 1962), no donations tax (section 56(1)(*r*) of the Income Tax Act, 58 of 1962), no transfer duty (section 9(1)(*l*)(ii) of the Transfer Duty Act, 40 of 1949), no securities transfer tax (section 8(1)(*a*) of the Securities Transfer Tax, Act 25 of 2007) and no value-added tax incurred, if certain requirements are met. The transferral of assets is deemed not to be a supply for value-added tax purposes (section 8(25) of the Value-Added Tax Act, 89 of 1991), provided the assets are transferred as a going concern and both parties have agreed in writing that this is the case. This means that no value-added tax is levied on the transferral of the assets from the transferor to the transferee.

203 "International experience has, unfortunately, also shown that these measures are often abused to avoid tax. A balance must, therefore, be struck between the breadth of the concessions these measures introduce and the potential for tax avoidance" (National Treasury, 2001:6). .

Presently, two kinds of anti-avoidance provisions are relevant in respect of the intragroup relief rules set out in section 45. Firstly, an 18-month deemed sale rule was introduced to prevent the abuse of intragroup relief measures by utilising losses in the transferee company, and secondly, de-grouping rules were added to trigger a deemed sale where, after the initial intragroup transfer, the entities are no longer part of the group. The rollover provisions are applied at entry and exit points, but the rollover treatment reverts to a deemed sale in the event of specific avoidance schemes. In addition, overlapping rules have been introduced over the years to provide for situations where more than one corporate restructuring rule can be applied.

5.4.2.1 The 18-month deemed sale rule

As the relief measures may be susceptible to abuse through utilising an assessed loss of the transferee company, anti-avoidance rules had to be introduced where the transferee company sells the asset within the 18-month period following the acquisition of the asset in terms of an intragroup transaction.[204] The anti-avoidance rule provides that, in the case of a capital asset, the part of the capital gain that accrued prior to the intragroup transaction[205] is taxed immediately by including it into the taxable income of the transferee company at inclusion rate. The set-off of any loss[206] of the transferee against this part of the capital gain is not allowed. Any profit or loss relating to the increase or decrease in the value of the asset *after* the transferral is, however, allowed as set-off against a loss of the transferee.

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204 Section 45(5) of the Income Tax Act, 58 of 1962. Provisions to counter avoidance schemes, which are similar to those in section 45(5), were introduced in respect of asset-for-share transactions (see section 42(7)); amalgamations (see section 44(5)); and liquidations, winding-ups and de-registrations (see section 47(4)). The anti-avoidance sections referred to here are not applicable where the asset is disposed of involuntarily in terms of par 65 of the Eighth Schedule.

205 In terms of section 45(5)(a)(i) of the Income Tax Act, 58 of 1962, the portion of the capital gain that cannot be set-off against any loss is calculated as follows:

- Market value of the asset when acquired in terms of the intragroup transaction………….xxx
- Less: Base Cost (rolled over)……………………………………………………………………(xxx)

Where the amount constitutes a capital loss (not a capital gain) it must be disregarded in determining the aggregate capital gain or loss of the transferee company. The capital loss is “clogged” and may only be set off against any capital gain determined in respect of the subsequent disposal of any other asset acquired by the transferee company from the transferor company in terms of an intragroup transaction (section 45(5)(a)(ii) of the Income Tax Act, 58 of 1962).

206 This includes an assessed loss, balance of assessed loss, and capital loss or assessed capital loss.

If the asset comprises inventory and the transferee company disposes of the inventory during the 18-month period following the intragroup transfer, the part of the profit that accrued during the period preceding the intragroup transaction[207] will be taxed. The set-off of any tax loss (assessed loss or balance of assessed loss) will not be allowed, unless the inventory constitutes the kind of inventory that is ordinarily sold by the transferee company[208] in carrying on its trade.

If the asset comprises an allowance asset and the transferee company disposes of the asset within the 18-month period following its acquisition, the part of the recoupment that relates to the period preceding the intragroup transfer must be determined as if the disposal had been made at the date of the intragroup transfer. It is then added to the taxable income of the transferee company. The recoupment is deemed to have accrued in the hands of the transferee company from a trade that is separate from its normal trade. No loss setoff (in relation to any assessed loss or balance of assessed loss) can therefore be claimed by the transferee company.[209] Only that part of the recoupment that relates to the increase in value *after* the transferral date will be allowed as set-off against any loss (assessed loss or balance of assessed loss) of the transferee.

For practical purposes, this anti-avoidance provision results in a “deemed sale” for tax purposes on the date of the transfer. Where the “deemed sale” results in a profit, it is included in the taxable income of the transferee. Where the “deemed sale” results in a loss, the set-off of the loss will not be permitted. Thereafter, normal tax provisions will apply. Any increase in the value of the asset following the date of the intragroup transfer will be taxed according to the nature of the asset. This means that tax will be calculated on any capital gain in the case of capital assets, any profit in the case of inventory, and any recoupment in the case of allowance assets.

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207 In terms of section 45(5)(b)(i) of the Income Tax, Act 58 of 1962, the portion of the profit that cannot be set-off against an assessed loss or balance of assessed loss is calculated as follows:

- Market value of the inventory when acquired in terms of the intragroup transaction….....xxx
- Less: Cost price (rolled over)………………………………………………………………(xxx).

208 Section 45(5)(b)(i) of the Income Tax Act, 58 of 1962.

209 Section 45(5)(b)(ii) of the Income Tax Act, 58 of 1962.

5.4.2.2 The de-grouping charge

The de-grouping charge[210] was introduced to prevent groups of companies from utilising the corporate restructuring rules for the deferral of taxation, and then de-grouping immediately afterwards. If one of the group members involved in an intragroup transfer exits the group of companies, or no longer forms part of the same group following the intragroup transfer, a deemed disposal occurs in terms of this anti-avoidance rule (National Treasury; 2007:23). The effect of the de-grouping charge is that it protects SARS against disposals by outside parties concealed in the form of section 45 intragroup transfers (National Treasury; 2007:23). According to National Treasury (2007:22), “this charge again stems from the branch analogy, which would trigger a gain if the two branches were no longer part of the same company.”

The two anti-avoidance provisions that can be triggered in the case where de-grouping relates to different time periods, namely anti-avoidance where de-grouping occurs within six years[211] and anti-avoidance where de-grouping occurs within two years.[212] The six-year de-grouping charge is triggered when the transferee member is no longer a member of the same group of companies in relation to either the transferor member or a controlling company in relation to the transferor member, within a six year period from the date of the intragroup transfer and the transferee member has not yet disposed of the transferred asset.[213] An example of this situation is where the transferee company still holds the asset, but ceases to form part of the same group because its shareholding fell below 70%. This de-grouping rule does not apply where a member ceases to be part of the same group because [214] either the transferor member or the transferee member is liquidated, wounded up, or deregistered, and the resident controlling company holds a minimum of 70% of the equity shares of the member that is liquidated, wound up, or deregistered. In such a situation, the resident controlling company steps into the shoes of the member that is liquidated, wound up or deregistered, and they are treated as one and the same taxpayer.

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210 Section 45(4) of the Income Tax Act, 58 of 1962.
211 Section 45(4) of the Income Tax Act, 58 of 1962.
212 Section 45(4B) of the Income Tax Act, 58 of 1962.
213 Section 45(4)(*b*) of the Income Tax Act, 58 of 1962.
214 Section 45(4)(*b*A) of the Income Tax Act, 58 of 1962.

As the resident controlling company remains within the group, de-grouping provisions are unnecessary. This means that de-grouping does not occur.[215]

Where de-grouping occurs, the transferee company is deemed to have sold its assets still on hand that formed part of the intragroup transaction. The result of the de-grouping charge is that the transferee becomes liable for normal tax on all the “built-in” gains on capital assets, allowance assets, and inventory still on hand. The de-grouping charge is, however, not applicable to any asset that constitutes inventory that is normally sold as part of the trade of the transferee company.[216]

Previously, to avoid the de-grouping charge, members within the same group undertook in multiple rollovers. Where a group of companies consisted of more than two members, the base cost (and with it, the built-in gain) was rolled over from company to company within the group. In terms of the original section, the de-grouping charge was only triggered when the ultimate transferee member and transferor member were no longer members of the same group of companies. Therefore, no de-grouping charge was levied where the ultimate transferor member and transferee member left the larger group of companies, but still remained members of the same group with regard to each other (National Treasury, 2004:69). In terms of an amendment to the then de-grouping charge, the anti-avoidance rule is also triggered with effect from 2004 if a transferee member holds an asset it acquired because of more than one disposal following the initial intragroup transferral. It is furthermore required that all the profits or losses on the transferrals had to be deferred in terms of section 45.[217] The result is that, since the amendment in 2004,[218] the de-grouping charge is also triggered when the transferee member is no longer part of the same group of companies in relation to the transferor member that effected the initial intragroup transfer.

Another problem at that stage was that the de-grouping charge applied, irrespective of the number of years after the initial intragroup transfer. In 2007, a time limit of six years was introduced[219]with the effect that the exiting of any group member, after the six-year period,

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215 Section 45(4)(*d*) of the Income Tax Act, 58 of 1962.

216 Section 45(4)(*a*)(ii) of the Income Tax Act, 58 of 1962.

217 Section 45(4)(*b*) of the Income Tax Act, 58 of 1962.

218 The amendments to section 45(4) were introduced by section 35(1)(*a*) of the Revenue Laws Amendment Act, 32 of 2004, and became effective from 26 October 2004.

219 Section 56(1)(*a*) of the Revenue Laws Amendment Act, , 35 of 2007.

is now disregarded. The period limit of six years is in line with the United Kingdom de-grouping charge.[220]The 2007 amendment caused some confusion, as it was unclear whether the de-grouping rule of six years applied from the earliest intragroup transfer or from the final intragroup transfer, where there were multiple intragroup transfers. In 2008, the wording of the de-grouping charge was amended again[221] to clarify that, in order to determine if the de-grouping charge was applicable or not, the de-grouping date must be established and the prior period of six years applied. If an asset was passed on through a number of intragroup transfers, each intragroup transferral is to be investigated in order to test for the six-year rule. It is possible that several de-groupings may occur during the six-year period, and each should then be treated as a separate de-grouping transaction (National Treasury, 2008a:42). Another amendment in 2008 determined that the de-grouping charge could only give rise to gains and not to losses, which are ignored. Previously, a loss would have resulted in a clogged loss[222] (National Treasury, 2008a:42).

In terms of the de-grouping charge, there is a deemed sale of a capital asset in the hands of the transferee company at market value on the date of the de-grouping. The deemed capital gain[223] is limited to the greatest of all the capital gains disregarded in any intragroup transfer within the six-year period before the date on which the transferee member no longer formed part of that group of companies.[224] After applying the limitation (which is effectively the same as taking the lesser of the two amounts), the amount must be added to the taxable income of the transferee company at the appropriate inclusion rate.

With regard to an allowance asset, a deemed recoupment must also be added to the transferee's gross income. To ensure that there is no loss for SARS, the deemed recoupment is determined as the higher of any recoupment previously disregarded in an

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220 Section 179 of the Taxation of Chargeable Capital Gains Act, 1992.

221 The amendment to section 45(4)(b) was introduced by the Revenue Laws Amendment Act, 60 of 2008. It was deemed to have come into operation on 21 October 2008. It became applicable in respect of all de-groupings on or after that date.

222 A "clogged loss" means that the loss could only be deducted from capital gains arising from disposals of assets to the same person, either during the same or a later year of assessment.

223 In terms of section 45(4)(b)(i) of the Income Tax Act, 58 of 1962, the deemed capital gain is calculated as follows:

- Market value of the asset on the date of the de-grouping…………………………………….xxx
- Less: Base Cost (rolled over)……………………………………………………………………(xxx).

224 Section 45(2) of the Income Tax Act, 58 of 1962.

intragroup transfer within the six-year period before the date on which the transferee member stopped being a member of the group and the recoupment at the time of the de-grouping, assuming the asset is disposed of at its market value.[225]

The cost of the asset on hand (capital asset or allowance asset) at the date of the de-grouping must furthermore be adjusted by adding 80%[226] of the capital gain that is triggered because of the de-grouping and by adding 100% of the recoupment that is triggered because of the de-grouping. After the de-grouping date, the transferee company is allowed to claim capital allowances on the adjusted cost amount. The adjusted cost amount will also be deemed to be the cost price when determining the base cost in the case of a capital asset.

Similar de-grouping provisions apply to inventory. When de-grouping occurs, there is a deemed sale at market value on the date of the de-grouping. The deemed profit[227] is limited to the greatest of all profits disregarded in any intragroup transfer within the six-year period before the date on which the transferee member ceased to be part of the group of companies. After applying the limitation,[228] the amount is added to the transferee's taxable income. The cost of the inventory on hand is then adjusted by adding the amount included in the taxable income. The adjusted cost amount is then deemed to be the cost price of the inventory for income tax purposes.

Apart from the six-year de-grouping rule, a two-year de-grouping provision[229] was added in 2008. The new rule was introduced to stop certain avoidance schemes taking place within two years following a sequence of section 45 intragroup transactions.[230] This de-grouping rule is applicable when the consideration[231] that accrued to the transferor company from

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225 Section 45(4)(*b*)(ii) of the Income Tax Act, 58 of 1962.

226 The inclusion rate for capital gains tax purposes.

227 In terms of section 45(4)(*b*)(iii) of the Income Tax Act, 58 of 1962, the deemed profit is calculated as follows:
- Market value of the inventory on the date of the de-grouping…………..…………………….xxx
- Less: Cost price (rolled over)……………………………………………………………… (xxx).

228 The same effect is achieved by taking the lesser of the two amounts.

229 Section 45(4B) of the Income Tax Act, 58 of 1962.

230 In terms of these schemes, section 45 was used not just for the deferral of the tax on the intragroup transfer until the asset is sold to a third party, but also to transfer assets completely tax free (Deloitte, 2008).

231 In terms of section 45(4B)(b) of the Income Tax Act, 58 of 1962, the de-grouping rule is triggered only if > 10% of an amount directly or indirectly derived from such section 45 consideration is paid outside the

an intragroup transfer leaves the group in terms of a transaction, operation, or scheme[232] within a two-year period determined from the intragroup transfer date. It is deemed that the transferor company and transferee company no longer form part of the same group in relation to each other. Tax consequences similar to those that normally apply in respect of the six-year de-grouping rule are then triggered.

The practical effect of both de-grouping anti-avoidance provisions is that a "deemed sale" is assumed on the *de-grouping* date, and not on the date of the initial *intragroup transaction*. This means that the growth in the assets after the initial intragroup transaction is also taxed in terms of these de-grouping rules. This treatment differs from the 18-month rule where a "deemed sale" is assumed on the date of the intragroup transfer. Another difference is that with the 18-month rule, the profit has actually been realised and there are funds available to pay the tax, whereas with the de-grouping rules, no profit has been realised and therefore there are no funds available to pay the tax. If it is triggered, the de-grouping charge has an adverse effect on the cash flow of the company, as it then becomes liable for the outflow of cash in respect of taxation on unrealised profits which will only be realised in future (Hunter, 2010).

The de-grouping charge is often the reason why corporate groups avoid using this corporate restructuring rule. The two-year de-grouping rule can become particularly difficult to deal with because it is required that assets are located and allocated to the income generated from a certain intragroup transfer. It can be problematic as proceeds start to lose their identity over the years. Even the six-year de-grouping rule can become problematic, as it is difficult to trace the date of the intragroup transfer, or dates in the instance of numerous intragroup transfers, as well as other specifics[233] relating to the specific assets. This contributes to the severity of the de-grouping rules. Moreover, the periods of two and six years are extremely long, considering how quickly things can change in the business world.

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group. This de-grouping rule was narrowed to exclude *de minimis* amounts (National Treasury, 2008b:117). .

232 In terms of section 45(4B) of the Income Tax Act, 58 of 1962, the consideration leaves the group if it is sold by the transferor member or by any other member that forms part of the same group in relation to the transferor member to any person not forming part of the same group in relation to the transferor member, either for Rnil consideration, for a non-arm's length consideration, or by way of a distribution.

233 Refers to cost, tax value and nature of the assets.

According to Hunter (2010), the de-grouping charge remains a challenge when the use of section 45 is under consideration. The de-grouping rules are currently perceived by corporate groups as being unfair and unnecessarily strict and are perhaps the most problematic of all provisions in the corporate restructuring rules (Hunter, 2010).

5.4.2.3 Overlapping with other sections of the Act

Anti-avoidance rules had to be introduced to avoid the overlapping of the corporate rules in certain instances. Firstly, the intragroup rules are not applicable in respect of the transfer of assets if the transferee issues its own shares in exchange.[234] The reason for this exclusion is to avoid the overlapping of the intragroup rules of section 45 with the "asset-for-share" relief provisions in section 42 (National Treasury; 2007:24). In this instance, section 42 will apply automatically if the shares are equity shares.

Secondly, the intragroup rules are not applicable in respect of any transfer of assets by a transferor company in terms of a liquidation distribution.[235] This provision was introduced to avoid any overlapping with the section 47 liquidation provision. Thirdly, the intragroup rules are not applicable in respect of the distribution of shares by the transferor company to the transferee company within the same group of companies.[236] This provision was introduced to prevent any overlapping with section 46. In this instance, section 46 will apply automatically (National Treasury, 2007:24).

5.4.3 <u>Avoidance schemes involving section 45</u>

Despite implementing several anti-avoidance measures at the time of implementation of the corporate restructuring rules, avoidance schemes still emerged. Section 45 has been applied in the majority of these avoidance schemes. The corporate restructuring rules had to be amended frequently to curb these avoidance schemes. In 2008, the National Treasury (2008b:1-3) pointed out that the frequent amendments to the corporate

234 Section 45(6)(c) of the Income Tax Act, 58 of 1962.
235 Section 45(6)(e) of the Income Tax Act, 58 of 1962.
236 Section 45(6)(d) of the Income Tax Act, 58 of 1962.

restructuring rules were caused by the continuing tax avoidance schemes and were required to remove ambiguities in respect of the corporate restructuring relief measures. The large number of amendments enacted from 2001 onwards indicates serious structural problems, and not the mere correction of complex tax legislation (National Treasury, 2008b:1). From an analysis of the different avoidance schemes, the following conclusions can be drawn regarding the corporate restructuring regime, specifically section 45:

- Through the misuse of section 45 in debt push-down schemes,[237] large interest deductions have been claimed, which led to significant revenue losses for the South African tax authorities.[238] Normally, interest expended to acquire shares in a company is not deductible because the interest was not incurred in the production of **"**income**"** (dividend income is normally exempt and does not constitute **"**income**"**). However, an interest deduction can be achieved in these circumstance through the use of debt push-down structures, generally using section 45 of the corporate restructuring rules. Through the introduction of various amendments, National Treasury has since then managed to restrict these interest deductions as part of the government's longer-term solutions[239] to this problem.

- For tax purposes, corporate groups in South Africa operate on both the single enterprise principle, when restructuring, and the separate entity principle, for other tax purposes, thereby creating tension between the two principles. Asymmetries or mismatches are created that have been misused in some avoidance schemes. An example of these mismatches is the asymmetry between the value of the assets transferred in terms of section 45 (the difference between the tax cost and the market value, which normally equals the consideration received in exchange) (National Treasury, 2008b:3). The conflict is caused by the fact that, under the corporate restructuring rules, group members are treated as divisions of the enterprise and

237 In general, "debt push-down" refers to the practice of transferring the debt financing obtained by a parent company (buyer) during the acquisition of a subsidiary (target company) from the parent company to the target company, in other words "pushing the debt down" (PricewaterhouseCoopers, 2017b).

238 According to National Treasury and SARS (2011:1), the losses to the fiscus from debt push-down schemes were estimated at between R3 billion to R5 billion. It was therefore proposed in the initial media statement that the intragroup relief rule, section 45, should be suspended as part of the first phase in a two-phase approach, with the second phase involving the implementation of longer-term solutions (National Treasury, 2011:8).

239 Sections 24O, 23N, 23M and 8FA of the Income Tax Act, 58 of 1962, were introduced after 2011. Sections 24O, 23N and 23M of the Income Tax Act, 58 of 1962, are discussed in 5.5.

therefore, in terms of section 45, assets are rolled over at cost, with no tax effects. Yet, in another aspect of the income tax system, these group members are still treated as separate taxpayers. Therefore, in determining the amount of a "dividend", market values are used. This asymmetry was exploited in some avoidance schemes. Clearly, the underlying structural flaw in the corporate restructuring rules lies in the fact that the general tax system under which these companies are taxed adheres to the traditional separate entity principle, while the corporate restructuring regime adheres to the single enterprise principle.

- The increased pressure on tax advisors to achieve tax savings in restructuring transactions,[240] coupled with a corporate restructuring regime that adheres to the single enterprise principle, while the remainder of the tax statutes adhere to the separate entity principle, creates opportunities for tax advisors[241] to devise a multitude of tax planning schemes. Periods of difficult economic circumstances are furthermore conducive to the marketing of these aggressive tax schemes. Apparently, the taxes saved in respect of these schemes are used to fund the "substantial fees" charged by these tax advisors (National Treasury & SARS, 2011:5).

In 2011, National Treasury (2011:9) investigated the wide-spread misuse of section 45 by considering longer-term solutions to protect the fiscus. They admitted that inter-connected areas need to be considered, as the corporate rules cannot be viewed in isolation. National Treasury (2011:8) furthermore recognised that intragroup relief is a common feature of most advanced tax systems, and that there is a need for tax-free movement of target company assets within an intragroup context (one of the objectives of a group tax system). According to National Treasury (2011:9), the problems relating to section 45 are part of a larger set of problems, which include "the need for the movement of losses within

240 Tax planning is an important component in restructuring deals. Of the global tax directors surveyed internationally in 2012, 84% said there was an increased emphasis on finding tax efficiencies to reduce the costs of merger and acquisition deals and/or to improve returns on merger and acquisition transactions (Ernst & Young, 2012). Furthermore, nearly two-thirds of the directors admitted that there is an increasing level of scrutiny from tax authorities with regard to the tax implications of merger and acquisition deals (Ernst & Young, 2012). This means that, internationally, governments are becoming more concerned about the revenue issues regarding restructuring transactions (Ernst & Young, 2012). It would seem that tax savings and managing the tax risks have become key drivers in restructuring transactions.

241 During the consultation process, following the proposed suspension of section 45, National Treasury and SARS (2011:5) indicated that a reason for the abuse is a "small clique of aggressive advisors and intermediaries" that are responsible for the core of the most "aggressive schemes of concern".

a single domestic group" (the other objective of a group tax system). It appears that National Treasury recognised in 2011 that the lack of a group tax system was part of a larger set of problems.

5.4.4 Criticism of the section 45 corporate rules

Since 2001, the corporate restructuring regime has been the focus of numerous comments, amendments and modifications devised to prevent their exploitation for tax purposes. Kotze (2012:1) is of the opinion that section 45 is the one section of the corporate restructuring rules that has been subject to the most scrutiny over the last few years. This has led to frequent anti-avoidance measures, which makes it problematic for taxpayers to comply with the requirements of section 45. The corporate restructuring rules are complicated, and circumstances unavoidably arise where the rules cannot be straightforwardly applied, or where there are unintentional and undesirable outcomes (SAICA, 2004). National Treasury (2007:22) acknowledges that there is a significant price to pay if intragroup relief in the corporate restructuring rules is used.[242] One of the penalties is in the form of the de-grouping charge.

Visagie (2016:55) is of the view that, if interpreted textually, the de-grouping anti-avoidance provisions provided for in section 45 could lead to de-grouping charges being applied in situations that were never intended.[243] Any variation in share ownership higher up in the group structure can lead to the application of a de-grouping provision lower down

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242 At the time that the de-grouping charge was limited to six years,[242] National Treasury (2007:23) admitted that the de-grouping charge was viewed as harsh. National Treasury (2007:23) clarified in the Explanatory Memorandum to the Revenue Laws Amendment Bill of 2007 that the reason for introducing the six-year time limit was to improve the de-grouping charge and make it less rigid. Unfortunately, the six-year time limit is still considered to be too strict (Kotze, 2012:1).

243 According to Visagie (2016:53-54), the word "any" in section 45(4)(*b*) in the first requirement that the transferee must cease "to form part of any group of companies" could be interpreted to mean the transferee ceases to form part of *any* of the groups of companies. Simultaneously, the "a" in "relation to a controlling company of the transferor company" (second requirement) could be interpreted very specifically to mean that the controlling company in that group ceases to be *a* controlling company in relation to the transferor company, regardless of the fact that there are still other controlling companies in relation to the transferor company. If this interpretation is followed, any variance in share ownership further up the group structure could trigger a de-grouping anti-avoidance provision while the original group, as was required for purposes of section 45, is still in place. Visagie (2016:55) argues that such a literal interpretation is possible, but not recommended, as it does not correspond with the purposive interpretation that is often applied in interpretation internationally.

in the group structure at a place where the group structure is still perfectly intact (Visagie, 2016:54). It could not have been intention of the legislator to apply de-grouping in a situation where no abuse occurs (Visagie, 2016:57). Furthermore, according to Cornelissen (2009:39), companies find it particularly problematic to meet the administration and compliance prerequisites required in the de-grouping provisions, specifically in the case of numerous rollovers within a single group of companies. Temkin (2008:1) is of the opinion that the corporate rules are administratively burdensome for both the taxpayer and SARS.

The 18-month de-grouping rule is also perceived as being unreasonably unjust and stringent. According to Middelmann (2004:27), the anti-avoidance provision of 18 months is strict and does not contribute to fiscal neutrality. The 18-month period has been criticised as being lengthy and impractical in a new world where business deals take place at an enhanced rate. It appears that this anti-avoidance rule can also be considered unrealistic and its practical application uncertain.

One of the reasons for the perceived abuse of the corporate restructuring rules that was identified by the South African Institute of Chartered Accountants (SAICA) was the absence of a formal group tax system in South Africa (SAICA, 2012). According to SAICA (2012), one of the benefits of having a formal group tax system is that it facilitates the re-organisation of assets within the group envelope in a tax-neutral fashion[244] (SAICA, 2012). According to Rood (2011:2-3), the abuse of the corporate rules is partly because of the delay by the government in implementing group taxation. Rood (2011:2-3) is of the view that a more holistic approach for treating a group as an economic unit, with intragroup transactions effectively being disregarded for tax purposes, is urgently needed.

It is problematic that a shareholding of 70% is required to qualify for this relief in respect of the intragroup transfer of assets in terms of section 45, and that there are no provisions catering for minority shareholders (Middelmann, 2004:28). There are also no provisions, similar to the provisions in the United Kingdom, dealing with the tax implications of compensation paid to minorities.

244 Although this statement is true in respect of the consolidation models, it is not necessarily true in respect of all group tax models. For example, the United Kingdom's loss-transfer model, which only provides for the offset of losses in a group. Separate statutes had to be introduced in the United Kingdom to deal with the tax-free transfer of assets in restructuring.

Moreover, where capital assets become inventory and *vice versa* within the same company (where assets are, for example, moved between divisions) there are specific provisions in the Act dealing with the tax implications. A change in the nature of assets often occurs where assets are transferred between companies with different intentions with regard to the assets. Section 45, however, requires the nature of the asset to remain the same in intragroup transactions. There are no provisions in section 45 providing for the intragroup transfer of assets where there is a change in the nature of the assets (Middelmann, 2004:28).

Furthermore, the wording of section 45 with regard to allowance assets appears to be anomalous, as the rollover relief will not be applicable to assets where the transferee is not entitled to claim an allowance because the allowance is not transferrable. An example is allowances on hotel buildings, which are normally not transferable (Haupt, 2016:551).

In addition, section 45 can be applied to achieve the tax-free intragroup transfer of most assets, but does not provide for the tax-free transfer of trade debtors or liabilities. These assets and liabilities have tax implications that are not provided for in a group context (Middelmann, 2004:28).

Even after the numerous amendments that have been made each year after 2001, the corporate rules have not evolved to the extent where they have developed into the useful set of group taxation relief provisions they were meant to be (Cornelissen, 2009:98). This raises the question whether the corporate restructuring rules can be considered to be an ideal group tax system that provides adequate group tax relief in South Africa[245].

5.5 SEPARATE GROUP RELIEF PROVISIONS

In addition to the corporate restructuring rules, South African tax legislation includes various sections that have attributes of group taxation, where the companies in a group are taxed as a single enterprise. Although some of these provisions provide relief, while others are anti-avoidance provisions, these measures suggest that the South African

245 The appropriateness of the corporate restructuring rules, together with other separate group relief provisions currently included in the South African tax legislation (up and until 31 December 2018), are assessed in Section 5.6 of this chapter.

Government acknowledges the single enterprise principle. The first group of provisions that will be discussed are those that relate to corporate restructuring, providing relief during the reorganisation of corporate groups. Thereafter, other tax measures that provide relief to corporate groups will be dealt with, as well as provisions where relief from anti-avoidance rules is provided to corporate groups, followed by anti-avoidance rules relating to corporate groups. Next, other provisions that contain elements of group tax systems will be considered. Finally, a summary of the separate group relief provisions is provided, indicating how each group of provisions recognise the single enterprise principle.

5.5.1 <u>Tax provisions that relate to corporate restructuring</u>

South African tax legislation comprises of many separate statutes that relate to corporate restructuring where the corporate group is treated as a single enterprise. Although this study focuses on income tax, and therefore excludes value-added tax and taxes other than income tax, other taxes are briefly mentioned for the sake of completeness.

5.5.1.1 Value-Added Tax

For value-added tax purposes, a group of companies cannot register as a single vendor. This means that the group of companies is not recognised as a single enterprise. Each group member must register as separate vendor, and all intragroup transactions are subject to value-added tax. Where the requirements of certain corporate restructuring rules[246] are complied with, however, the transferor company (which must be a registered vendor) and the transferee company (which must also be a registered vendor) are deemed to be one and the same person.[247] The effect of this provision is that a restructuring transaction for value-added tax purposes is deemed to be a non-event.[248]

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246 Sections 42, 44, 45 or 47 of the Income Tax Act, 58 of 1962. In the case of section 42 and section 45, the restructuring supply will only qualify for as a non-supply if the enterprise or part of the enterprise is supplied as a going concern, and if the supplier and recipient agree in writing that the business or part thereof is transferred as a going-concern.

247 Section 8(25) of the Value-Added Tax Act, 89 of 1991.

248 This means that no value-added tax is charged on the supply and that no adjustments are required.

5.5.1.2 *Transfer Duty*

Transfer duty is an indirect tax that is payable when acquiring fixed property in South Africa. When property is acquired by a company in terms of certain restructuring transactions[249] that meet the requirements of the corporate restructuring rules, the transaction is exempt from transfer duty. In these instances, the supplier and the recipient of the property are considered as the same person.[250] For this exemption to apply, the company's public officer must make a sworn affidavit[251] that the acquisition transaction also abides by the prerequisites of the Value-Added Tax Act.[252]

5.5.1.3 *Securities Transfer Tax*

Securities transfer tax is payable by the purchaser on the transfer of shares in companies incorporated in South Africa, as well as on the transfer of shares of non-resident companies that are listed on the Johannesburg Stock Exchange.[253] There are certain circumstances[254] (which includes intragroup asset transfers) where the single enterprise principle is recognised by granting exemption from securities transfer tax.[255]

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249 The restructuring transactions referred to are an asset-for-share transaction as contemplated in section 42 (section 9(1)(*l*)(i) of the Transfer Duty Act, 40 of 1949), an amalgamation transaction contemplated in section 44 (section 9(1)(*l*)(iB) of the Transfer Duty Act, 40 of 1949), an intragroup transaction contemplated in section 45 (section 9(1)(*l*)(ii) of the Transfer Duty Act, 40 of 1949) and a liquidation distribution contemplated in section 47 (section 9(1)(*l*)(iii) of the Transfer Duty Act, 40 of 1949).

250 Similar to the provision in terms of section 8(25) of the Value-Added Tax Act of 1991.

251 Or, alternatively, a solemn declaration.

252 Section 9(15A) of the Transfer Duty Act, 40 of 1949, stipulates that the requirements in section 8(25) of the Value-Added Tax Act of 1991 are met.

253 Section 2 of the Securities Transfer Tax Act, 25 of 2007.

254 In the case of all corporate restructuring transactions: asset-for-share transactions as contemplated in section 42 (section 8(1)(*a*)(i) of the Securities Transfer Tax Act, 25 of 2007), an amalgamation transaction contemplated in section 44 (section 8(1)(*a*)(ii) of the Securities Transfer Tax Act, 25 of 2007), an intragroup transaction contemplated in section 45 (section 8(1)(*a*)(iii) of the Securities Transfer Tax Act, 25 of 2007), an unbundling transaction contemplated in section 46 (section 8(1)(*a*)(iv) of the Securities Transfer Tax Act, 25 of 2007) and a liquidation distribution contemplated in section 47 (an intragroup transaction contemplated in section 45 (section 8(1)(*a*)(v) of the Securities Transfer Tax Act, 25 of 2007).

254 Section 9(15A) of the Transfer Duty Act, 40 of 1949.

255 Section 8(1)(*a*) of the Securities Transfer Tax Act, 25 of 2007.

5.5.2 **Other tax legislation relating to group tax relief**

Apart from the corporate restructuring provisions, the South African legislature has also introduced other income tax measures that provide relief to corporate groups.

5.5.2.1 Interest incurred on the acquisition of shares in an operating company

Section 24O provides that an interest deduction can be claimed in respect of debt used to obtain a controlling share interest in an operating company.[256] The section *deems* the incurral of interest in terms of specific debts[257] to be "in the production of income", despite the fact that the interest expense is incurred in producing exempt income, thereby meeting the "in the production of income" requirement of the interest provision (section 24J[258]). The purpose of section 24O is only to deem that the interest was expended "in the production of income" and laid out for the purposes of "trade".[259] It does not provide for the deduction of the interest expense itself. This is in line with and legislates the principle originally established in the *Drakensberg Garden Hotel* case[260] that if the *intention* in acquiring shares is to guarantee the continuation of a revenue stream from the taxpayer's trade operations, with the additional advantage of improved income, then the interest incurred on the money borrowed to obtain the shares is deductible.

Although section 24O allows the deduction of interest in acquiring shares in an operating company, the amount of the interest deduction is limited to the extent that the equity shares acquired in terms of a direct or indirect acquisition constitute qualifying shares in an

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256 Section 24O(2) of the Income Tax Act, 58 of 1962.

257 It allows a deduction for interest incurred on certain debts used to acquire equity shares in an operating company in terms of an "acquisition transaction" as defined in section 24O(1) of the Income Tax Act 58 of 1962. An "acquisition transaction" is defined as a direct or indirect acquisition of equity shares in an operating company if, at completion of the transaction, the companies form part of the same group of companies ("group of companies" must be considered per the definition used for the corporate restructuring rules). An "operating company" means a company, of which a significant part of its income (80% or more) is earned from carrying on a business continuously and where goods are provided or services rendered for consideration in the course or furtherance of such business (section 24O(1)).

258 Section 24J of the Income Tax Act, 58 of 1962, requires the interest expenditure to be incurred in the process of producing income in order to claim the interest deduction.

259 Section 24O(2) of the Income Tax Act, 58 of 1962.

260 *Commissioner for Inland Revenue v Drakensberg Gardens* 1960 (2) SA 475 (A).

operating company.[261] Where the shares are acquired as part of certain restructuring transactions, the interest deduction is further limited.[262] Section 24O deviates from the traditional approach to prohibit the deduction of interest on the acquisition of shares and acknowledges the demands of the corporate group to operate as single enterprise. It is, however, submitted that section 24O, together with all the limiting provisions, would be unnecessary if a full consolidated group tax system, eliminating all intragroup transactions, were to be introduced.

5.5.2.2 Taxation on dividends

In terms of the secondary tax on companies (STC) regime (the previous tax on dividends), the subsidiary could elect that the dividend be exempt from STC, provided the shareholder for whose advantage the dividend was declared formed part of the same group of companies.[263] The STC regime was replaced by the dividends tax regime, which became effective on 1 April 2012.[264] An election similar to the STC provision is not provided for under the dividends tax regime, as all dividends declared by a subsidiary to its parent company will be exempt from dividends tax where the beneficial owner of the dividend is a resident company.[265] It even provides that a company that declares and pays a dividend is relieved of the obligation to obtain a declaration and written undertaking where the beneficial owner and the company that pays the dividend form part of the same group of

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261 In terms of section 24O(3), the shares are qualifying shares in an operating company, if:

- in the instance of a direct acquisition, the shares consist of equity shares in an operating company (section 24O(3)(*a*)); and
- in the instance of indirect acquisition, to the extent that the interest in the target company's shares are represented by equity shares held in operating companies (section 24O(3)(*b*)). The target company must be a controlling group company of these operating companies, and must in the end be part of the same group of companies in relation to each other (see definition of group of companies in section 41(1)). In instances where >90% of the value of the target company's shares is derived from equity shares held in operating companies, the full interest expenditure will be permitted as a deduction on debt used in acquiring the equity shares of the target company (proviso to section 24O(3)(*b*)).

262 Refer to the limitation in terms of section 23N of the Income Tax Act, 58 of 1962.

263 Section 64B(5)(f) of the Income Tax Act, 58 of 1962.

264 Dividends tax is levied at a rate of 15% (subject to relief in terms of a double tax agreement) on the amount of any dividend paid by any company other than a headquarter company (section 64E(1) of the Income Tax Act, 58 of 1962).

265 Section 64F(1)(*a*) of the Income Tax Act, 58 of 1962.

companies, as defined in section 41.[266] Where a dividend consists of an asset *in specie* and the beneficial owner and the company that pays the dividend form part of the same group of companies, the dividend will also be exempt from dividends tax.[267]

5.5.2.3 Deferral of foreign gains and losses in a group context

In terms of section 24I(10A) of the Income Tax Act, foreign exchange gains and losses that relate to a loan between members forming part of the same group of companies[268] are deferred until realisation date, or until the provisions of the deferral provision no longer apply. In practice, this means that where a loan is granted between companies forming part of the same group of companies, no exchange differences will be taken into account until the loan is repaid (realisation date), or until the companies no longer form part of the same group of companies (provided that the companies are also not connected persons).[269] This deferral provision only applies in respect of a debt, other than a current asset or a current liability, for the purposes of financial reporting in accordance with the International Financial Reporting Standards.[270] This deferral provision, to the extent that it relates to groups of companies, has elements of group taxation.

5.5.2.4 Expenditure in respect of research and development incurred in a group context

Another provision that contains elements of group taxation is the section that provides for a deduction of research and development expenditure.[271] A group member that incurs research and development expenditure to finance the expenditure of another group member carrying on research and development on behalf of the first group member may

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266 Section 64G(2)(*b*) of the Income Tax Act, 58 of 1962.

267 Section 64FA(1)(*b*) of the Income Tax Act, 58 of 1962.

268 This provision also applies if the debt is between connected persons.

269 In terms of section 24I(10A)(*a*) of the Income Tax Act, 58 of 1962. However, this deferral does not apply if a forward exchange contract or a foreign currency option contract have been entered into in respect of the debt (Section 24I(10A)(*a*)(i)(bb)).

270 Section 24I(10A)(*a*)(ii) of the Income Tax Act, 58 of 1962.

271 Section 11D of the Income Tax Act, 58 of 1962. The deduction is available if the company actually incurred operational (noncapital) expenditure on or after 1 January 2014, but before 1 October 2022 exclusively and directly for purposes of research and development (as defined in subsection 1 of section 11D) in South Africa.

deduct an amount of 150% of the research and development expenditure incurred. Both group members must form part of the same group of companies[272] and the deduction applies, provided the group company that carries on the research and development does not claim a deduction in terms of this provision.[273] In addition to this, the expenditure must be incurred on or after the date of receipt of approval of that research and development by the Department of Science and Technology.[274]

5.5.2.5 Participation exemptions

Two other provisions that contain aspects of a group tax regime are the participation exemptions,[275] one relating to foreign dividend income, and the other dealing with capital gains or capital losses resulting from the disposal of an interest in a foreign company. Firstly, foreign dividends[276] may qualify for a participation exemption if the recipient holds at least 10% of the total equity shares and voting rights in the company declaring the foreign dividend.[277] If the person receiving the foreign dividend is a company in a group of companies, the interests held by other group members, forming part of the same group of companies, should be added to the recipient's interest in the calculation, to determine if the 10% threshold is exceeded. Secondly, any capital gain or loss on the disposal of equity shares in a foreign company must be disregarded if the shareholder holds at least 10% of the total equity shares and voting rights in the foreign company.[278] If the shareholder is a company in a group of companies, the interest held by other group members forming part of the same group of companies, should be added to the shareholder's interest in determining if the 10% limit is exceeded. There are other requirements that must also be

272 Group of companies, as defined in section 41 of the Income Tax Act, 58 of 1962.

273 Section 11D(4) of the Income Tax Act, 58 of 1962.

274 Section 11D(9) of the Income Tax Act, 58 of 1962.

275 Participation exemptions are normally used by governments internationally to provide tax relief to groups of companies by removing double taxation at the level of the shareholder (parent company). This is achieved by providing for tax exemptions on dividends and/or capital gains that fall in the hands of the parent company (Nikolakakis, 2008:27).

276 The participation exemption may also be claimed in respect of dividends declared by a headquarter company.

277 Section 10B(2)(*a*) of the Income Tax Act, 58 of 1962. .

278 Paragraph 64B(1) of the Eighth Schedule of the Income Tax Act, 58 of 1962.

met.[279] In respect of these two participation exemptions, the group of companies is recognised as a single enterprise.

5.5.2.6 Donations tax

Donations tax is levied on the gratuitous disposal of assets by one person to another.[280] Donations tax is levied on the value of the property donated at a rate of 20%. This rate increases to 25% for donations exceeding the value of R30 million.[281] An exemption from donations tax applies where both the donor and the donee are members of the same group of companies in relation to each other, and the donee member is a resident.[282]

5.5.3 <u>Tax provisions granting relief from anti-avoidance measures to groups</u>

The fact that groups are sometimes granted relief from anti-avoidance provisions also suggests that the South African Government recognises the single enterprise principle.

5.5.3.1 Relief from anti-avoidance measures in respect of hybrid equity instruments

Certain anti-avoidance measures[283] in respect of hybrid equity instruments[284] were introduced to protect the *fiscus* against persons receiving exempt dividend income in respect of equity instruments, while the instruments are actually akin to debt. The dividend income is usually exempt from taxation in the hands of the person receiving the dividends.

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279 It is required that the person must have held the required percentage of 10% for a minimum of 18 months before the disposal. In addition, it is required that the foreign equity shares must have been disposed of to a foreign person other than a controlled foreign company or a connected person, and the person must have received full compensation for the foreign equity shares transferred.

280 The donations tax provisions are contained in sections 54 to 64 of the Income Tax Act, 58 of 1962.

281 Section 64 of the Income Tax Act, 58 of 1962.

282 Section 56(1)(*r*) of the Income Tax Act, 58 of 1962.

283 Section 8E and section 8EA of the Income Tax Act, 58 of 1962. .

284 A “hybrid equity instrument” is defined in section 8E(1) and deals with three types of shares, namely a preference share, a share other than an equity share, and an equity share that has certain characteristics that are similar to that of a debt instrument. In essence, the shares are used to facilitate what is in substance a loan (Haupt, 2016:506-507).

In terms of these anti-avoidance provisions, dividends[285] received in respect of hybrid equity instruments are deemed to be income accrued to the recipient.[286] As the amount received is deemed to be income, as opposed to interest or dividends, no exemptions will be available.

The two anti-avoidance provisions, section 8E and section 8EA of the Income Tax Act, 58 of 1962, are similar, but where the holder of the share has the right to require someone else other than the company that issued the shares to buy back the shares, the shares are considered to be third-party backed shares[287] and section 8EA applies.[288] A special exclusion from this anti-avoidance provision (section 8EA) is provided where the funding relates to the acquisition of shares in an operating company [289] and the right is enforceable against any company forming part of the same group of companies in relation to the operating company.[290] Such share will not meet the definition of a third-party backed share, and will therefore not fall within the ambit of the anti-avoidance provision. As a result, the dividends relating to the shares will not be considered income in the hands of the recipient but will remain dividend income. This exclusion demonstrates that the legislator recognises the need for third-party backed shares in funding the acquisition of the shares in operating companies within a group of companies (National Treasury, 2012).[291]

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285 Includes local and foreign dividends.

286 Section 8E(2) and section 8EA(2) of the Income Tax Act, 58 of 1962.

287 A third-party backed share is defined in section 8EA(1). It refers to a preference share or equity share in respect of which an enforcement right is exercisable by the holder thereof, or an enforcement obligation which is enforceable as a consequence of a dividend amount, foreign dividend amount, return of capital amount or foreign return of capital amount that can be attributed to that share or equity instrument not yet received or accrued.

288 If the right is only exercisable against the company that issued the share, or the obligation only lies on the company that issued the shares, then section 8EA cannot apply and one has to test whether section 8E is applicable to the equity instrument.

289 Referred to as a “qualifying purpose” in terms of section 8EA(1). A qualifying purpose can be one of three things, namely the funds relate directly or indirectly to:

- the acquisition of shares in an operating company,
- the repayment of bridging loans to acquire shares in an operating company, or
- any refinancing in order to acquire shares in an operating company (Haupt, 2016:510).

290 Section 8EA(3)(*b*)(iv)(*aa*) of the Income Tax Act, 58 of 1962.

291 Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012.

5.5.3.2 *Relief from tax implications on the reduction of debt*

Where a debt is reduced or cancelled in terms of a concession or compromise, this has certain tax implications for the borrower (debtor), depending on what the debt was initially used for. The amount of the debt benefit can be taken into account as income if the debt was used to fund deductible expenses, inventory, or allowance assets,[292] and it may have capital gains tax implications if the debt was used to fund allowance assets or capital assets.[293] Where intragroup debts are waived, however, and the debtor and creditor are members of the same group of companies,[294] the tax provisions will not apply in certain instances.[295]

5.5.3.3 *Relief from the limitation of capital losses incurred on disposals between group members*

In terms of an anti-avoidance provision[296] relating to capital gains tax, a capital loss incurred in respect of the disposal of an asset to a connected person is disregarded and taxed as a "clogged" loss.[297] The capital loss will be allowed, however, on a disposal to a member of that same group of companies if it qualifies as a member of that same group immediately after the disposal.[298]

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292 Section 19 of the Income Tax Act, 58 of 1962, deals with the income tax implications in respect of the debt benefit.

293 Paragraph 12A of the Eighth Schedule of the Income Tax Act, 58 of 1962, deals with the capital gains tax implications in respect of the debt benefit.

294 The definition of a "group of companies", as defined in section 41 of the Income Tax Act, 58 of 1962.

295 In terms of section 19(8) and paragraph 12A(6) of the Eighth Schedule of the Income Tax Act, 58 of 1962.

296 Paragraph 39 of the Eighth Schedule of the Income Tax Act, 58 of 1962.

297 A "clogged loss" may only be set-off against capital gains that arise from transactions with the same connected person afterwards, provided the other person still qualifies as connected person following the subsequent disposal (par 39(2)).

298 Paragraph 39(1)(*b*)(i) of the Eighth Schedule of the Income Tax Act, 58 of 1962.

5.5.3.4 *Assets acquired through the issue of shares for a non-arm's length consideration*

The rollover relief provisions of the corporate restructuring rules involving the issue of shares in exchange for assets are subject to section 24BA. This anti-avoidance provision[299] addresses the situation where assets are acquired as consideration in respect of shares issued and the consideration does not reflect an arm's length value. The provisions of this section do not apply where they form part of the same group of companies following the acquisition of the asset by the company.

5.5.3.5 *Value-Added Tax*

Other value-added tax provisions, where the single enterprise principle in respect of corporate groups is recognised, comprise the adjustments provided for in respect of taxable supplies where all or part of the consideration subsequently becomes irrecoverable. When a vendor has accounted for output tax, the vendor becomes entitled to an input tax deduction when the vendor's debtors are unable to settle their outstanding debts.[300] Similarly, the vendor becomes liable for output tax during the period in which a balance owing to a creditor has been outstanding for more than 12 months.[301] In essence, these adjustments provide for a reversal of the initial value-added tax implications that were accounted for when the tax invoice was issued.

These adjustments are unrealistic in relation to corporate groups, as group members often do not have written agreements in place in respect of intragroup transactions processed through the means of a loan account. Group members normally operate for business purposes using intragroup loan accounts which are not settled for years on end (Stiglingh, Koekemoer, Van Schalkwyk, Wilcocks & De Swardt, 2017:1003). In terms of the value-added tax provisions, these loan accounts between group members are not subject to the bad debt input tax adjustment[302] or the 12-month unpaid creditor adjustment.[303] For the

299 Section 24BA of the Income Tax Act, 58 of 1962.
300 Section 22(1) of the Value-Added Tax Act, 89 of 1991.
301 Section 22(3) of the Value-Added Tax Act, 89 of 1991.
302 Section 22(6)(*a*) of the Value-Added Tax Act, 89 of 1991.
303 Section 22(3A) of the Value-Added Tax Act, 89 of 1991.

purpose of applying this relief, the general definition of a group of companies[304] is used, with the exception that the 70% shareholding is replaced with a 100% shareholding.[305] Clearly, only wholly owned groups of companies will qualify for this relief.

5.5.4 Tax provisions relating to anti-avoidance in respect of groups

Some of the South African tax provisions that treat the group of companies as a single enterprise provide relief, while others are anti-avoidance provisions.

5.5.4.1 The connected persons definition

Although the "connected persons" definition[306] itself is not a group relief provision, part of the definition dealing with companies deems members of a group of companies to be connected persons. For defining connected persons, the definition of a group of companies is used, except that the phrase "at least 70 per cent of the equity shares" is replaced by the phrase "more than 50 per cent of the equity shares or voting rights", which ultimately widens the concept of a "group of companies" in respect of anti-avoidance provisions.[307]

When the concept of "connected persons" was first introduced in South Africa, it was introduced to limit capital allowances where capital assets are purchased from a connected person, in other words for anti-avoidance purposes.[308] Since then, various anti-avoidance provisions in relation to connected persons have been introduced. Clearly, it is the intention of the legislature that all anti-avoidance provisions dealing with connected persons will also apply to group companies, and even a wider range of group companies, because the definition is extended to include group companies in which more than 50% of the equity shares or voting rights are held directly or indirectly. It is obvious that the legislature is of the view that transactions between group companies are not the same as transactions with unrelated third parties and should therefore be treated differently.

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304 Section 1(1) of the Income Tax Act, 58 of 1962.
305 Section 22(6)(*b*) of the Value-Added Tax Act, 89 of 1991.
306 According to the "connected person" definition in section 1(1) of the Income Tax Act, 58 of 1962.
307 According to the "group of companies" definition in section 1(1) of the Income Tax Act, 58 of 1962.
308 The definition of "connected person" was first introduced in 1993 by section 2(1)(*b*) of Act, 113 of 1993.

Anti-avoidance provisions dealing with the concept of a “connected person” are found in some of the capital gains tax provisions, for example in the “value shifting arrangements”[309] and donations between connected persons.[310] For normal tax purposes, anti-avoidance measures with regard to a “connected person” are found in the recoupment of allowances section,[311] the transfer pricing rules relating to international transactions,[312] and in many other anti-avoidance provisions.

5.5.4.2 Applying the connected persons definition where there is a circular flow of funds

Although an analysis of all anti-avoidance provisions dealing with “connected persons” is beyond the scope of this study, the anti-avoidance provisions relating to section 24J, dealing with the deduction of interest, will be considered in more detail. Two proviso paragraphs were introduced into section 24J as anti-avoidance measures. First, the proviso to the definition of “adjusted initial amount” provides that certain payments made as part of a scheme by a connected person in relation to the issuer[313] must be deducted when calculating the adjusted initial amount (Stiglingh *et al.*, 2017:739). Secondly, the proviso paragraph in the definition of “yield to maturity” provides that certain payments made as part of a scheme by a connected person in relation to the issuer[314] must be deemed amounts payable when calculating the yield to maturity (Stiglingh *et al.*, 2017:745). These provisos were introduced to address tax avoidance schemes based on the circular flow of funds to which more than one member in a group of companies is party. The effect of the provisos is that the interest claimed is limited to the interest on the net amount borrowed by the group of companies in terms of the scheme (Stiglingh *et al*, 2017:745). Although none of these proviso paragraphs refer specifically to a “group of companies”, they refer to connected persons, which include an even wider range of group

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309 Paragraph 23 of the Eighth Schedule of the Income Tax Act, 58 of 1962.

310 Paragraph 38 of the Eighth Schedule of the Income Tax Act, 58 of 1962.

311 Section 8(4)(*k*) of the Income Tax Act, 58 of 1962.

312 Section 31 of the Income Tax Act, 58 of 1962. Section 31(7)(*a*) provides for an exception to the transfer pricing rules with regard to equity loans entered into between a company resident in South Africa, or any company forming part of the same group of companies in relation to that company, and any company (not resident in South Africa) in which that company forming part of the same group of companies, directly or indirectly, holds at least 10% of the equity shares and voting rights.

313 Including payments made by the issuer.

314 Including payments made by the issuer.

companies (group companies in which in excess of 50% equity shares or voting rights are held directly or indirectly).

5.5.4.3 The limitation of interest payments to persons not liable for tax

Section 23M limits the amount of the interest deduction where interest payments are made to persons not liable for tax in South Africa on that interest income. This anti-avoidance section applies where the debtor and creditor are in a controlling relationship[315] or where a person who is in a controlling relationship with the debtor advanced the amount to the creditor or guarantees the debt.[316] A "controlling relationship" is defined as a relationship where a person holds a minimum of 50% of the equity shares in that company, directly or indirectly, or where a person can exercise a minimum of 50% of the voting rights in that company.[317] Similar to the two anti-avoidance provisos in section 24J, section 23M includes a wider range of group companies in relation to a company than the definition of a "group of companies" does. Again, this indicates the legislature's intention to widen the concept of a "group of companies" in respect of anti-avoidance provisions. In terms of section 23M, the aggregate deductions for interest expenditure relating to debt owed to persons in a controlling relationship with the debtor is restricted to an annual limitation that is determined in terms of a defined formula.[318]

According to the Explanatory Memorandum to the Taxation Laws Amendment Bill, 2013, section 23M was introduced to limit interest deductions where the creditor and debtor are part of the same economic unit in relation to each other (National Treasury, 2013a:38). National Treasury (2013:38) is of the opinion that, in this case, the parties are capable of freely changing the terms of the loan instrument in order to serve the overall interest of the group, which causes the terms of the loan instrument to become irrelevant. This section would be unnecessary in a full consolidation group tax system that includes both resident

315 Section 23M(2)(*a*) of the Income Tax Act, 58 of 1962.

316 Section 23M(2)(*b*) of the Income Tax Act, 58 of 1962.

317 Definition of "controlling relationship" in section 23M(1) of the Income Tax Act, 58 of 1962.

318 The formula determines that the aggregate deductions for these amounts must be limited to the total interest received or accrued to the debtor, plus 40% of adjusted taxable income, reduced by interest incurred in respect to debts (other than debts to which section 23M applies, and which *exceeds* amounts not allowed to be deducted under section 23N. (Section 23M(3) of the Income Tax Act, 58 of 1962.)

and non-resident members, because all intragroup transactions will be eliminated. Group tax systems, however, seldom include non-resident members as part of the tax group.[319]

5.5.4.4 Interest deduction when acquiring shares in a restructuring transaction

The aim of section 23N is to minimise the potential loss of revenue by the government in respect of debt push-down structures. This is achieved by limiting the interest expense that a company may claim in an acquisition transaction[320] or a reorganisation transaction[321] that is funded through debt. In terms of this provision, the interest incurred will still be allowed as a deduction, but limited to a formula[322] in the year of assessment in which the transaction is entered into, as well as for a period of five years directly thereafter.[323] It is submitted that by introducing section 23N,[324] the legislature indicates its appreciation of the fact that a corporate group acts as a single economic unit. The aim with section 23N is, however, to limit any potential abuse of the corporate restructuring rules by corporate groups claiming excessive interest deductions.

5.5.5 <u>Other provisions containing elements of group tax</u>

The South African legislature has also introduced other provisions that contain elements of group tax systems, thereby recognising the single enterprise principle to a certain extent.

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319 See Chapter 7, Section 7.4.3 of this study.

320 An "acquisition transaction" is a transaction in terms of which a company acquires an equity share in an operating company in terms of paragraphs (*a*) or (*b*) of the definition of "acquisition transaction" (as contained in section 24O(1)), and as a result of which the company becomes a controlled group company in relation to the acquired company at the end of the day of the transaction. (Definition of "acquisition transaction" contained in section 23N(3) of the Income Tax Act, 58 of 1962.)

321 A "reorganisation transaction" is an intragroup transaction as contemplated in section 45 or a liquidation distribution as contemplated in section 47 (section 23N(1) of the Income Tax Act, 58 of 1962).

322 According to the formula, the interest deduction is limited to the amount of the interest received plus a percentage of adjusted taxable income, less interest received, other than interest subject to the section 23N limitation (section 23N(3) of the Income Tax Act, 58 of 1962). The percentage is determined in terms of section 23N(4) of the Income Tax Act, 58 of 1962.

323 Section 23N(3) of the Income Tax Act, 58 of 1962.

324 In addition to section 23N, section 23M was introduced to limit interest deductions in respect of debt owed to persons who are not subject to normal tax in South Africa.

5.5.5.1 *Controlled foreign company[325] regime*

Although South Africa's controlled foreign company regime[326] is primarily an anti-avoidance provision, it could be regarded as similar to a group taxation regime, as it contains elements of a group tax regime. In a full consolidation system (absorption and attribution approaches), the income of a controlled member is attributed to the parent member, as if the parent and the subsidiary form part of a single unit. The same principle is applied in terms of the controlled foreign company rules. The effect of the controlled foreign company rules is to attribute certain income[327] of the foreign company to the resident shareholder if South African residents, in aggregate, hold in excess of 50% of the participation rights or exercise in excess of 50% of the voting rights in the foreign company.[328] The portion of the income[329] to be included in the income of the resident will be based on the residents' participation rights[330] in that company.[331] Clearly, the controlled foreign company rules and the single enterprise principle operate on a similar basis.

In terms of the controlled foreign company regime, a minimum shareholding ownership level of 50% is required in a foreign company. A controlled foreign company could form part of a group of companies,[332] if at least 70% of the equity shareholding[333] in the foreign company is held by a South African resident. Therefore, because the threshold requirement of the controlled foreign company regime is lower than the threshold

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325 Controlled foreign company rules (also referred to in its abbreviated form as "CFC rules") are rules which respond to the risk for authorities that taxpayers with a controlling interest in a foreign low-taxed subsidiary can shift income into it and avoid taxation. Controlled foreign company rules combat this by enabling jurisdictions to tax income earned by foreign subsidiaries without waiting for an actual distribution of the income, which may be postponed indefinitely (OECD, 2015).

326 Section 9D of the Income Tax Act, 58 of 1962.

327 The income referred to is "passive income", for example, interest, dividends, rentals, income from intellectual property, and insurance premiums. Income from *bona fide* business operations will usually qualify for exclusion from the application of this provision (see proviso (i)(*bb*) of the definition of "net income" in section 9D(2A)).

328 In terms of the definition of "controlled foreign company" in section 9D(1) of the Income Tax Act 58 of 1962.

329 Certain income relating to income from business activities with substance carried on in the foreign country is excluded from the controlled foreign company rules (see section 9D(2A) and section 9D(9) of the Income Tax Act, 58 of 1962, for exclusions).

330 These provisions are not applicable if the resident and any connected persons, in aggregate, hold less than 10% of the participation rights of the controlled foreign company at the end of the controlled foreign company's tax year (proviso (A)(i) to section 9D(2)).

331 Section 9D(2) of the Income Tax Act, 58 of 1962.

332 Group of companies as defined in section 41 of the Income Tax Act, 58 of 1962.

333 This means 70% of the voting or participation rights.

requirement of a "group of companies", the passive income of any foreign group member is automatically attributed to the parent of a "group of companies", regardless of the fact that South Africa does not have a consolidation system in place.

5.5.5.2 Headquarter company regime

The headquarter company regime[334] was introduced as an incentive to promote South Africa as a headquarter jurisdiction for international groups wishing to invest in Africa. In the past, South Africa's high tax costs and strict exchange control regulations may have discouraged foreign groups from setting up headquarter companies in South Africa. Before the introduction of the headquarter company regime, four main tax hurdles prevented international groups from setting up a headquarter company in South Africa. These hurdles comprised the controlled foreign company rules, the dividends tax provisions, withholding taxes on royalties, and the transfer pricing rules, and have now been addressed by the insertion of the headquarter relief regime into the Income Tax Act.[335] In essence, these relief measures treat a headquarter company like a non-resident company for tax purposes, even though in actual fact it is a South African resident company.

In terms of this regime, a resident company can elect to be a headquarter company if each shareholder holds a minimum of 10% of the equity shares and voting rights in the company. Where a shareholder is a member of a group of companies, the interests of all the members in group must be added together in order to calculate the minimum participation shareholding of 10%.[336] It is submitted that by allowing this concession with regard to a group of companies, the legislature acknowledges that a corporate group acts as a single economic unit.

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334 The headquarter company regime was introduced by the Taxation Laws Amendment Act, 7 of 2010, to apply with effect from 1 January 2011, with a simultaneous relaxation in South Africa's exchange controls. Significant amendments to the headquarter company regime were introduced by the Taxation Laws Amendment Act, 24 of 2011, which came into effect on 10 January 2012.

335 Section 9I and other relief-provisions that apply specifically to headquarter companies were inserted into the Income Tax Act, 58 of 1962. .

336 This requirement must be satisfied throughout the year of assessment and for all previous years of assessment of the company (par (*a*) of s 9I(2)).

5.5.6 Summary of separate tax provisions relating to corporate groups

Sections of the South African income tax system that recognise the group as single enterprise have been discussed above. Five groups of provisions included in the South African tax legislation that have elements of group taxation were identified. The first group of provisions identified provides group relief relating to corporate restructuring transactions. This group of provisions provides relief from:

- value-added tax,
- transfer duty, and
- securities transfer tax,

during the reorganisation of corporate groups in terms of the corporate restructuring regime.

The second group of tax provisions provides relief to corporate groups, but does not form part of the corporate restructuring regime. These provisions are included in various sections of South African tax laws and contain elements of group taxation. The following provisions in this group recognise the demands of the corporate group as single enterprise:

- the interest deduction,[337] which moves away from the traditional approach to prohibit the deduction of interest on the acquisition of shares, to a system which acknowledges the demands of the corporate group to operate as single enterprise;
- a dividend tax exemption in respect of dividends paid in the same group of companies;[338]
- a deferral of foreign gains and losses in respect of intragroup loans;
- a research and development allowance granted to a group member that incurs the expenditure to fund the expenditure of another group member;

337 In terms of in section 24O of the Income Tax Act, 58 of 1962.

338 Cash dividends declared by a subsidiary to its parent company will be exempt from dividends tax where the beneficial owner of the dividend is a resident company (section 64F(1)(*a*) of the Income Tax Act, 58 of 1962).

- two participation exemptions to avoid double taxation on foreign dividends and capital gains on the disposal of foreign shares within the same group of companies; and
- a donations tax exemption that applies in respect of transactions between group members.

In addition to the second group of provisions, there is a third group of provisions that provides relief to groups of companies outside the corporate restructuring regime. This relief is provided from anti-avoidance rules. The following measures were identified, namely:

- relief from anti-avoidance measures in respect of hybrid equity instruments,
- relief from tax implications where intragroup debt is cancelled or reduced,
- relief from anti-avoidance rules that apply where assets are acquired for a non-arm's length consideration from a group member, and
- relief from certain value-added tax adjustments.

All these provisions move away from the traditional approach that considers the members of the corporate group as separate taxpayers, to a system which acknowledges the demands of the corporate group to operate as single enterprise. It is, however, submitted that all the relief provisions from the second and third group would be unnecessary, if a full consolidation group tax system, eliminating all intragroup transactions, were to be introduced.

The fourth group of provisions comprises anti-avoidance rules aimed at attacking avoidance transactions carried out within corporate groups, thereby also recognising the group as a single enterprise. It appears that in most of these anti-avoidance provisions, the concept of a "group of companies" is widened to include group members in which only 50%[339] or in excess of 50%[340] of the equity shares or voting rights are held, indicating a stricter approach by the government with regard to anti-avoidance than with regard to relief for groups of companies. This group of provisions mostly concerns the "connected

339 Requirement in section 23N of the Income Tax Act, 58 of 1962.
340 Requirement in the definition of "connected person" in section 1 of the Income Tax Act, 58 of 1962.

persons” definition where the members of a group are defined as connected persons in relation to each other, and which are used in several anti-avoidance provisions throughout the Act. These provisions illustrate the point that the South African tax authorities are of the opinion that transactions between group members should be dealt with differently for tax purposes, as these transactions differ from transactions between unconnected parties.

Finally, the fifth group was discussed, which comprises regimes legislated as part of South African tax law and which contain elements of group tax systems. Two regimes were considered, namely the headquarter company regime and the controlled foreign company regime. The headquarter company regime provides relief from controlled foreign company rules, dividends tax, withholding taxes, and transfer pricing rules to multinational groups wishing to set up their headquarters in South Africa. It is submitted that by introducing an international headquarter company regime, the South African Government has illustrated its willingness to facilitate the operation of multinational groups. In terms of the controlled foreign company regime, the passive income of a foreign group member is automatically attributed to the parent of the group. It is submitted that in this regard, it contains elements of a group tax regime, notwithstanding that it is an anti-avoidance measure.

From the analysis of the separate tax provisions relating to corporate groups, it is evident that the South African Government recognises the group as economic unit, to a certain extent, and wishes to accommodate the existence of the single enterprise principle. These provisions furthermore suggest that SARS has the ability to implement and manage provisions relating to the single enterprise principle. In the next section, whether these provisions, together with the corporate rules, can be considered a suitable group tax system in the South African context, is discussed.

5.6 THE SUITABILITY OF CURRENT TAX PROVISIONS AS A GROUP TAX SYSTEM

In order to evaluate whether the current tax statutes for South Africa appropriately tax corporate groups as single enterprises in line with the economic reality, two evaluations will now be performed. Firstly, the current tax provisions are evaluated against the objectives that the ideal group tax regime aims to achieve, namely the tax-free intragroup transfer of assets within a group and the set-off of losses within the group. As these two ideal objectives refer to the purpose for which group tax systems are designed, it would also be correct to refer to the two *functions* of group tax systems. Secondly, the current tax provisions will be evaluated against the policy objectives and guidelines identified in Chapter 4 as being important when considering a group tax regime. In order to evaluate the current tax regime relating to corporate groups in South Africa, whether the present tax system, although *not* a formal group tax regime, adheres to these objectives will be investigated, and can therefore be considered as a suitable regime for corporate groups in South Africa.

5.6.1 Ideal group tax assessment

The extent to which the objectives of the ideal group tax regime are achieved indicates the degree to which the current provisions in South Africa support the single enterprise principle. From the summary in Table 5.1 below, it appears that only one objective is achieved, namely the tax-free intragroup transfer of assets. Currently, only the corporate restructuring rules, including tax provisions that relate to corporate restructuring, allow for the tax-free intragroup transfer of assets. In general, the corporate restructuring rules only deal with certain types of transaction, and not with all types of intragroup transactions.[341] The previous rationalisation relief rules also allowed for the tax-free movement of assets, but were repealed with the introduction of the corporate rules. It furthermore appears that the second objective (the set-off of losses) is not achieved by any of the South African tax provisions.

341 This was confirmed in the study by Middelmann (2004:30).

Table 5.1: Assessing whether the South African tax provisions achieve the objectives of the ideal group tax regime

	Rationalisation Relief Rules	**Corporate Restructuring Rules**	**Separate Group Relief Provisions**
Objectives of the ideal group tax regime:			
1. Tax-free movement of assets:	Yes (Applied on a temporary basis, but since repealed)	Yes (Also tax provisions that relate to corporate restructuring)	No
2. Set-off of losses:	No	No Except for the group tax regime that applied to the shipping industry but since repealed	No

(Own formulation)

5.6.2 Tax objectives and guidelines assessment

The tax objectives and guidelines identified in Chapter 4 as being important when considering a group tax regime are now used to evaluate South Africa's group tax provisions. The tax objectives identified in Chapter 4 are the single enterprise principle, competitiveness, anti-avoidance, fairness, efficiency, neutrality and simplicity, with the single enterprise principle, competitiveness and fairness being dominant objectives, while the single enterprise principle is considered the core of all objectives.[342]

342 It was determined in Chapter 4 that these policy objectives also comply with the principles of a good tax system.

5.6.2.1 *Single enterprise principle*

There has been a gradual movement away from the old separate entity principle to the newer single enterprise principle in South African tax legislation, where the single enterprise principle is recognised during corporate formation,[343] in the reorganisation of companies,[344] and during ongoing corporate group operations,[345] albeit in an informal manner.

As a core principle, the single enterprise principle also relates to the objectives that the ideal group tax regime aims to achieve, namely the tax-free intragroup transfer of assets within a group and the set-off of losses within the group. The larger the number of objectives achieved in a group tax regime, the stronger the application of the single enterprise principle in that group tax regime will be. It appears that the application of the single enterprise principle remains weak in tax legislation in South Africa, as only one of the objectives of the ideal group tax regime is met (tax-free transfers of intragroup assets), and this objective is only met in certain instances. Refer to the assessment of whether the South African tax provisions achieve the objectives of the ideal group tax regime in Section 5.6.3 below.

5.6.2.2 *Competitiveness*

Competitiveness, as a dominant objective, gives priority to growth, as well as attracting the capital and the mobile economic activity of multinational companies.[346] Competitiveness was probably the reason for previously permitting a group tax regime in the shipping industry in South Africa.[347] The introduction of the corporate restructuring regime in 2001 also had competitiveness as a tax objective. At that stage, countries with capital gains tax regimes had similar rollover rules to provide for the possible cascading implications of

343 Section 42 of the Income Tax Act, 58 of 1962.

344 Section 42 to 47 of the Income Tax Act, 58 of 1962, section 8(25) of the Value-Added Tax Act, 89 of 1991, section 9(1)(*l*)(i) of the Transfer Duty Act, 40 of 1949, and section 2 of the Securities Transfer Tax Act, 25 of 2007.

345 Only in certain circumstances where section 45 of the Income Tax Act, 58 of 1962, applies and where separate group relief provisions apply.

346 See discussion in Section 4.2.2 in Chapter 4.

347 See discussions on the group tax regime in the shipping industry in Sections 5.2.1 and 5.2.2 of this chapter.

taxation on capital gains when disposing of assets in multi-tiered corporate groups. By introducing the corporate restructuring rules, government made sure that corporate groups in South Africa would experience the same benefits as corporate groups elsewhere in the world. It is submitted that competitiveness was also the reason for introducing the international headquarter company regime, i.e. to attract multinational groups wishing to set up their headquarters in South Africa.

In order to remain competitive, tax systems should be able to adapt to new developments on an ongoing basis. Internationally, after 2001, various jurisdictions have implemented formal group tax systems because of the increase in cross-border trade and the number of multinational corporate groups, coupled with growth in international economies.[348] It appears that the international trend is to have a formal group tax system in place. At present, South Africa has no formal group tax regime in place to ensure that the country keeps pace with international developments, and South Africa is therefore not competitive in this regard.

5.6.2.3 Anti-avoidance

It was found earlier in this chapter that tax advisors are under pressure to engineer avoidance schemes by using the corporate restructuring rules to reduce tax during reorganisation transactions.[349] It is also evident that opportunities will continue to exist for tax advisors because of the fact that the corporate restructuring regime adheres to the single enterprise principle, while other provisions in the tax statutes adhere to the separate entity principle, which creates mismatches and opportunities for avoidance schemes to be engineered.

Abuse is also possible in other provisions of the South African tax statutes by the manipulation of tax cost values to contrive timing, capital or revenue mismatches.[350] Although intragroup transactions outside of section 45 normally have no business or

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348 By 2010, over two-thirds of OECD countries had some type of formal group tax regime in place (Canada, 2010:29).

349 Refer to the discussion in this chapter in Section 5.4.4.

350 The Katz Commission (1995:§10.2.5) made a similar finding in 1995, but added the “losing” of one end of a transaction as a method to manipulate intragroup transactions.

monetary effect, they do have tax implications, as other provisions in the South African tax legislation do not recognise the single enterprise principle. In this regard, the Katz Commission (1995:§10.2.4) commented that corporate management in South Africa often invests enormous amounts of time and energy in finding methods that have no commercial substance in order to avoid tax through the use of intragroup transactions, for example management fees and transfer pricing.[351] This appears to be an ongoing practice. In spite of presently having complex anti-avoidance rules in place,[352] the manipulation of intragroup transactions remains difficult to police and hard to detect.[353] This also challenges the consistency of the South African tax structure, as these activities are motivated not by commercial reasons, but by an aspiration to avoid tax – the very result that a tax structure should attempt to prevent.

5.6.2.4 Fairness

Fairness implies that businesses with the same or equivalent structures should be taxed alike (horizontal equity), while the tax system should also provide for smaller corporate groups with different needs and fewer resources than larger groups to manage their tax burdens differently (vertical equity).[354] The fact that South Africa's corporate restructuring rules provide tax relief to group companies in general, regardless of their size and without providing for smaller corporate groups with different needs and fewer resources to manage their tax burdens differently, indicates that the principle of fairness is compromised (vertical equity). Furthermore, a tax system is not a fair tax system if it still gives rise to anomalies due to the tax treatment of transactions between members of the same corporate group, compared with the tax treatment of similar entities like the divisions of a single company (horizontal equity). It is therefore submitted that the issue of fairness, in relation to both

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351 The transfer pricing provision, contained in section 31.

352 See the discussions of anti-avoidance provisions in Section 5.4.2 of this chapter.

353 This agrees with a finding of the Katz Commission (1995:§10.2.5). The fact that group members are assessed individually means that SARS cannot always retrieve all the data relating to all the members within a group of companies as these members may be submitting their returns at different offices. According to the Katz Commission (1995:§10.2.6), a formal group tax regime would guarantee a complete audit trail in respect of all intragroup transactions, as well as accurate tax results in respect of transactions with third parties. Such a system would raise the ability of SARS to regulate the system.

354 The issue of fairness was analysed in Chapter 4 (see Section 4.2.4).

horizontal equity and vertical equity, is not addressed by the current corporate tax provisions.

5.6.2.5 Neutrality

The Katz Commission (1995:96-97) recommended a formal group tax regime because the Commission was of the opinion that the South African tax regime did not address the principle of neutrality at that stage. According to the Katz Commission (1995:96-97), the members of a group of companies should enjoy the same tax neutrality as a company under divisionalisation (Katz 1995: 96-97). Currently in the South African tax system, every member within a group of companies is still taxed as an individual taxpayer, and apart from section 45 transactions, intragroup transactions continue to result in tax consequences. These tax consequences often produce inconsistent results for the group members that transact and therefore do not follow the single enterprise principle. When comparing the tax effects of intragroup transactions with the tax consequences that stem from the same transactions between various divisions within the same company, the tax anomalies arising indicate that the tax system is not neutral in relation to the different entity forms (Wilcocks & Middelmann, 2004:50; Stack *et al*., 2015:160).

The following anomalies exist in the South African tax system regarding the tax treatment of transactions between companies in the same group, when compared with the tax treatment of divisions of a single company:

- The offsetting of tax losses between group companies is not allowed.
- Timing mismatches of income and expenditure in relation to intragroup transactions occur between group companies.[355]

355 Timing mismatches occur where an amount of income is received in one year by the recipient member, but the same amount is only deductible as expenditure by the paying member in the following year. This relates specifically to advance payments where the gross income definition in section 1(1) of the Income Tax Act, 58 of 1962, requires that any receipt should be taxed immediately, but the general deduction formula only allows the deduction of advance payments subject to the strict requirements of section 23H of the Income Tax Act, 58 of 1962. Other examples of these included lease premiums and lease improvements.

- Taxability versus deductibility mismatches occur with some transactions, as the prerequisites of the deduction provisions are not met or are not the same as the taxing provisions.[356]
- Income and expenditure consequences are shifted between profitmaking and lossmaking members.[357]
- There is a potential cascading effect of tax on capital gains and other tax implications resulting from specific intragroup transactions in multi-tiered groups (double taxation).[358]

Most of these anomalies referred to result from a failure to recognise business realities or a mismatch between the amount that is taxed in one member's hands and the amount allowed as a deduction in the hands of the other member within the same group.

Cross-border neutrality is further compromised in South Africa because foreign branches of a resident company (that may form part of a group of companies) are in some instances treated differently from controlled foreign companies. The Davis Tax Committee (2018:8) recommended that this issue should be addressed.

5.6.2.6 Efficiency

It was determined in Chapter 4 that a tax system is efficient if it raises revenues in a cost-efficient way, both from the taxpayer's point of view and from government's point of view.[359] From the perspective of the *taxpayer*, the current tax regime is not cost effective, as resources are often wasted in consulting tax experts about methods and structures in order to benefit from restructuring transactions in terms of the corporate restructuring

356 Taxability vs deductibility mismatches occur where the recipient company is taxed on an amount of income because it meets the requirements of the gross income definition contained in section 1(1) of the Income Tax Act, 58 of 1962, but the deduction is not allowed in terms of the general deduction formula or any other deduction provision in the Income Tax Act, 58 of 1962, in the hands of the paying member because it does not meet the requirements of any deduction provision.

357 In general, one of the most popular ways to shift income from one group member to another group member is by means of year-end adjustments to management fees or administration fees. There is often no basis for these adjustments, and upon a review from SARS, group members may find it hard to prove the substance of these adjustments (Middelmann, 2004:21).

358 Participation exemption provides some relief in the form of exemption from tax on dividends and on gains made on the sale of shares.

359 See discussion in Chapter 4, Section 4.2.6.

rules.[360] These resources should rather be used in making business and operational decisions that are based on commercial merit.[361] The reason why the corporate restructuring regime is not cost effective from the viewpoint of the *government* is because this regime often leads to tax avoidance schemes that in turn create substantial revenue losses for the fiscus. This became clear from the range of avoidance schemes involving corporate restructuring rules.

5.6.2.7 Simplicity

From the analysis in Chapter 4, it is clear that simplicity is the one tax principle that is most difficult to achieve in any tax regime that recognises the single enterprise principle. The current corporate restructuring rules are complicated and there is a lack of clarity on how to apply the rules. Clearly, the current regime does not adhere to the principle of simplicity. The main reason is the tension that exists between the larger part of the tax structure, base on the traditional separate entity principle, while the corporate restructuring regime adheres to the single enterprise principle.

5.6.2.8 Assessment

It is evident from the summary in Table 5.2 below that, although the objectives of competitiveness and the single enterprise principle are currently achieved to some extent, the objectives of anti-avoidance, fairness, neutrality, efficiency, and simplicity are not being achieved.[362]

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360 Refer to the discussion in this chapter, Section 5.4.

361 Intragroup transactions are sometimes executed only with the aim of obtaining an advantageous tax treatment, which does not necessarily stem from sensible business decisions. According to Wilcocks and Middelmann (2004:49-50), tax-driven business decisions may cause resources to be misallocated and can be detrimental to South Africa’s economy.

362 This conclusion is similar to the conclusions by Wilcock & Middelman (49-50) and Stack, *et al*. (2015:160). In their analysis of case law, Stack, *et al*. (2015:159-160) find that principles such as equity, flexibility and neutrality are not achieved in the tax treatment of corporate groups in the South African judicial system.

Table 5.2: Evaluating whether the current South African tax provisions adhere to tax objectives important when considering group tax systems

Important tax principles:	**Adhered to by current South African tax provisions?**
Single enterprise principle	Weak application of the single enterprise principle.
Competitiveness	Yes, in relation to the corporate restructuring regime. Worldwide, corporate restructuring tax relief rules are applied as an accepted standard to decrease any possible cascading consequences of capital gains tax on the selling of assets in multi-tiered corporate units. No, in relation to other provisions of the South African tax regime relating to corporate groups.
Anti-avoidance	No, opportunities for avoidance schemes continue to exist because the corporate restructuring regime adheres to the single enterprise principle, but other provisions in the tax statutes adhere to the separate entity principle.
Fairness	No, in relation to vertical equity. No, in relation to horizontal equity.
Neutrality	No, mismatches or anomalies still arise when comparing the tax effects of intragroup transactions with the tax results that stems from similar transactions within divisions in the same company.
Efficiency	No, from the viewpoint of the *taxpayer*: the current tax regime is not cost effective as resources are often wasted in consulting tax advisors. From the viewpoint of the *government*, the current regime creates revenue losses due to the regular occurrence of tax avoidance schemes.
Simplicity	No, the current rules are complicated and there is a lack of clarity on how to apply the corporate restructuring rules.

(Own formulation)

5.6.3 Final evaluation and assessment

In the above evaluations in sections 5.6.1 and 5.6.2 it was assessed whether the current provisions meet the objectives of the ideal group tax regime (the tax-free movement of assets and the set-off of losses within the group) and whether the present group tax system achieves the objectives identified as relevant and important in a group tax system. From the above assessments, it seems that the current system cannot be considered as being a suitable group tax system for South Africa, adhering to the single enterprise principle. Firstly, it was assessed that the South African tax system does not meet the two ideal objectives for which a group tax system is designed. In the second assessment certain policy objectives, identified in Chapter 4, were used as yardstick. In Chapter 4 it was found that these policy objectives also comply with the principles of a good tax system. Because the policy objectives are not adhered to in the current tax regime applying to groups, it by implication, means that the current group tax system in South Africa is not a good tax system. It appears that the introduction of an appropriate group tax system that adheres to the canons of a good tax system is required.

5.7 CONCLUSION

This chapter aimed to evaluate the current tax system in South Africa dealing with corporate groups. In order to provide context, the chapter started by considering the findings of Margo Commission, the Katz Commission, and the Davis Tax Committee, on group taxation in South Africa and two separate sets of statutes introduced to provide relief similar to that provided by group tax systems[363] were also discussed. Although the Katz Commission recommended the implementation of a formal group tax system and parliament accepted the recommendations in principle, its recommendations have not yet been implemented. It appears that government's reasons[364] for not implementing a group tax regime are no longer valid, as SARS has had more than enough time to improve its systems since 1996 (identified as reasons why the introduction should be delayed). Furthermore, the fact that the shipping group tax system had been in operation, for almost 20 years until 2013, indicates that SARS has the ability to deal with a group tax system. Yet, after 1996, the Katz Commission's recommendation for introducing a formal group tax system was never again addressed by government.[365] Thereafter, only two sets of restructuring relief measures were introduced. The first set of restructuring relief measures comprised the rationalisation relief regime.[366] It was a temporary relief regime which was

363 These relief measures also provide for the tax-free transfer of intragroup assets, which is one of the objectives of a group tax system.

364 Apparently, a group tax system would place severe stress on government's tax administration.

365 The Katz Commission Report forms part of the authoritative literature on group taxation in South Africa, and their recommendations with regard to certain structural elements will therefore be drawn on when considering a suitable group tax system for South Africa.

366 This regime applied initially to groups of companies that had to go through a rationalisation process from 17 June 1988 until 30 June 1991. It was re-introduced in 1994 and the second relief opportunity applied until 1 March 2002. It is submitted that the first phase of rationalisation relief measures was problematic, causing certain mismatches, as it did not provide for rollover provisions at entry and exit points. These provisions were necessary when shifting from the normal tax system, designed under the traditional separate entity principle, to the rationalisation regime that adhered to the single enterprise principle. By providing for rollover provisions in the second phase rationalisation rules, the challenges that the first phase rationalisation rules experienced at entry and exit points were avoided. The rationalisation relief regime was very limited in its application and there was consensus amongst many experts that

repealed with the introduction of the corporate restructuring rules (the second set of restructuring relief measures) in 2001. The corporate restructuring regime still applies today.

The corporate restructuring provisions in section 45 specifically provide for the tax-efficient transfer of assets from one group company to another, which is one of the objectives of a group tax system. Section 45 protects qualifying intragroup transactions from the negative tax consequences that would typically apply to such transactions, with the tax effects "rolled-over" to a later date when the relevant asset is sold to a third party. Unfortunately, this intragroup corporate restructuring relief measure is often used to avoid tax, and anti-avoidance measures had to be introduced at inception in the form of an 18-month deemed sale rule, with de-grouping rules being introduced a few years thereafter. In terms of these anti-avoidance rules, the rollover relief upon entry and exit points revert to a deemed sale. These anti-avoidance measures are complex and problematic, causing negative cash flows if triggered, are difficult to administer, and apparently have a negative impact on business decisions because of their "long" waiting periods.

The corporate restructuring rules also contain structural defects because they adhere to the single enterprise principle in one respect, while other provisions of the statutes adhere to the traditional separate entity principle. This provides opportunities that are exploited by certain tax advisors in devising tax avoidance schemes. In the past, section 45 was used in numerous avoidance transactions, including debt push-down schemes that involved claiming substantial interest deductions. These schemes, considered by National Treasury as unlawful, led to revenue losses for the South African fiscus. It is submitted that tax avoidance schemes that abuse the current structural defects in the system will continue until the current system relating to corporate groups is replaced by a formal group tax regime.

The corporate restructuring regime uses complex rules, and the rules are considered an administrative problem for both the taxpayer and the revenue authorities. Situations often arise where the rules cannot be applied in a practical way or where unintentional and undesirable consequences result. The application of the corporate restructuring rules

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restructuring relief should be made available to groups of companies in general, and on a more permanent basis. This second phase rationalisation rules were repealed with the introduction of the corporate restructuring rules.

creates various challenges, even though they are often applied in practice. Tax experts are of the opinion that the corporate restructuring regime is not nearly the efficient instrument that it was initially intended to be. It appears that, to a certain extent, the regime was ill-conceived from the start. This is not only obvious from the number of amendments that have been promulgated and that are continuously being promulgated every year, but also from the difficulties experienced by taxpayers in meeting the compliance requirements in respect of certain corporate rule provisions. Even after the numerous amendments, it appears that the corporate restructuring rules have not developed into an acceptable regime.

The corporate restructuring rules were not introduced as a *formal* group tax regime with the aim of treating a group of companies as a single enterprise, but was implemented to avoid negative capital gains tax results stemming from transactions within a group of companies, with the purpose of bringing the South African tax system into line with international practice. It was implemented with the policy objective of keeping the tax system of South Africa globally competitive and to stimulate local restructuring transactions to promote growth in South Africa. Although technically considered to be a group tax system because it meets one of the objectives of a group tax system,[367] the corporate restructuring regime is not a *formal* group tax regime. It is an informal group tax system introduced to deal with restructuring transactions and only deals with certain types of transactions and not with all transactions that occur daily between companies in a group. It is not a formal group tax system that caters for the taxation of the corporate group's ongoing operations as single enterprise.

Following the analysis of the corporate restructuring rules, separate aspects of the current South African income tax system that recognise the group as single enterprise were discussed. Five groups of provisions that have elements of group taxation were identified. These provisions suggest that, to a certain degree, the South African Government wishes to adhere to the single enterprise principle and therefore recognises the corporate group as economic unit. These provisions suggest that SARS has the expertise and capacity to implement and manage provisions relating to the single enterprise principle.

367 The tax-free intragroup transfer of assets.

The question may well be posed as to whether the current tax regime in South Africa, with its corporate restructuring rules and certain separate group relief provisions, is an appropriate group tax system that provides adequate group tax relief in South Africa. This appears not to be the case. Firstly, the current regime does not appear to adhere to acceptable tax principles and does not achieve the objectives identified in Chapter 4 that also meet the recognised principles of a good tax system. It does not promote neutrality, efficiency, fairness and anti-avoidance, while the dominant objectives of competitiveness and the single enterprise principle are also compromised to some extent. Furthermore, a tax system that creates anomalies does not promote fairness, a dominant objective for which demands are being made increasing significantly and on a global basis.[368] Such a deficient system encourages taxpayers to take advantage of anomalies and to undertake tax avoidance schemes. It does not promote competitiveness and is counter-productive, as taxpayers will apply their resources to identifying tax avoidance schemes and ways to deal with anomalies. Such a tax system does not serve the interests of the South African economy.

Secondly, it appears that the single enterprise principle is not being recognised by the current regime. Only one of the objectives of an ideal group tax system is being achieved, namely the tax-free intragroup transfer of assets. This objective is achieved by the corporate restructuring rules, specifically section 45, which only applies in certain circumstances and is accompanied by problems. The current tax regime does not allow for the transfer of losses (or expenditure) between companies in a group, which is one of the fundamental elements of group taxation. Clearly, the current regime in South Africa, with its corporate restructuring rules and certain separate group relief provisions, cannot be considered as being a simplified group tax regime that adheres to the single enterprise principle suited to the South African context.

Furthermore, because the current tax regime fails to achieve the objectives that are sought after by countries that have implemented formal group tax regimes, this indicates that there is a need to implement a *formal* group tax system in South Africa. The emergence of multinational corporate groups requires a new bold approach to be taken, in which the corporate group, as a whole, is taxed as the enterprise, and not the constituent companies. It is proposed that the introduction of a formal group tax system is the only

368 Specifically in terms of the OECD BEPS project.

way to achieve this in South Africa. Although the Davis Tax Committee recommended that a formal group tax system should not be implemented in the present time, they did agree to the implementation of a formal group tax system. It is submitted that a framework for the design of such formal group tax system should be developed in the interim.

From the findings in Chapter 3, it appears that it would not be best practice to simply apply another jurisdiction's group tax model in South Africa, as that foreign jurisdiction's tax policies would also be applied to the South African tax regime. It was suggested that an optimal group tax system for South Africa might be one that is developed through a process in which the structural elements underlying group tax regimes internationally are identified (specifically group tax regimes in jurisdictions that are of economic importance to South Africa) and adapted to suit the policy considerations of the South African Government. From the discussion in Chapter 3, it was not yet clear which group tax models should be investigated to identify the structural elements that should be considered for designing of a suitable group tax model for South Africa. In the next chapter, a framework of international group tax designs is considered in order to identify practical options for designing a group tax system for South Africa.

CHAPTER 6: A TAXONOMY OF INTERNATIONAL GROUP TAX SYSTEMS

6.1 INTRODUCTION

In the previous chapters, it has been suggested that a formal group tax system for South Africa could be developed through a process in which the structural elements of group tax regimes, internationally, are identified and adapted to suit the South African policy objectives. To achieve this, a framework into which all international group tax systems fit should first be explored.

The aim of this chapter is to explore a basic framework of international group tax systems, based on their design, in order to identify feasible options for designing a group tax system for South African. This chapter commences by examining how the different international group tax systems identified in Chapter 3 fit into a basic conceptual framework developed according to the design of group tax systems. It is submitted that such a framework can assist in identifying the different options when designing a suitable group tax regime for South Africa. In concluding the discussion of a theoretical framework of group tax systems, the theoretical framework is considered from a South African perspective in order to identify viable design options for South African.

6.2 A THEORETICAL FRAMEWORK OF GROUP TAX SYSTEMS

There are various options that can be explored in designing a theoretical framework within which international group tax systems can be fitted. The first illustration of such a framework was provided in Figure 3.5 in Chapter 3, where all the international group tax systems are placed on a continuum. The continuum begins at the one end with the full consolidation models (the attribution approach and the absorption approach), representing the strongest application of the single enterprise principle, while the loss-transfer model, placed at the other end of the continuum, represents a weak application of the single enterprise principle. All other group tax models are placed between these two extremes, depending on the degree to which the single enterprise principle is applied. Ting (2013b:39) designed a similar framework of the different group tax regimes, locating them on the framework to the extent to which they meet the two objectives that an ideal group tax system could achieve.[369] In this framework, the extent of the application of the enterprise principle is evaluated according to whether it achieves one, both, or neither of the two objectives. This framework of Ting (2013b) can also be considered a continuum that indicates the degree to which the single enterprise principle is applied, from not at all to strong.[370]

An alternative method of classification is to develop a theoretical framework for international group tax systems according to their design. Such a framework can assist in identifying the different options when designing a suitable group tax regime for South Africa. The classification of taxes with reference to their design is referred to by researchers (Ting, 2013b; Cynader, 2014) as the taxonomy[371] of taxation. In deciding on an appropriate tax system, governments have to make decisions about certain concepts: the taxable unit, which refers to the taxpayer or person liable for paying the tax, the tax base upon which the tax is levied, the tax rate that is applied to the tax base, the tax period over which the tax base is measured, and the administrative arrangements for collecting the tax (Cynader, 2014:6). These concepts are normally designed in line with a government's policy objectives. By applying one or two of the objectives of a formal group tax system (the tax-free intragroup transfer of assets and the set-off of losses in a group) to a tax design, the single enterprise principle could be met.

6.2.1 <u>The design or taxonomy of group tax systems as a theoretical framework</u>

When using the design of group tax systems to develop a conceptual framework, two concepts can be considered in applying the single enterprise principle: the "taxable unit" and the "tax base" (Ting, 2013b:28). In developing the taxonomy of group taxation, there

369 The two objectives are to provide for the tax-free intragroup transfer of assets in a group and to allow for the set-off of losses within the group without the need for a corporate restructuring. Ting (2013b:52) referred to these two objectives as "the two key functions that a group tax regime is typically designed to achieve". Because a full consolidation model is the only group tax regime that achieves both "key functions", it represents the strongest application of the single enterprise principle in terms of which a group is taxed as a single unit. On the other hand, where no regime exists that achieves either of these "key functions", there cannot be any application of the enterprise doctrine.

370 Refer to Figure 3.6 and the discussion in Chapter 3.

371 "Taxonomy" is defined in the Oxford English Dictionary as the scientific process of classifying things (*Oxford Online Dictionary*, 2017).

is firstly the question of determining the proper “unit” of taxation (Nikolakakis, 2008:31). Most countries develop their corporate income tax regimes from the position of treating a company as a separate “taxable unit”.[372] In these conventional corporate income tax systems, the “tax base” refers to the taxable amount of the separate company on which tax is imposed. Where there is a shift away from the separate entity principle to the single enterprise principle, the “taxable unit” may become the corporate group (Ting, 2013b:28). There is, however, an alternative whereby the “taxable unit” remains the company within the corporate group, but its “tax base” is expanded to take into account the profits and losses from all group members (Nikolakakis, 2008:31). For example, where the taxable unit is expanded to the group, the tax base must be adjusted to include the taxable profits and losses of all group companies (Nikolakakis, 2008:31). However, the converse does not apply where the “tax base” is extended to the group. Where the “tax base” is extended to include the offsetting of losses from other group members, like the group relief system of the United Kingdom, the taxable unit will still be the company as a separate taxable unit (Nikolakakis, 2008:31). Clearly, the option of extending the “taxable unit” will consequentially also lead to the extension of the “tax base”, whereas the option of extending the “tax base” will affect only the “tax base”.

It is obvious that the shift from a separate entity principle to a single enterprise principle could be achieved by extending either the “taxable unit” or the “tax base”. In turn, these two options contain various possibilities that could be used in the design of a group tax regime (Bird, 1996:16). For example, an additional function can be added in order to meet another objective of a formal group tax system.

Using the extension of the two concepts of “tax base” and “taxable unit” to provide for the single enterprise principle, Ting (2013b:37) developed a theoretical framework for all the group tax regimes. From Figure 6.1 below, it is clear that the three possibilities for the

372 This is based on the legal principle that a company is a person, separate from its shareholders. However, since most companies are ultimately owned by individuals (the shareholders), it leads to the problem of double taxation, as taxation can also be imposed on the individual (shareholder-level) when profits are distributed as dividends, as well as on the capital gain when the shares are sold (Bird, 1996:11). In order to relieve the “double tax” burden, most jurisdictions’ tax systems provide for the exemption of the shareholder. This is known as the “participation exemption” regime (also known as the PEX regime) (Nikolakakis, 2008:27). Because most jurisdictions provide for a participation exemption (the exemption of the shareholder), only the company as “taxable unit” will be considered in this study.

“taxable unit” are the country group, the bloc group, and the worldwide group.[373] Also illustrated in Figure 6.1, is that in addition to extending the “taxable unit”, the “tax base” should also be adjusted when the “taxable unit” is extended.[374]

Figure 6.1 furthermore illustrates that where the “tax base” (keeping the company as “taxable unit”) is extended, *only* the “tax base” is extended.[375] References to the appropriate paragraphs in this study, discussing each possibility, have been added to the diagram.

From Figure 6.1, it is also clear that an additional function can be added to an option in order to meet another objective of formal group tax systems, like tax-free intragroup asset transfers. This theoretical framework in Figure 6.1 indicates the various options available to governments when designing a group tax system.

373 Discussed in more detail in Section 6.2.2 of this section.
374 This concept is discussed in Section 6.2.3 of this section.
375 See Section 6.2.4 for the different variants of group tax systems extending the “tax base”.

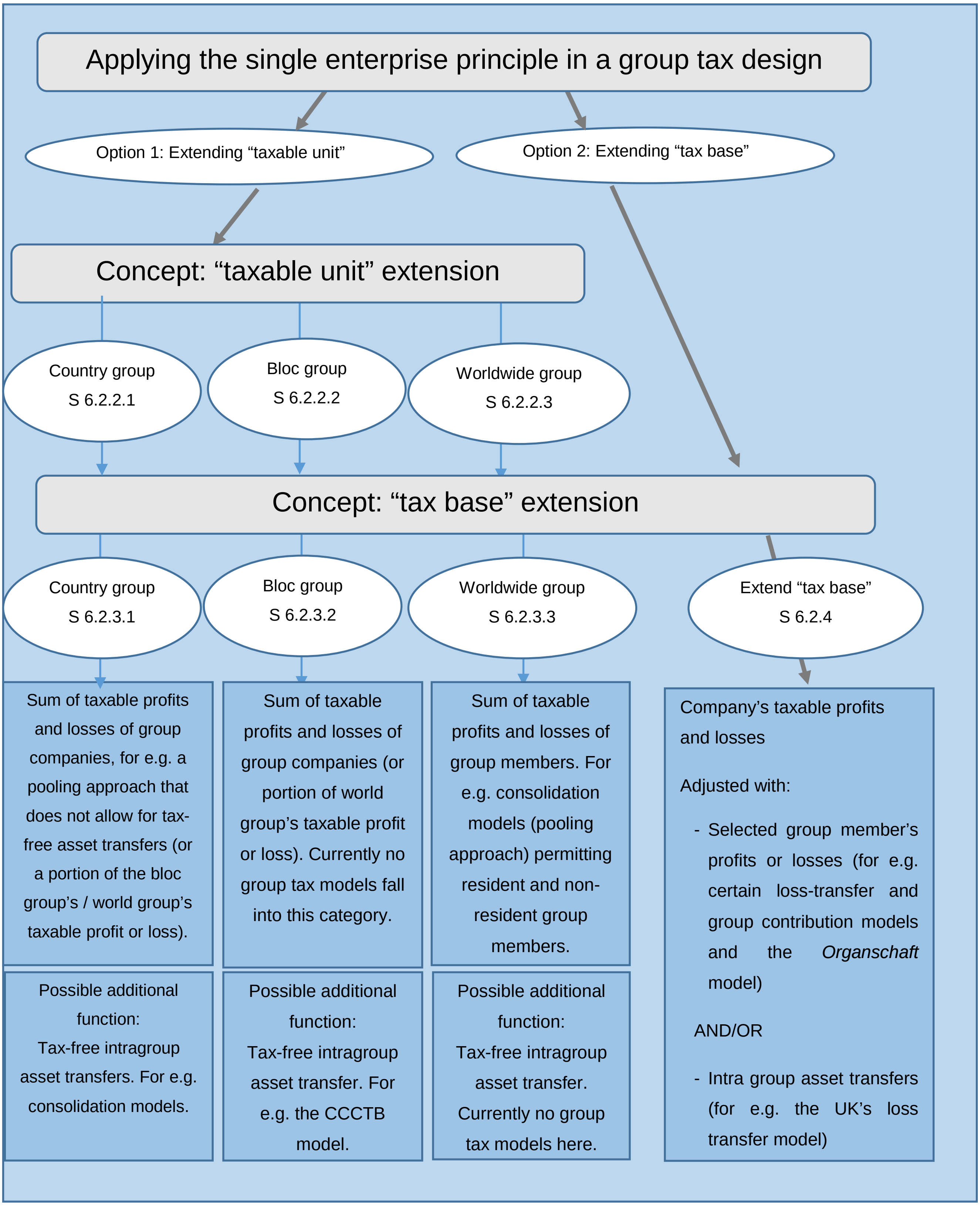

Figure 6.1: The taxonomy of different group tax regimes

(Source: Adapted from Ting, 2013b:37)

6.2.2 Extending the "taxable unit"

Under the separate entity regime, the taxable unit is the company, while under the single enterprise principle, the taxable unit may be extended to the corporate group. The following options for extending the taxable unit to the corporate group were identified by Ting (2013b:28-29).

6.2.2.1 The taxable unit is the country group

Firstly, the taxable unit may include all resident group members under control of a common parent resident company, referred to by Ting (2013b:28) as the "country group". The consolidation regime in Australia is an example of this.

6.2.2.2 The taxable unit is the bloc group

The second possible taxable unit is to include only group companies that are resident in specific participating countries ("bloc group"). The CCCTB is an example of a "bloc group". It is also considered to be a "multilateral model"[376] because not only is the taxable unit defined to include only participating countries (in this case the member states of the European Union), but the same tax base[377] is also shared amongst participating countries (European Commission, 2011d).

6.2.2.3 The taxable unit is the worldwide group

The third possibility is to extend the taxable unit further to include non-resident group members under control of a common resident parent company. Ting (2013b:28) referred to this taxable unit as a "worldwide group". The Danish group tax system is an example of a

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376 According to Ting (2013b:28), it is highly unlikely that a country will unilaterally define the tax base to be a bloc group. It is more likely for a bloc of countries (like the member states of the African Union) to define the taxable unit to be a bloc group on a multilateral basis.

377 In terms of the CCCTB, a single set of group tax rules would apply across the European Union (European Commission, 2011d).

group tax system that extends beyond international borders to include foreign companies (PricewaterhouseCoopers, 2017a).

The application of the single enterprise principle expands from the “country group” to the “bloc group” to eventually apply in its strongest form to the “worldwide group”, where all countries are included in the taxable unit. Ting (2013b:29) provides the following diagram (see Figure 6.2 below) to illustrate the three possible definitions of the “taxable unit” for corporate groups under the single enterprise principle.

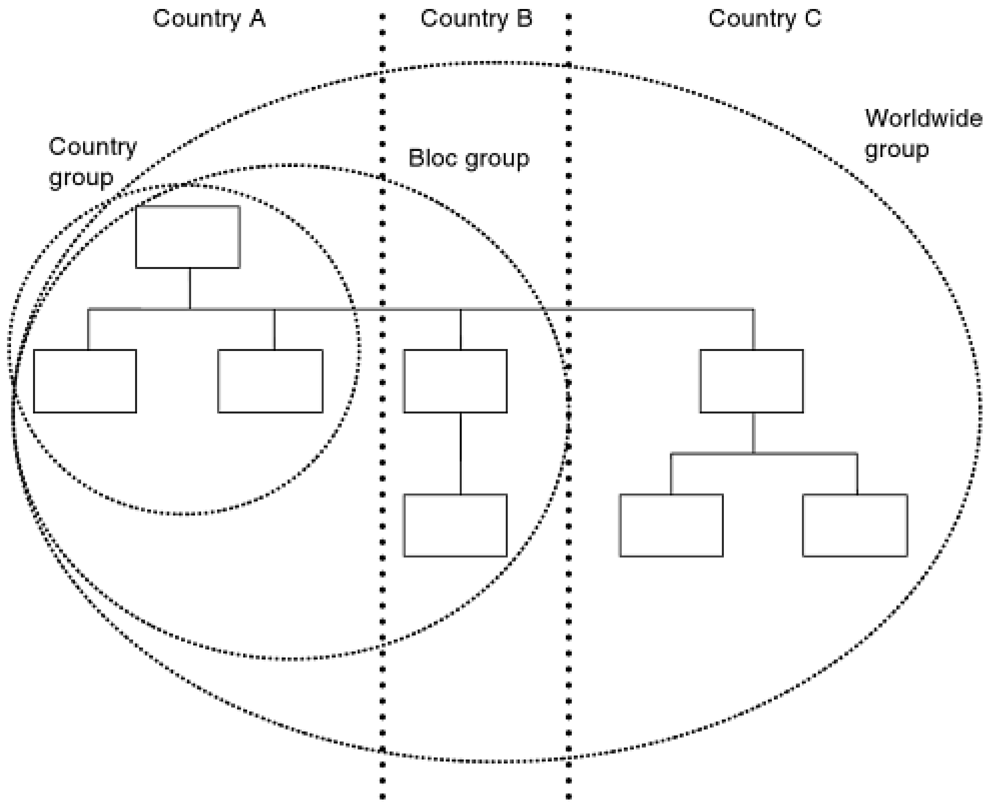

Figure 6.2: The alternative definitions of a taxable unit
(Source: Ting, 2013b:29)

6.2.3 <u>Extending the “tax base” where the “taxable unit” is extended</u>

As already explained, the option of extending the “taxable unit” will lead to the extension of the “tax base”, with the effect that both the “taxable unit” and the “tax base” will be extended. It follows, then, that the “tax base” has to be extended in each of the three possibilities discussed in Section 6.2.2 where the “taxable unit” is extended, namely the country group, the bloc group, and the worldwide group

6.2.3.1 “Tax base” for the “country group” as taxable unit

The group of companies (consisting only of resident group members) is defined as the taxable unit. The tax base is defined as the sum of the taxable profits and losses of the group members, thereby meeting one objective of a formal group tax systems, namely the set-off of losses. The tax base is calculated according to the tax laws of the specific country, which allows for intragroup loss offset (Ting, 2013b:32). This system is straightforward as the tax base relates only to the tax rules of the specific country.

To achieve the second objective of formal group tax systems, the tax base of the “country group” could include tax-free intragroup asset transfers as a possible additional function. This model has to provide for a comprehensive single enterprise treatment, as it applies to both intragroup losses and intragroup asset transfers. Clearly, consolidation models such as the attribution approach applied by the Netherlands and the absorption approach applied by Australia will fit into this category, but not all the pooling consolidation models will, as not all provide for tax-free intragroup asset transfers (Ting, 2013b:43-44). Figure 6.1 above (Section 6.2.1) illustrates where group tax models falling under the “country group” as taxable unit fit into the framework of the different group tax regimes.

Alternatively, instead of defining the tax base of a country group as the sum of the taxable profits and losses of the group members, a country may define the tax base as a portion of the taxable profits or loss of the bloc group or the worldwide group to which it belongs (Ting, 2013b:33). There are various methods for apportioning the taxable profits or losses of the bloc group or worldwide group to the country group. The following apportionment methods have been suggested:[378] macro-based formula,[379] value-added approach,[380] and formulary apportionment method[381] (Agúndez-García; 2006:32-85). The formulary apportionment method was ultimately accepted as the fairest and most preferred method for the CCCTB project (Nerudová, 2012:470). There are currently no group tax regimes that fit this model.

6.2.3.2 "Tax base" for the "bloc group" as a taxable unit

Under the "bloc group", a group of companies that is resident in member countries of a bloc group, like the African Union, can be treated as a taxable unit. The tax base will be defined as the sum of the taxable profits and losses of those group companies, calculated according to the tax law of that specific bloc group (a group of countries like the African Union countries), which also allows for intragroup loss offset. This means that one objective of a formal group tax systems is met, namely the set-off of losses. There are currently no group tax regimes in this category (Ting, 2013b:42).

To achieve the second objective, the tax base can include tax-free intragroup asset transfer as a possible additional function. The proposed CCCTB project falls into this category. It is also the first serious worldwide attempt to apply the enterprise principle on a multilateral basis. In terms of the CCCTB project, a group of countries that are member states of the European Union treat the bloc group (companies qualifying as a group and resident in these member states) as a taxable unit. The bloc group, as the taxable unit, will file a single return to report the taxable profits or loss of the group. The group's tax base will be shared among the member states, using an apportionment method, such as the

379 The macro-based formula apportions a group's taxable income across countries, based on factors aggregated at national level such as GDP, national value-added tax bases, etcetera (European Commission, 2006:4).

380 The value added method is well known to tax administrations in the European Union and allocates the group's taxable income based on profit (loss) realised per country (European Commission, 2006:4).

381 The federal apportionment method has its origin in the United States. It uses factors, such as interest held in property, payroll (gross salary account) and gross receipts, to assign a weight to each federal state, which is used to distribute the tax base across the federal states of the United States. The same method, using factors that are relevant to the European Union, is suggested for the CCCTB regime (Weiner, 2005:8).

proposed federal apportionment method (Ting, 2013b:45). The future of this proposed group tax model is still uncertain, as it has not yet been implemented.[382] Figure 6.1 (see Section 6.2.1) illustrates where proposed group tax models falling under the "bloc group" as taxable unit will fit into the framework of the different group tax regimes.

Alternatively, instead of defining the tax base of a bloc group as the sum of the taxable profits and losses of the group members, the tax base may be defined as a portion of the taxable profits or loss of the worldwide group to which it belongs, using an appropriate apportionment method (Ting, 2013b:35). There are currently no group tax models or even proposed models in this category.

6.2.3.3 "Tax base" for the "worldwide group" as a taxable unit

This taxable unit consists of a worldwide group of companies, whether resident in the country of concern or not. The tax base of the worldwide group is the sum of the taxable profits and losses of the world-wide group members, computed according to the tax law of the group's home country[383] and allowing for intragroup loss offset (Ting, 2013b:35). Again, this means one objective of a formal group tax systems is met, namely the set-off of losses. The consolidation model is the only group tax model where the group operates as a single fiscal unit (Masui, 2004:30). Therefore, only consolidation models permitting resident and *non*-resident group members will fit into this category. There are currently two consolidation regimes applying the pooling approach that fit into this category, namely Denmark and Austria (after 2005).

To meet the second objective, the tax base can include tax-free intragroup asset transfers. There are, however, currently no group tax models in this category that also allow for tax-free intragroup asset transfers (Ting, 2013b:43). Figure 6.1 (see Section 6.2.1) illustrates

382 The CCCTB regime was proposed by the European Commission in 2011, but was not implemented. It was relaunched by the European Commission in 2015 as part of their Action Plan for a Fairer and Efficient Corporate Tax System in the European Union (European Commission, 2016). It has not yet been implemented.

383 It is uncertain where the home country will be in such an instance. It is submitted that the home country can either be specified as the home country of the parent company or where the majority of the group members are resident.

where group tax models falling under the "worldwide-group" as taxable unit fit into the framework of the different group tax regimes.

6.2.4 Extending only the "tax base" and not the "taxable unit"

As previously discussed, it is possible to apply the single enterprise principle even if a country defines the separate company as the taxable unit. When keeping the company as a separate taxable unit, the single enterprise principle is applied in the definition of the "tax base". This is achieved by defining the "tax base" as the company's taxable income or loss, plus certain tax attributes of other group members. Tax group models that will fit into this category will be models where each member company remains liable for submitting its own corporate tax return. In other words, each company determines its taxable profit or loss on a stand-alone basis, as if no group relationship exists.

The following group tax models fit into this category as they first compute the company's taxable income separately, and then take into account the tax attributes of other resident group companies. Firstly, the loss-transfer model, where the company's taxable profit or loss is first computed separately. The tax attribute that is added to this is any tax loss of another company within the group. This model enables a transfer of losses from a loss-making group member to a profit-making member within the group (Masui, 2004:30). Examples of this model are found in Cyprus, Ireland, Malta and Latvia.[384]

Secondly, in the group contribution model, each group entity is treated as a separate taxpayer, determining its taxable income separately. Thereafter, the group company may transfer ("contribute") some of its profits (but not losses) to another group member. Through this contribution, a loss-making company can offset its losses against the profits contributed by a profit-making member of the group. Finland employs this model.[385]

Thirdly, there is the *Organschaft* model, where a parent and its subsidiaries can choose to have the taxable profit or loss of the subsidiaries transferred to the parent, thereby

384 Although the loss-transfer model is also applied in the United Kingdom, it provides for the additional function of tax-free intragroup asset transfers.

385 Although the group contribution model is also applied in Sweden and Norway, these countries provide for an additional function, i.e. tax-free intragroup asset transfers.

accomplishing the set-off of losses between group members at the parent level. The subsidiaries remain separate entities for tax purposes and submit tax returns showing zero taxable income each year. The taxable profit or loss of the subsidiaries, before it is transferred to the parent, is calculated on a separate entity basis, and intragroup transactions are not eliminated. The *Organschaft* model is a stronger application of the enterprise principle than the other models in this category, as it combines both the taxable profits and losses of the subsidiaries (Ting, 2013b:49).

In order to achieve the second objective, the “tax base” may include adjustments for intragroup asset transfers to provide for tax-free intragroup asset transfers as an additional function (Ting, 2013b:35). Japan, Norway, Sweden, and the United Kingdom already have a group system in place that allows intragroup loss offset but have introduced separate statutes to allow for tax-free intragroup asset transfers whereby capital profits may be deferred in certain specified circumstances (Ault & Arnold, 2010:398). India and South Africa are unique, as these jurisdictions do not have a formal group system allowing intragroup loss offset but have introduced separate statutes to allow for tax-free intragroup asset transfers. They, therefore, also fall under this category. Figure 6.1 (see Section 6.2.1) illustrates where group tax models applying the “tax base” fit into the framework of the different group tax regimes.

Alternatively, the tax base of a separate company as a taxable unit may be defined under the single enterprise principle as a portion of the taxable income or loss of the corporate group (for example: the country group, bloc group, or the worldwide group to which the company belongs), using an apportionment method (Ting, 2013b:35). There are currently no group tax regimes in this category, and accordingly this category is not illustrated in Figure 6.1.

6.3 CONCLUSION

The aim of this chapter was to examine a basic framework of international group tax systems, developed according to their taxonomy, in order to identify viable alternatives for designing a group tax system for South Africa. The chapter explores a basic conceptual framework developed according to the design of international group tax systems. Two main design options were identified as viable design options for moving from the separate entity principle to the single enterprise principle in the South African context.

The first option is to extend the tax base (not the taxable unit) by introducing, for example, a loss-transfer model (the group tax model currently applied in the United Kingdom) in South Africa. The second main design option, illustrated in the theoretical framework of group tax regimes, is to extend the taxable unit (and therefore also the tax base). This can be achieved by introducing the consolidation model. It is suggested that the following three approaches to the consolidation model should be considered for the South African context:[386] Australia's absorption approach, the Netherlands' attribution approach, and the United States' pooling approach. These three group tax regimes achieve both objectives of an ideal group tax system (loss offset and tax free intragroup asset transfers). It is evident that the taxonomy of a group tax system affects the way the structural elements are applied, and this should therefore be considered when analysing the structural elements. These two main design options are selected because they provide examples of the different approaches to group taxation that could be used to analyse the philosophies, policies and structures that could be applied in designing a group tax system for South Africa.

In Chapter 3, it was suggested that a formal group tax system for South Africa could be developed through a process in which the structural elements of group tax regimes, internationally, are identified and adapted to suit the South African context. In the next chapter of this study (Chapter 7), the structural elements of formal group tax systems, identified in Chapter 3, will be considered. This will be done in order to suggest an optimal set of structural elements that could be adopted in the South African context reflecting the fact that the taxonomy of a group tax system affects the way the structural elements are applied.

386 Only designs in respect of the "country group" were considered for the South African context.

CHAPTER 7: THE STRUCTURAL ELEMENTS OF FORMAL GROUP TAX SYSTEMS

7.1 INTRODUCTION

In the previous chapter, two main design options are identified for developing a formal group tax system for South Africa. In this chapter, the structural elements of group tax systems (identified in Chapter 3) are considered in terms of these two main group tax design options. The list of common features identified in Chapter 3 serves as a starting point for determining the list of structural elements for group tax systems for purposes of this study. Thereafter, the structural elements are analysed in detail. The common features identified in Chapter 3 serve as a starting point to identify the structural elements that should be analysed. The aim of this chapter is two-fold: firstly, to identify and analyse in detail the structural elements in terms of the two main design options, and secondly, to determine how these structural elements are influenced by the different policy objectives that are essential to consider when designing a formal group tax regime (these policy objectives were identified in Chapter 4).

7.2 THE LIST OF STRUCTURAL ELEMENTS

The list of structural elements for group tax systems first needs to be considered and finalised. On comparing the formal group tax systems applied in comparable jurisdictions, it became clear that there are certain common features addressed in the group tax statutes of these jurisdictions. The following five shared features were identified and grouped together (the fourth bullet/attribute – tax attributes – could be divided into three features and this division increases the initial five shared features to the proposed seven features):

- the rules used to compute the tax base of an eligible group on a combined basis (including the proportion of the member's tax base to be included in the combined tax base);

- the definition of the group of companies (including common ownership requirements and eligibility requirements);
- the participation rules (whether the group tax regime is compulsory or voluntary, whether revocable after a certain period, and whether all qualifying members are eligible);
- the treatment of tax attributes (when entering the group, during consolidation, and when exiting the group); and
- other practical considerations (liability of group members, fiscal year end, and submission of tax returns).

These common features can be considered to constitute the structural elements of international group tax regimes. After comparing these structural elements with the structural elements identified in the report by the International Fiscal Association in 2004[387] (Masui, 2004:21-22), the Canadian Consultation paper (2010)[388] and Ting's study (2013b),[389] it became clear that structural elements were identified in their studies that are like the ones identified in Chapter 3. One of the structural elements, namely the treatment of tax attributes,[390] contributes to three separate elements: Firstly, the treatment of tax

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387 The design issues were discussed under the following headings: scope (definition of group, the "all-in" rule), shares in a subsidiary (treatment of intragroup shareholdings), proportional consolidation (consolidation of group results), legal construction (single entity concept), and other design issues (practical issues such as the liability to tax) (Masui, 2004:21-22).

388 The design parameters identified were: eligible groups; degree of common ownership, non-corporate entities and non-resident corporations and common parent corporation; range of attributes; elective components; pools of unused tax attributes; existing approach; and the use of previously accumulated attributes in a new system (Canada, 2010:21-22).

389 In a study by Ting (2011:421-462), a comprehensive comparative analysis was performed of the consolidation models employed in eight countries: Australia, France, Italy, Japan, the Netherlands, New Zealand, Spain, and the United States. In his study, Ting compared the alternative policy options with respect to the elements of the eight chosen consolidation regimes in an effort to identify an ideal regime or prototype that could assist as a starting point for a Canadian regime. In performing the comparative analysis, the following key elements of the consolidation model, further refined in a subsequent study by Ting (2013b), were identified: the single enterprise concept, the consolidation of group results, the liability to tax, mandatory versus elective application of the regime, the "all-in" rule, the definition of a group, the treatment of losses, the treatment of assets, and the treatment of intragroup shareholding.

390 Tax attributes are features of a tax structure that can be ascribed to taxpayers and that can be carried over from one taxation cycle to another (Harris, 2013:112). Tax losses (referred to as "assessed losses" in South African tax legislation) are an example of tax attributes because tax losses are attached to a taxpayer and can be used in the tax cycle in which they are suffered, but can also be carried forward or backward to other tax periods. Assets are another example of a tax attribute, as they carry unused

attributes is split into two elements to accommodate the “treatment of tax losses” separately from the “treatment of assets”. In its turn, the “treatment of assets” is split into two different structural elements. The “treatment of assets” includes intragroup shares, which are also part of the assets of group companies, but because the “treatment of intragroup shareholdings” raises different issues, it is preferable to consider it separately. After then splitting the treatment of tax attributes into three parts, being rules on the “treatment of tax losses”, rules on the “treatment of assets”, and rules on the “treatment of intragroup shareholdings” there are now seven structural elements to consider.

These structural elements are influenced by the taxonomy of a specific group tax system. It was found[391] that the shift from a separate entity principle to a single enterprise principle can be achieved by extending either the “tax base” or the “taxable unit”. It is clear that two main design options exist, which will be explored further in this chapter. Firstly, the loss-transfer model of the United Kingdom will be analysed, which extends the tax base and not the taxable unit (the taxable unit remains the separate company). Secondly, the consolidation regimes of Australia (absorption approach), the Netherlands (attribution approach) and the United States (pooling approach), which extend the taxable unit (and therefore also the tax base), will be analysed. It is evident that the taxonomy of a group tax system affects the way in which the structural elements are applied, and should therefore be considered when analysing the structural elements.[392]

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capital allowances with them. Depending on a jurisdiction’s tax laws, the following tax attributes can also be considered: capital losses, unused research and development allowances, foreign tax credits, and unused charity contributions (Canada, 2010:24). A group tax regime could possibly permit group companies the right to apply numerous types of taxation attributes that stem from other members within the same corporate group (Canada, 2010:23). The more tax attributes introduced into the group tax system, the closer the system comes to taxing the group as a single tax unit.

391 Refer to the discussion in Chapter 6.

392 For example, where the definition of the group is considered as a structural element, the definition will determine the taxable unit for the consolidation regimes, but not for the loss-transfer regime of the United Kingdom, as the taxable unit remains the company. Only the tax base of the company can be extended in the United Kingdom, to allow for the offset of tax losses between that company and other members of the group of companies, as defined. Another example is seen in the structural elements of the treatment of assets and the treatment of shareholdings that would be a non-issue in a loss-transfer system, where only one objective, namely the set-off of losses within the group, is achieved.

7.3 THE RULES USED TO CALCULATE THE TAX BASE

This structural element refers to two issues, firstly, the rules used to combine or consolidate the tax base of the group, and, secondly, the proportion of the subsidiary's taxable profit or loss to be added to the tax base of the taxable unit.

7.3.1 Rules used to combine or consolidate the tax base

The rules that enable a jurisdiction to calculate a qualifying group's or group company's tax base relate directly to the main design option elected, as well as to the typology of the various group tax regimes employed by the specific jurisdictions, as described in detail in Chapter 3 (the loss-transfer model, the consolidation model, and others). The starting point in most group tax regimes comprises the separate financial statements of each group member that are compiled using the same accounting rules (Endres, 2007:92). The consolidated financial statements using the accounting approach[393] to consolidation is not appropriate for taxation (Endres, 2007:84). One of the reasons is the way that minority interests are treated in the profit and loss account. Another reason is the fact that, for accounting purposes, all the activities, both domestic and foreign, of all members of the group (non-residents and residents) are combined. The European Commission (2006; 2005) investigated the possibility of using the consolidated financial statements as a starting point for tax purposes. Concerns were raised about a potential lack of equality between large and small companies, as most small companies do not comply with the full International Financial Reporting Standards, thereby excluding smaller corporate groups from group taxation, should the consolidated statements be used as a starting point (European Commission, 2005:4). There were also contributors who felt that companies have too much flexibility when applying the principles in accounting standards, as opposed to the strict rules required by tax legislation (European Commission, 2005:4). It would furthermore require a large number of adjustments to reconcile the consolidated profit with the group's taxable income. In the end, it was found that the number of adjustments would

393 Provisions for consolidated financial statements are found mainly in the International Accounting Standard 27 and International Financial Reporting Standard 3. According to the International Accounting Standard 27, consolidated financial statements consolidate a parent and all of its subsidiary companies (foreign and domestic) when the subsidiaries are controlled by the parent (see Chapter 7, Section 7.4.1 for a discussion of the meaning of "control") (Endres, 2007:84).

be so numerous that there would be no benefit in commencing with the consolidated statements (European Commission, 2006:3).[394]

According to the taxonomy of group tax systems, the rules used to compute an eligible group's tax liability on a combined basis relates to the calculation of the *tax base*. In group tax models where the taxable unit remains the company, but only the tax base is extended, such as the loss-transfer model of the United Kingdom, the tax base of the *group company* that qualifies under the loss-transfer system should be considered. In group tax models where the taxable unit is extended to include all group companies that qualify, such as all consolidation models, the tax base of the *group* should be considered.

7.3.1.1 The loss-transfer model of the United Kingdom

In the United Kingdom, every member of a group remains a separate taxable entity for tax purposes, and calculates its tax base separately. The United Kingdom group tax system[395] only provides for the transfer of tax losses between companies that are entitled to receive the relief, being part of the same group of companies. Two companies are members of a group of companies if one company is a 75% subsidiary of the other company, or both of those companies are 75% subsidiaries of a third company (section 402 of the Income and Corporation Taxes Act, 1988). The loss-transfer system allows tax losses[396] in one company, the surrendering company, to be surrendered and offset against profits of another company (the claimant company) that qualifies to be part of the same group of companies in terms of the loss-transfer rules (Ault & Arnold, 2010:400). The claimant company uses the loss surrendered to reduce its liability for company tax.[397] Losses can

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394 Some of the criteria and principles used in the International Accounting Standard (IAS 27), however, constitute a useful reference point for the determination of the eligible group to be consolidated, as is illustrated in this chapter.

395 Chapter IV (sections 402 to 413) of the Income and Corporation Taxes Act, 1988 (United Kingdom, 1988).

396 Trading losses, certain excess capital allowances from leasing, deficits on non-trading loan relationships (excess interest charges), an excess of management expenses, property business losses, qualifying charitable donations, and non-trading losses on intangible fixed assets can be surrendered from one company to the other in terms of section 402 of the Income and Corporation Taxes Act, 1988 (Partington, 2014).

397 In the 2016 Budget, the United Kingdom Government announced rules to allow the surrendering company to surrender tax losses to more than one claimant company (effective from 1 April 2017). The claimant company is allowed to utilise the loss against more than one type of income. It was

be surrendered in any direction, from the parent company to the subsidiary company, from the subsidiary company to the parent company, or between sister companies (Pinsent Masons, 2016).

The maximum tax loss that can be surrendered is the lesser of the existing loss in the surrendering company or the existing profit in the claimant company.[398] The amount that is surrendered can therefore not create a loss in the claimant company. Although members tend to use similar year-ends for accounting purposes, it is not a requirement of the United Kingdom's loss-transfer system[399] (Pinsent Masons, 2016).

The following example illustrates the working of the loss-transfer system. Assume that Company A earns a net trading profit of £500 000 for the accounting period of 12 months. Company B (a subsidiary of Company A) incurs a net trading loss of £300 000 for the same accounting period. Included in the net trading profits and losses of both Company A and Company B are intragroup transactions amounting to £20 000 (Company A provided management services to the value of £20 000 to Company B). Both companies accounted for the intragroup transaction amount of £20 000 in the same accounting period, Company A as income, and Company B as a deduction of expenses.[400] Table 7.1 below indicates that each company first calculates its taxable income or loss separately. In terms of the loss-transfer group tax system, Companies A and B are part of the same group. Company B will therefore be able to surrender its loss of £300 000 in favour of Company A, to enable Company A to set off the loss against its taxable income of £500 000.

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furthermore announced that from 1 April 2017, companies with profits in excess of £5 million are only allowed to offset 50% of their profits against losses carried forward. The £5 million profit ceiling applies per group, and not per surrendering company (Pinsent Masons, 2016).

398 Section 405 of the Income and Corporation Taxes Act, 1988.

399 Section 408 of the Income and Corporation Taxes Act, 1988, provides for situations where the companies do not have the same accounting periods, to allow for the transfer of losses on a time-apportioned basis.

400 By implication, the tax loss of Company B is therefore increased by £20 000 (loss of £280 000 plus management expenses of £20 000). In terms of section 402 of the Income and Corporation Taxes Act, 1988, excess management expenses can also be surrendered by the surrendering company.

Table 7.1: Example of the calculation of the tax base in loss-transfer models

	Company A	**Company B**
Net trading profit or (loss)	£500 000	(£300 000)
Eliminate intragroup transactions	-	-
Transfer loss from loss-making Company B to Company A	(£300 000)	£300 000
Separate taxable income of each member company	**£200 000**	**£nil[401]**

(Own formulation)

7.3.1.2 The pooling consolidation system of the United States

The pooling system of the United States can be considered a hybrid system, first applying the separate entity principle to calculate each group company's tax base separately in accordance with the United States statutory rules applicable to the individual company,[402] before applying the single enterprise principle. In the first stage, the taxable unit and tax base apply to the separate company, while the group itself is ignored (Spaulding, 2016). Thereafter, the single enterprise principle is applied to calculate the tax base (consolidated taxable income[403]) of the corporate group (Ting, 2013b:80).

In the second step, each group company adjusts its taxable income for intragroup transactions.[404] Only certain intragroup transactions are adjusted, depending on the regulations. Some regulations treat members engaging in intragroup transactions[405] as separate companies. The intragroup transactions, adjusted in terms of these regulations, are only those that affect consolidated taxable income because the corresponding item is

401 As can be seen in Table 7.1, Company B has no tax liability for the period, while Company A will have a tax liability of £40 000 (£200 000 (£500 000 - £300 000) x 20%). In practice, Company A will pay Company B £60 000 (£300 000 x 20%) to compensate Company B for the tax loss surrendered by it. This subvention payment of £60 000 will not be taxed in Company B's hands, or claimed as tax deduction by Company A.

402 Section 1502-11(a)(1) of the Internal Revenue Code.

403 The detailed rules for calculating the consolidated taxable income are found in section 1502 of the Internal Revenue Code (United States, Department of Treasury).

404 Section 1502-80 of the Internal Revenue Code.

405 The intragroup transactions referred to include performance of services, licensing of technology, renting of property, lending of money, and the subsidiary's distribution to the parent (Anderson, Pope & Kramer, 2011:8-15).

not accounted for in the other member company's taxable income. For example, if Company A provides services valued at $25 000 to Company B, Company A records the income, while Company B records the $25 000 deduction. The net effect of the transaction is nil, and the combined taxable income of the corporate group remains the same and should therefore not be adjusted. Consequently, there is no adjustment necessary in Step 2 (Spaulding, 2016). Certain other regulations treat members engaging in intragroup transactions as divisions of a single company, for example the sale of *property* between group members to ensure it has no immediate tax effect[406] (Whittington, 2007:2).

These regulations are contained in two rules, the matching rule and the acceleration rule. If the amount of the intragroup transaction is not taxed as income in the hands of the recipient company because of the method of accounting used by it (in other words the net effect of the transaction in the group is *not* nil), then the deduction may not be claimed by the other group company, even if it would be deductible by that company for tax purposes. The deduction is then postponed until the amount is included in the recipient company's income in a subsequent tax year. This is referred to as the matching rule[407] as it matches corresponding items between group members over time (Bittker, Emory & Streng, 2006: §13-4). The acceleration rule[408] requires items deferred in terms of the matching rule to be realised once it becomes clear that it is no longer possible to attain single-entity treatment in terms of the matching rule. This normally happens when the selling or buying member is no longer part of the group, generally when either member exits the group[409] (McMahon, 2012:154).

In the third step, all items reported on a consolidated basis are removed in order to calculate each group member's separate taxable income.[410] The reason why some

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406 Regulations concerning intragroup *property* transactions always treat group members like divisions of a single corporation and the gains or losses are excluded from consolidated income until a subsequent event triggers recognition (United States, Treasury, Regulations, section 26 1.1502-13 of the Internal Revenue Code). Examples of subsequent events are the depletion of the purchased asset, departure from the group by the buyer or seller member or where the asset is sold to a non-member (Anderson, *et al*., 2011:8-17).

407 The matching rule is contained in section 1502-13(c)(2) and section 1502-13(b)(3) of the Internal Revenue Code.

408 The acceleration rule is set out in section 1502-13(d)(1) of the Internal Revenue Code.

409 When either the selling member or the buying member exits the corporate group, it is no longer possible to match the selling member's deferred gain or loss with the buying member's accounting records. The deferred gain or loss will then be accounted for (McMahon, 2012:154).

410 Section 1502-12(a) of the Internal Revenue Code.

consolidated items have to be calculated separately is to test certain limitations based on the consolidated taxable income of the group (Anderson *et al*., 2011: 8-19). Consolidated items are first excluded from the individual member's separate taxable income (Step 3) and then consolidated separately to adjust the consolidated taxable income of the group (Step 5). An example of such a consolidated item is charitable donations. The individual member's charitable donation should be excluded when calculating its separate taxable income (Step 3). In Step 5, the affiliated group's charitable contribution deduction is computed on a consolidated basis by using the sum of all the members' charitable contributions but limiting the deduction to 10% of adjusted consolidated taxable income. Other consolidated items treated on a similar basis are certain capital gains or losses (net section 1231[411] gain or loss), the dividends received deduction,[412] and the United States production activities deduction.[413]

It is only in the fourth step that the combined taxable income of the group of companies is calculated. This is achieved by aggregating the separate taxable incomes of each group member.

In the fifth step, the combined taxable income is adjusted with the consolidated items of the group[414] (specific items referred to in Step 3 are computed on a consolidated basis) to arrive at the group's combined taxable income. Thus, the tax base of the entire group of companies is determined in order to submit a single consolidated tax return (Anderson *et al*., 2011:8-12).

The following example illustrates the working of the pooling system of consolidation used in the United States. Assume that Company A earns a net trading profit of $500 000, after taking into account a charitable contribution of $50 000 for the accounting period of 12 months. Company B (a subsidiary of Company A) incurs a net trading loss of $300 000

411 Section 1231; capital gains or losses refer to gains and losses incurred on the selling of assets used in business. Since these rules are found in section 1231 of the Internal Revenue Code, they are referred to as section 1231 assets (Spaulding, 2016).

412 Dividends received from other group members are excluded from the separate taxable income of group members in order to determine the dividends-received deduction on a consolidated basis for dividends received from non-group members (Anderson *et al*., 2011:8-23).

413 The group's United States production activities deduction is calculated on a consolidated basis on the lesser of consolidated productive activities income or consolidated taxable income, before this deduction (Anderson *et al*., 2011:8-24).

414 Section 1502-11(a)(2) - (8) of the Internal Revenue Code.

for the same accounting period. Assume further that in terms of the pooling method of the consolidation group tax system, Companies A and B are part of the same group. Included in the net trading profits and losses of both Company A and Company B are intragroup transactions to the amount of $20 000 (Company A provided services valued at $20 000 to Company B). Both companies accounted for the intragroup transaction amount of $20 000 in the same accounting period, Company A as income and Company B as a deduction of expenses. As illustrated in Table 7.2 below, each company's separate taxable income should first be determined by adjusting firstly for intragroup transactions (only if there is no corresponding item or in the case of property transactions) in Step 2, and secondly for consolidated items in Step 3. Thereafter, the consolidated taxable income of the group is calculated by combining the separate taxable incomes of the members and adjusting it with the combined consolidated items.

Table 7.2: Example of the calculation of the tax base in the pooling approach of consolidation models such as in the United States

	Company A	Company B	Consolidated
Step 1: Taxable income or (loss)	$500 000	($300 000)	N/a
Adjustments:			N/a
Step 2: Adjustment for intragroup transactions[415]	0	0	N/a
Step 3: Adjustment for consolidated items[416]	$50 000	0	N/a
Separate taxable income	**$550 000**	**($300 000)**	
Step 4: Combined taxable income[417] ($550 000 - $300 000)	N/a	N/a	$250 000
Step 5: Adjust for consolidated items: Charitable contribution (10% of $250 000)	N/a	N/a	($25 000)[418]
Consolidated taxable income[419]	N/a	N/a	**$225 000**

(Own formulation)

415 Because the corresponding item is accounted for in both members' taxable incomes (Company A as income and Company B as a deduction), no adjustment for the intragroup transaction amount of $20 000 is required.

416 Certain items, like charitable contributions, need to be computed on a consolidated basis. The separate taxable income of the company is therefore first adjusted to exclude the item.

417 Combine the separate taxable incomes of each member in order to calculate the combined taxable income.

418 The balance of $25 000 is carried forward and considered for deduction in the following year of assessment.

419 Adjust the combined taxable income for items reported on a consolidated basis (in this case the charitable contribution). The resulting amount is the consolidated taxable income (or the net operating loss in a loss-situation).

7.3.1.3 The attribution consolidation system of the Netherlands

The Netherlands introduced the attribution approach in 2003 (referred to as "fiscal unity" or "*fiscale eenheid*"[420]) (Masui, 2004:43). Upon application to the fiscal authorities, a domestic parent company, and some or all its domestic subsidiaries that are legally and economically at least 95%-owned, can be treated as a fiscal unit for tax consolidation purposes (Ault & Arnold, 2010:400). In terms of the Dutch Corporate Income Tax Act, the members of the group are taxed as one taxpayer after application of the fiscal unit is approved.[421]

The Netherlands group tax system consolidates the identity of the subsidiaries into their parent company (Harris & Oliver, 2010:51). Thereafter, only the parent company, representing the whole group, is considered as the taxpayer for domestic tax law purposes.[422] The activities and equity of the consolidated subsidiaries form part of the activities and equity (assets and liabilities) of the parent company (Müller, 2008:266). Step 1 in calculating the taxable income of the group is to deem the income and expenses of the subsidiaries to be those of the parent company.[423] In Step 2, all intragroup transactions are eliminated. Assets and liabilities can furthermore be transferred between members within the fiscal unit, without members being liable for corporate income tax (Müller, 2008:266-267). In Step 3, the parent company files the consolidated taxable income using a consolidated tax return. The following example illustrates the working of the attribution

420 The rules of "fiscal unity" or "fiscale eenheid" are provided for in the Corporate Income Tax Act (*Wet op Vennootschapsbelasting*), 1969. On 1 January 2003, the Corporate Income Tax Act, 1969, was amended to include a "new" fiscal unity regime. The rules dealt with the codification into the Corporate Income Tax Act of numerous resolutions that had previously been issued by the Dutch Ministry of Finance dealing with the then existing fiscal unity rules (Chorus, Gerver & Hondius, 2006:459-460). For Dutch corporate income tax purposes, only the parent company is considered the taxpayer, while for double tax agreement purposes, the subsidiaries are still considered to be independent taxpayers, separate from the parent company (Chorus *et al*., 2006:459-460).

421 Section (*Artikel*) 15(5) and section (*artikel*) 15(8) of the Corporate Income Tax Act (*Wet op Vennootschapsbelasting*), 1969.

422 According to Harris and Oliver (2010:51), these group tax systems adopt a relatively pure version of consolidation, which collapses the identity of subsidiaries into that of their parent companies.

423 In the case of a permanent establishment, only the profits and losses (consisting of income and expenses) of the permanent establishment that is subject to tax in the Netherlands will be included in the group's consolidated income. Section (Artikel) 15(4) of the Corporate Income Tax Act (Wet op Vennootschapsbelasting), 1969.

system of consolidation used in the Netherlands. Assume that Company A earns a net trading profit of €500 000 for the accounting period of 12 months. Company B (a subsidiary of Company A) incurs a net trading loss of €300 000 for the same accounting period. In terms of the attribution method of the consolidation system, Companies A and B are part of the same group. Included in the net trading profits and losses of both Company A and Company B are intragroup transactions to the amount of €20 000 (Company A provided services valued at €20 000 to Company B). Both companies accounted for the intragroup transaction amount of €20 000 in the same accounting period, Company A as income and Company B as a deduction of expenses. Each company's income and expenses are first determined by using normal corporate tax rules, and by eliminating all intragroup transactions (see the illustration in Table 7.3 below). Thereafter the expenses and income are combined at parent level to calculate the consolidated taxable income.

Table 7.3: Example of the calculation of the tax base in the attribution approach of consolidation models

	Company A	**Company B**
Step 1: Net trading profit or (loss) consisting of income and expenses	€500 000	(€300 000)
Step 2: Eliminate intragroup transactions	(€20 000)	€20 000
Net trading profit or (loss) consisting of income and expenses after intragroup transactions are eliminated	€480 000	(€280 000)
Step 3: Attribute income and expenses of the subsidiary to the parent	(€280 000)	€280 000
Consolidated taxable income taxed in parent's hands	**€200 000**	**€nil**

(Own formulation)

7.3.1.4 The absorption consolidation system of Australia

At present, Australia is the only country that uses the absorption approach, which represents a very strong application of the single enterprise principle. In terms of Australia's "single entity rule",[424] introduced for years of assessment beginning after 30 June 2003, consolidated subsidiaries are deemed to be divisions of the parent

424 Provided in sections 700 – 721 of the Income Tax Assessment Act, 1997, of Australia. Referred to as the "SER" in its abbreviated form.

company (Maisto, 2008:31). In contrast to the attribution approach of the Netherlands, the consolidated subsidiaries no longer exist as separate tax entities.

From the beginning of the consolidation process, all the income and expenses of the members of a corporate group become the income and expenses of the parent company (no consolidation steps). Intragroup transactions are disregarded because the members of the corporate group are treated as a single unit (Maisto, 2008:35). This also implies that asset transfers within a group have no tax implications. Contrary to the pooling approach of the United States, where the profits or losses on intragroup asset transfers are deferred until a group member is no longer part of the group or where a subsequent event involving a third party occurs, profits or losses are not deferred (Maisto, 2008:35). In fact, no records are kept of assets transferred and no gains or losses are realised later, even where the buyer or seller exits the group (Maisto, 2008:35).

The following example illustrates the working of the absorption system of consolidation used in Australia. Assume that Company A earns net trading profit of AUS$500 000 for the accounting period of 12 months. Company A owns 100% of the shareholding in Company B, which incurs a net trading loss of AUS$300 000 for the same accounting period. In terms of the absorption method of the consolidation system, Companies A and B are part of the same group (Company B is a subsidiary of Company A). Included in the net trading profits and losses of both Company A and Company B are intragroup transactions to the amount of AUS$20 000 (Company A provided services to the value of AUS$20 000 to Company B). It is clear from Table 7.4 below that for tax purposes, neither of the companies would have accounted for the intragroup transaction of AUS$20 000, as the income and expenses of both companies would have been absorbed by the parent company and accounted for in the hands of the parent company. This means that the parent company would have calculated a net profit of AUS$200 000 (AUS$480 000 profit of Company A less AUS$280 000 loss of Company B) for the accounting period of 12 months.

Table 7.4: Example of the calculation of the tax base in the absorption approach of consolidation models

	Company A	Company B
Net trading profit or (loss) (AUS$480 000 less AUS$280 000)	$200 000	N/a
Eliminate intragroup transactions	-	N/a
Consolidated taxable income taxed in parent's hands	**$200 000**	N/a

(Own formulation)

7.3.1.5 Policy objectives influencing the rules used to calculate the tax base

This structural element is greatly influenced by the single enterprise principle.[425] The larger the number of objectives achieved, the stronger the application of the single enterprise principle in that group tax regime will be. Under the loss-transfer model applied in the United Kingdom, only the set-off of losses is achieved[426] which indicates a weaker application of the single enterprise principle. In terms of the loss-transfer system, every company in a group remains an individual taxable entity for tax purposes and calculates its tax base separately. It allows for tax losses of one group company to be surrendered and offset against profits of another group company.

More objectives are achieved in consolidation systems, which indicates a stronger application of the single enterprise principle. Of the three consolidation systems, the application of the single enterprise principle is weakest in the United States' pooling approach. This approach can be considered a hybrid approach, first applying the separate entity principle to calculate each group company's tax base separately according to the United States tax legislation that applies to the individual company. Thereafter, the consolidated taxable income of the group is calculated by combining the separate taxable incomes of the members and adjusting it with certain intragroup transferrals. The application of the single enterprise principle is second strongest in the Netherlands' attribution approach. In terms of this approach, consolidated subsidiaries continue to exist

425 This structural element is also influenced by the objective of simplicity, which is compromised for the sake of adhering to the single enterprise principle.

426 The second objective is not achieved in terms of the loss-transfer model itself, but in terms of separate statutes.

as separate companies, but their results are consolidated annually by deeming the income and expenses of the subsidiaries to be those of the parent. During the consolidation process, intragroup transactions are eliminated and only the parent company, representing the group as a unit, is the taxpayer for domestic tax law purposes. Amongst countries that employ the consolidation model, Australia's absorption approach represents the strongest version of the single enterprise principle. In terms of this approach, consolidated subsidiaries are considered as divisions of the parent, as they cease to be separate taxpayers from the time they join the consolidated group for income tax purposes.

As was found in Chapter 3, it is clear from Table 7.5 below that moving from a loss-transfer system to a consolidation model involves more complexity and administration, but also increased fiscal unity. The policy options with regard to this structural element are summarised in Table 7.5.

Table 7.5: Comparison of the rules used to calculate tax base and the related policy options in loss-transfer and consolidation models

Countries:	***United Kingdom***	***United States***	***Netherlands***	***Australia***
Group tax model:	Loss-transfer	Pooling	Attribution	Absorption
Tax-free movement of assets	Only achieved by using separate statutes (not the formal system)	Yes	Yes	Yes
Set-off of losses	Yes[427]	Yes	Yes	Yes
Elimination of intragroup transactions	No	Yes, but only certain intragroup transactions	Yes	Yes, because subsidiaries are treated as divisions of a single unit
Policy objectives:[428]				
Single enterprise principle	Weak	Strong (a hybrid system adhering to both the single enterprise and separate entity principle is applied)	Strong (consolidation at parent company level)	Strongest (subsidiaries cease to exist from beginning of consolidation process)
Simplicity	Adhered to (relatively simple)	Adhered to (relatively simple, yet more difficult than the loss-transfer model)	Compromised (complicated)	Compromised (extremely complicated)
Efficiency	Adhered to	Adhered to	Compromised (because of its complexity)	Compromised (because of its complexity)

(Own formulation)

7.3.2 <u>The proportion of the subsidiary's taxable income or loss to be added to the combined tax base</u>

Where a parent company owns less than 100% of the shares in a subsidiary, the question arises whether the group's consolidated taxable income or loss should include only the equivalent proportion of the subsidiary's taxable income or loss. It seems that this is not the case with the majority of group tax systems. For example, where a parent company owns 75% of the shareholding of a loss-making subsidiary in the United Kingdom, those

427 Trading losses, capital allowances, non-trading losses on loan relationships, excess management expenses, and excess charges on income can be surrendered.

428 It appears that the design options of this structural element are affected equally by the other policy considerations (competitiveness, fairness, and neutrality).

companies qualify for the loss-transfer group relief system. The loss-making subsidiary will be able to surrender 100% of its tax loss in terms of the loss-transfer system.[429]

Most of the consolidation regimes[430] combine 100% of the income and losses of a subsidiary, provided the minimum threshold requirement is met (Masui, 2004:44). The group tax systems of all four jurisdictions (the United Kingdom,[431] Australia,[432] the Netherlands[433] and the United States[434]) considered in this chapter include the full taxable income or loss of group members, once the member companies qualify for the group tax regime.

7.3.2.1 Policy objectives influencing the proportion of the subsidiary's taxable income or loss included in the combined tax base

The single enterprise principle assumes that a group is a single taxable unit under the common control of a parent. Therefore, once a subsidiary qualifies for consolidation, it should be treated as part of the single taxable unit, and 100% of its taxable income or loss should be included in the tax base of the taxable unit, regardless of its actual shareholding.[435] This rule is consistently applied in all four tax regimes analysed in this chapter.

This treatment, however, does not comply with the fairness principle in relation to minority interests, especially where a threshold lower than 100% is allowed, as in the United Kingdom (at least 75%), the United States (at least 80%) and the Netherlands (at least 95%). The policy options for this structural element are summarised in Table 7.6.

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429 It should be noted that minority interests are often treated differently in the profit and loss account of consolidated financial statements for accounting purposes (Endres, 2007:84).

430 Even in Italy, with its relatively low ownership threshold of 50%, and Spain with its 75% threshold, the total amount of a subsidiary's taxable income or loss is consolidated (Ting, 2013b:81-82).

431 Section 405 of the Income and Corporation Taxes Act, 1988.

432 Section 73-15(2) of the Income Tax Assessment Act, 1997.

433 According to Maisto (2008:384).

434 Sections 1502-11(a) and 1502-13 of the Internal Revenue Code.

435 It also adheres to the policy objective of simplicity, as the consolidation result is easier to calculate. This treatment does, however, not comply with the fairness principle in relation to minority interests, especially where a threshold lower than 100% is allowed.

Table 7.6: Comparison of the percentage used to calculate the proportion of the subsidiary's taxable income or loss included in tax base

Countries:	***United Kingdom***	***United States***	***Netherlands***	***Australia***
Group tax model:	Loss-transfer	Pooling	Attribution	Absorption
Percentage used to calculate consolidation of group results:	100%	100%	100%	100%
Percentage required to apply group tax regime:	≥75%	≥80%%	≥95%	100%
Policy objectives:[436]				
Single enterprise principle	Strong	Strong	Strong	Strongest
Simplicity	Adhered to	Adhered to	Adhered to	Adhered to
Fairness	Compromised with regard to minority interests (100% vs 75%)	Compromised with regard to minority interests (100% vs 80%)	Compromised with regard to minority interests (100% vs 95%)	Not an issue as 100% threshold required

(Own formulation)

7.4 THE DEFINITION OF THE GROUP

According to the International Fiscal Association report (Masui, 2004:37), the group tax regimes employed in countries are usually only available to certain qualifying entities connected through a required degree of common ownership. The definition of the group should be split into two parts: the ownership requirements, and entities eligible to be consolidated. Entities eligible to be consolidated involve not only the entity form, being companies, partnerships or trusts, but also the residency of the qualifying entities, in other words, whether only resident entities can participate or whether non-resident entities are also allowed to participate. Some group tax systems also specifically exclude taxpayers taxed in terms of special tax provisions, for example insurance companies (Ault & Arnold, 2010:397).

436 This structural element is not noticeably affected by the policy considerations of neutrality, competitiveness, and efficiency.

7.4.1 Common ownership

Different approaches can be used by group tax regimes to determine common ownership. These include an economic approach or a legal approach (European Commission, 2006:§15). Both of these approaches demand clear definitions and yardsticks for determining which companies form part of the group and which do not (European Commission, 2006:§18).

7.4.1.1 The economic approach

The economic approach focuses on both "control" and "economic integration". The economic approach aims to include all entities which are legally controlled, as well as entities which in relation to each other form part of a single, economically integrated business (European Commission, 2006:§17). This approach, like the legal approach, implies that, firstly, a set of minimum legal ownership requirements must be met. Thereafter, a second series of requirements relating to the operational and/or economic interdependence[437] between the members must also be met (European Commission,

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437 A number of tests are used to determine operational and/or economic integration between group members, such as management control or business connection (European Commission, 2006:§17). In modern corporate law in the United States common ownership is determined by applying the economic approach with "economic integration" indicated by six factors (Blumberg *et al.,* 2007: §6-9): (1) Control (the parent company possesses the power of control over the subsidiaries by virtue of *de jure* control or *de facto* control (St-Onge, 2005). The power of control is complete, but the extent to which it is exercised may vary (Blumberg *et al*., 2007:7).). (2) Integrated business enterprise (companies are a functional, integrated business enterprise, controlled as a unit under centralised management (Blumberg *et al*., 2007:8).). (3) Administrative interdependence, such as legal, accounting, tax, employment, and research and development for its various companies. Rather than providing these services themselves, affiliated companies rely on being provided with these services. Affiliated companies become interwoven and their independence diminishes (Blumberg *et al*., 2007:8).). (4) Financial interdependence (Subsidiaries do not seek financing independently, but depend on advances from parent companies. Alternatively, parent or sister companies provide surety when affiliate companies borrow directly. Financing frequently takes place on a group level, with cross-guarantees by affiliate companies (Blumberg *et al*., 2007:8).). (5) Employee interdependence (executive staff members are rotated between different affiliated companies that provide them with broader experience of group operations in preparation for greater responsibilities. Group training, group pension funds, group share schemes, and group insurance for employees are typical. Employees identify with the group as the employer, and not with a specific company (Blumberg *et al*., 2007:9).). (6) Common public persona (the group presents itself and its products as a single enterprise, with a shared trademark (Blumberg *et al*., 2007:9).).

2006:§17). Clearly, the first test refers to "control" and the second test to "economic integration".

Because group companies function as one enterprise,[438] the economic approach makes sense.[439] According to Ting (2013b:16), the application of both "economic integration" and "control" presents a stronger application of the enterprise principle than focusing mainly on the "control" factor, while ignoring "economic integration". Determining "economic integration", however, creates practical difficulties and complexities for group tax regimes when used to define the group (Weiner, 1999:17). Ultimately, the tests or factors used to determine "economic integration" introduce subjectivity into the group tax system (European Commission, 2006:§17). Complications arise when attempting to define a corporate group using "economic integration" (Agúndez-García, (2006:13). Consequently, international group tax regimes rely only on "control" to define the corporate group, with no group tax regime currently using the economic approach (Ting, 2013b:16; Endres, 2007: 85-88). The legal approach, taking only "control" into consideration, is easier to apply, straightforward and less prone to manipulation (Agúndez-García, 2006:13-14). It is therefore submitted that the economic approach is not a feasible approach and should not be explored as a possible option when designing a group tax system.

7.4.1.2 The legal approach

The legal approach focuses only on "control", and not "economic integration". In determining who controls a company, two kinds of control can be considered, *de facto* control (actual control) and *de jure* control (legal control[440]) (St-Onge, 2005).

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438 Group companies operate as one economic unit involving the control of a dominant entity; an integrated economic undertaking; administrative, financial and employee interdependence; and a common economic persona.

439 Certain states in the United States have been applying the "unitary business" principle when determining corporate taxable income. According to this principle, a single unit has to declare its worldwide income to the authorities, despite the fact the "unitary business" consists of various subsidiaries and permanent establishments around the globe. This practice was upheld by the United States Supreme Court in the case of *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159 (1983), I B (1). This practice follows the new tendency in modern corporate law in the United States to supplement and supplant the older single enterprise principle with the new enterprise principle (Blumberg *et al.*, 2007: §6-3). .

440 Holding the majority of voting rights or shareholding.

De facto control is experienced where a person or group is able to elect the majority of the board of directors using their influence, which is other than having *de jure* control. In other words, it means having the power, without necessarily holding a majority of the voting rights. *De facto* control arises from having direct and indirect influence (St-Onge, 2005).

The International Financial Reporting Standard (IFRS) 10[441] extends the criterion of "control" to cover *de facto* control, concentrating on the practical power to control, rather than on ownership. Therefore, in certain situations, control is regarded to exist, despite the fact that the parent does not hold a majority of the voting rights. In terms of IFRS 10, *de facto* control exists where contractual arrangements give the parent the right to control the votes of other holders (§ 11); or where rights in terms of arrangements give the parent the current ability to direct the relevant activities of a subsidiary (§ 12); or where the parent company has the practical ability to unilaterally direct the relevant activities of the subsidiary (§ 13), considering all facts and circumstances (§B42-45; IFRS 10); or where the parent company holds substantive potential voting rights (§B47-50; IFRS10). According to Van Noordwyk, Wise and Ludolf (2014:24-25), it is expected that the complexities and the bias arising from IFRS 10 may lead to inconsistent applications of the standard.

Masui (2004:37), on behalf of the International Fiscal Association (IFA), reported that *de facto* control may appear to be more accurate in capturing a control relationship, but cannot be used by group tax regimes as a means to determine control. It is not easy to ascertain or administer *de facto* control because it requires considerable judgment to identify. An example of such a situation is where a parent uses its employees to influence the decision of the management board in a subsidiary, and the parent owns only 25% of the shares issued by the subsidiary (Masui, 2004:37).

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441 IFRS 10 was built on concepts and principles that existed in the International Accounting Standard 27 and other accounting standards (SIC-12 Consolidation - Special Purpose Entities). IFRS 10 provides a revised definition of control, and applies effectively for periods ending after 1 January 2013. It concentrates on the necessity to have both power and variable returns in order to possess control. Power refers to the present capability to steer activities that substantially effects the outcome. Variable returns refer to the varying of returns as a consequence of the performance of the investee. In terms of the definition, entities need to determine if it possesses the following: power to control an investee, coverage, or the right, to variable returns from an investee, and the capability to exercise its power in order to manipulate the reporting entity's return (Van Noordwyk *et al*., 2014:24-25).

On the other hand, *de jure* control is present where a person or persons, by means of shareholding or voting rights, holds the power to select the majority of the board of directors. In practice, to determine "control", most countries adopt a clear-cut *de jure* control method, based on legal shareholding requirements[442] (Masui, 2004:37; European Commission, 2006:§16). The legal ownership threshold is determined using either shareholding,[443] voting rights,[444] participation rights in profits and capital repayment on winding-up,[445] value of shares,[446] or a combination of these factors (Oestreicher *et al*., 2011:8). Although the exclusive use of shareholding is simpler to administer, it disposes the group tax regime to abuse (Masui, 2004:37). Because "control" requires voting power, it seems more appropriate to use ownership of voting rights than ownership of equity shares (European Commission, 2007:4). The distinction between shareholding and voting rights only becomes relevant, however, where the shareholding differs from the voting rights.[447] It is submitted that all group tax systems should provide for a potential difference.

It is evident that *de jure* control requires strict legal limits. Any strict legal limitation creates the prospect for a group to purposely include or exclude certain members for tax purposes, and an anti-avoidance provision may have to be introduced to prevent this (European Commission, 2006:§22). The use of shareholding to determine control should, therefore, be protected by anti-avoidance provisions (Masui, 2004:37). Some jurisdictions, like the United Kingdom, require additional anti-avoidance measures to protect the minimum shareholding requirement, such as management control and business connection tests[448] (Masui, 2004:38). Germany is an example of a country where an additional requirement in the form of an agreement between the parent company and its subsidiary, the

442 This means determining the minimum ownership level for the inclusion of the group members in the group and the rules for computing the level, for instance applying direct or indirect ownership thresholds (European Commission, 2006:§16).

443 Used by the majority of countries with group tax systems (Oestreicher *et al*., 2011:8).

444 Germany uses voting rights only (Oestreicher *et al*., 2011:8).

445 Participation rights in profits and capital repayment on winding-up are used in Cyprus, Ireland and the United Kingdom (Oestreicher *et al*., 2011:8).

446 In the United States, the voting rights and the value of shares (excluding non-convertible preference shares without voting and capital rights) must be taken into account for consolidation (United States Department of Treasury, n.d.:§1.1504). .

447 The shareholding may differ from the voting rights because of non-voting shares allowed in terms of a jurisdiction's company law (Spengel & Wendt, 2007:20).

448 There are additional anti-avoidance tests for situations where shares are owned by an outside party or debt is provided by an outside party, or where any type of option in respect of shares in the subsidiary are existent (Pinsent Masons, 2016).

Gewinnabführungsvertrag, has to be entered into before qualifying for group taxation (Lang, 2008:215).

De jure control furthermore requires strict rules for calculating the ownership thresholds. Ownership thresholds can be defined on a narrow basis, taking into account only direct ownership, or they can be defined on a wider basis, taking into account direct and indirect ownership (European Commission, 2006:§16). The difference can be illustrated by the following example: assume a minimum ownership threshold of 80% is required. If the threshold requirement is based only on direct ownership, it means that the only subsidiaries that would qualify would be those in which at least an 80% interest is held directly by the parent company. Where the threshold also includes indirect ownership, it means that the combined holding of all group companies held via various levels of companies will determine the subsidiaries in which an interest of at least 80% is held (European Commission, 2006:§16).

The United States' pooling method of consolidation allows for an unusual way of determining share ownership in cases of indirect shareholding. In order to determine the "affiliated group" for consolidation purposes, shares held by subsidiaries are deemed to be directly owned by the parent company, and nominal ownership is ignored (Bittker *et al*., 2006: §13-4). According to their "deemed directly owned" method, a company may still be allowed to join the group even if the parent company effectively holds only 41% (80% x 80% x 80% x 80%)[449] of the subsidiary's shares (see Figure 7.1 below).

449 The United States requires a minimum threshold of 80%.

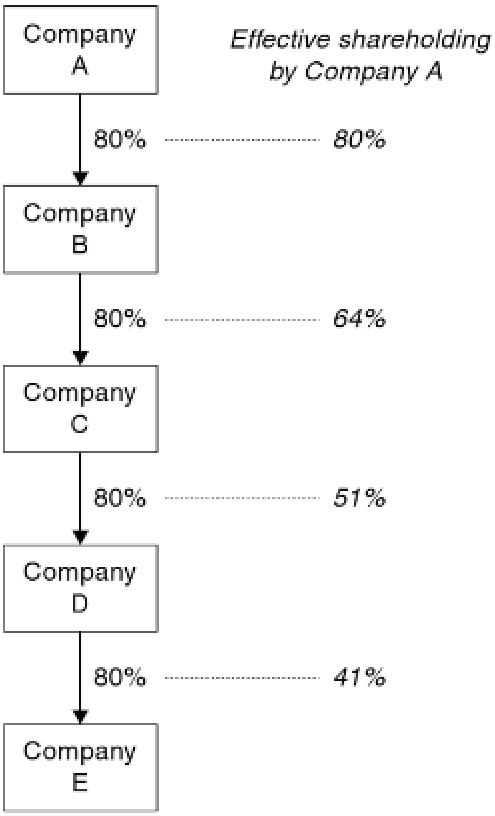

Figure 7.1: Indirect shareholding in the United States
(Source: Ting, 2013b:133)

According to the "deemed directly owned" method illustrated in Figure 7.1, it will be deemed that the parent company holds 80% in Company E, which therefore qualifies to be part of the group. While it is unlikely in practice that a corporate group will have such a "deep" structure as illustrated in Figure 7.1, this method maintains the single enterprise principle (Ting, 2013b:132-133). Unfortunately, it poses considerable risk for minority shareholders in the lower level subsidiaries. The "nominal method", whereby 41% would be considered the percentage holding of the parent in Figure 7.1, is more reasonable for minority shareholders, and is also the method used by most group tax regimes when testing indirect ownership requirements.

Clearly, taking indirect ownership into account leads to the inclusion of more subsidiaries and ultimately a wider taxable unit and wider tax base. It is also the option most often used in formal group tax systems[450] (Oestreicher *et al*., 2011:8).

From the comparative analysis in Chapter 3, it is clear that most group tax regimes provide for a minimum shareholding requirement in order to participate. All the jurisdictions considered (the United Kingdom, the United States, the Netherlands and Australia) apply only *de jure* control. In 2015, the Netherlands tightened their ownership requirement[451] to provide that the *full* legal and beneficial ownership of at least 95% of the shares[452] must be held in the subsidiary. Previously, the 95% requirement could be met if the legal title in respect of the shares was held by a company that was not part of the fiscal unit; for example, if the fiscal unit parent company owned depository receipts over shares of a subsidiary and *de facto* exercised the voting rights attributed to such shares at its sole discretion. The United States extended their shareholding requirement from "at least 80% of total voting power" to include "at least 80% of the total value of shares",[453] as an anti-abuse provision[454] (Teplinsky, 2007:36-37).

Internationally, *de jure* control is used by most jurisdictions to determine "control", with *de facto* control only applied on a limited basis, normally as an additional test to determine "control". Denmark is an example of a jurisdiction where *de facto* control is applied as an additional test, apart from the minimum shareholding requirement, to determine whether a group company meets the requirements for applying group tax relief (Oestreicher *et al*., 2011:8). Apart from the majority of voting rights, other possibilities, like the right to appoint

450 The exceptions are the group tax regimes of Australia, Japan, New Zealand, Latvia, Poland and Slovenia, allowing only direct shareholdings to be taken into account (Oestreicher *et al*., 2011:8; Ting, 2013b:135).

451 A tax bill was released on 16 October 2015 by the Dutch Government, which is designed to tighten the ownership requirement (Loyensloeff, 2015).

452 This means that to qualify for fiscal unity, the parent should hold a minimum of at least 95% of the voting rights and must be entitled to a minimum of 95% of the income and capital of the subsidiary (Deloitte, 2016).

453 Section 1504 (United States Department of Treasury, n.d.:§1.1504).

454 Referred to as the "80% vote and value test". Prior to 1984, section 1504 did not contain an ownership requirement based on value of shares, only voting power (Teplinsky, 2007:36).

or dismiss a majority of members of the subsidiary's management,[455] are also considered in Denmark (Oestreicher *et al*., 2011:8).

7.4.1.3 Policy objectives influencing the common ownership element

Firstly, when choosing an approach that is certain, simple to administer, and which would also give rise to lower compliance costs, the legal approach is preferred over the economic approach. The economic approach relies on subjective measures that would be difficult to apply in practice. This will eventually lead to higher compliance costs. Secondly, when considering the legal approach which focuses on control, *de jure* control requirements are preferred to *de facto* control requirements. *De facto* control requirements are vague, subjective, and not easy to administer. It is likely that uncertainties may arise which may again lead to higher compliance costs.

The structural element of common ownership is also influenced by the single enterprise principle. The economic approach, which focuses on "economic integration" and "control", presents a stronger application of the single enterprise principle than the strict legal approach. However, none of the jurisdictions considered in this chapter (the United Kingdom, the United States, the Netherlands, and Australia) applies the economic approach for determining ownership requirements. The policy options for this structural element are summarised in Table 7.7 below.

Another policy option that influences the structural element of common ownership is neutrality. Neutrality, as a policy consideration, requires that the tax treatment of an entity form should not influence investment decisions. The various group members have to be treated similarly for legal and tax purposes, and therefore the economic approach is more in line with the tendency in modern corporate law. Clearly, the economic approach would be preferred if a jurisdiction seeks to achieve neutrality in preference to other policy objectives. It is clear from Table 7.7 below that the policy objectives of simplicity and neutrality stand in direct conflict to each other. The choice between these two approaches,

455 Control can also be determined by using numerous other determinants, like options and convertible securities, the capability to select the majority of the board of directors, or specific shareholders' agreements (Ting, 2011:436).

the legal approach and the economic approach, depends upon the jurisdiction's choice between simplicity and neutrality.

Table 7.7: Comparison of the different approaches to ownership requirements and the related policy options in loss-transfer and consolidation models

Countries:	***United Kingdom***	***United States***	***Netherlands***	***Australia***
Group tax model:	Loss-transfer	Pooling	Attribution	Absorption
The economic approach:	Not applied	Not applied	Not applied	Not applied
The legal approach:				
• ***De Jure control***	Yes, use share capital,[456] directly or indirectly held (the nominal method is used to determine indirect ownership).	Yes, use voting rights and value of shares, directly or indirectly held (the "deemed directly owned" method is used to determine indirect ownership).	Yes, use share capital,[457] directly or indirectly held (the nominal method is used to determine indirect ownership).	Yes, use share capital, because of the 100% share-holding requirement, indirect share-holding need not be calculated.
• ***De Facto control***	Not applied	Not applied	Not applied	Not applied
Policy objectives:[458]				
Neutrality and single enterprise principle	Compromised as the economic approach is not applied	Compromised as the economic approach is not applied	Compromised as the economic approach is not applied	Compromised as the economic approach is not applied
Simplicity	Adhered to (control is simple to calculate)	Adhered to (control is simple to calculate)	Adhered to (control is simple to calculate)	Adhered to (control is simple to calculate)

(Own formulation)

456 There are additional anti-avoidance tests for situations where shares are owned by an outside party or debt is granted by an outside party or options in relation to shares in the subsidiary are in existence (Pinsent Masons, 2016).

457 The shares held in the subsidiary may not be held as inventory (Chorus *et al*., 2006:463).

458 This structural element is not noticeably affected by the other policy considerations (competitiveness, anti-avoidance, fairness, and efficiency).

7.4.2 Degree of common ownership

The degree of common ownership refers to the extent to which common ownership and control must be present to qualify as group, i.e. the level of ownership required to qualify to form part of the group. It is presumed that a parent company controls a group member if it holds, directly or indirectly, in excess of 50% of its voting power. A straightforward majority ownership should thus be considered as the minimum requirement.[459] From the comparative analysis in Chapter 3, it is clear that most group tax regimes provide for a minimum ownership requirement in order to form part of the group. Group members generally have to maintain these minimum ownership requirements throughout the tax period (European Commission, 2006:§20). These minimum ownership requirements apply with varying levels, ranging from a high level of ownership (100% to 95%) to a relatively low 50% ownership requirement.[460]

It also appears from the comparative analysis in Chapter 3 that the ownership requirements in countries like Australia and the Netherlands that employ full consolidation group tax models are significantly higher (Australia, 100%, and the Netherlands, ≥95%[461]). Nevertheless, more group tax objectives are achieved in these jurisdictions: the offset of losses and tax-free intragroup asset transfers. In practice, given the important benefits of intragroup transfers and the set-off of losses within a group, corporate groups do not raise many objections where jurisdictions set high ownership thresholds (Ting (2013b:123). Agúndez-García (2006: 12) argues that group members that are connected through a high ownership requirement are more likely to be economically interdependent, and therefore a high ownership requirement provides a better indication of whether a corporate group forms a single economic unit.

A high ownership requirement also reduces the demand for specific measures to deal with minority shareholders (Schön, 2007:431). Issues with minority shareholders arise when, for example, a minority shareholder questions why a company has to pay tax in a present tax year when in the previous tax year, the company incurred losses, which were utilised by other companies in the tax group (European Commission, 2006:§43). Minority

459 Further legal requirements should be introduced to avoid consolidation where the majority ownership of the company's voting rights does not represent control (Spengel & Wendt, 2007:22).

460 Germany has a 50% ownership requirement.

461 The ownership criterion of 95% implies that the parent company is required to hold nearly the entire control and financial interest in the subsidiary (Maisto, 2008:383).

shareholders may require compensation in such a situation.[462] It is submitted that the consolidation of members' results, where the parent only owns 50% of the voting power in a subsidiary, would create too many challenges relating to minority shareholders. It is submitted that a majority ownership level of more than 50% should be the minimum requirement.

In comparing the level of ownership requirements, it appears that three options are available: firstly, a *high* ownership threshold (100%[463]), avoiding issues of minority interests; a *relatively high* ownership threshold (more than 75% but less than 100%), where issues of minority interests may arise; and a *relatively low* ownership threshold of 50% to 75%, where additional requirements have to be considered in order to deal with issue of minority interests. It is common practice in the United Kingdom (75% threshold) that the claimant company will pay the surrendering company an amount in respect of the tax saving. Although not law, this practical arrangement between group companies ensures fair treatment for minority shareholders in the United Kingdom (Pinsent Masons, 2016). The United States (80% threshold) provides for a unique way of determining share ownership in cases of indirect shareholding that pose considerable risks for minority shareholders in the lower-level subsidiaries.

According to Ting (2011:437), subsidiaries of groups of companies are normally wholly owned for business reasons[464] and therefore a threshold of 100% does not represent a significant hurdle to consolidation. Furthermore, a 100% ownership situation is simpler to deal with, as there are no minority interests to consider. A high ownership threshold, however, creates the opportunity for a group to purposely include or exclude certain group companies (European Commission, 2006:§22). For example, a group company can easily be excluded from the group by disposing of a share to an outside party. Anti-avoidance measures must, therefore, be considered when using a *high* ownership threshold (100% or significantly 100%) to ensure that subsidiaries are not excluded where consolidation is not

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462 In Germany, dividend payments are normally made by the parent company to minority shareholders to compensate them for the additional tax payable (PricewaterhouseCoopers LLP, 2006:226). In the United Kingdom, a practical arrangement between group companies exists, whereby the claimant company compensates the surrendering company in respect of its tax losses surrendered, even though not required by law to do so.

463 Meaning 100%, or almost 100%.

464 More than 90% of subsidiaries in listed groups in Australia are wholly owned subsidiaries (Ramsay & Stapledon, 2001:3).

tax optimal from the corporate group's point of view (European Commission, 2006:§22). This element also relates to whether the group tax system is mandatory or elective (see Section 7.5.1 of this chapter).

Even with a relatively high ownership threshold (more than 75% to less than 100%), there is a possibility that tax avoidance schemes may occur. Parent companies could adjust their ownership interests in subsidiaries without suffering the loss of control, subject to whether separate accounting or consolidation is optimal for tax purposes (Spengel & Wendt, 2007:20). It is furthermore possible that those subsidiaries that do not qualify to be part of the group, but are still controlled by parent companies, are used for the shifting of profits (Agúndez-García, 2006: 12). Anti-avoidance measures will thus have to be considered.

7.4.2.1 Policy objectives influencing common ownership

Regarding the ownership threshold, two regimes use a *high* ownership threshold,[465] namely Australia (100%) and the Netherlands (95%), while two regimes use a lower, but still *relatively high*, ownership threshold,[466] namely the United Kingdom (75%) and the United States (80%). A *high* ownership level will be adopted if the following policy objectives are important: neutrality (a subsidiary of a parent company is treated like a branch), fairness (no minority interests to consider), efficiency (a higher threshold minimises the potential negative impact that group tax may have on revenue), and simplicity (no additional legislation needs to be introduced to provide for minority shareholders' rights). A *lower* ownership threshold will be chosen where anti-avoidance forms a key policy objective of the jurisdiction's tax system, as it is easier to manipulate a high ownership threshold. Ownership thresholds are also influenced by the objectives of the single enterprise principle and competitiveness, which conflict with each other. This means that a regime would adhere more to the single enterprise principle by raising its ownership threshold, but at the same time, it would also be less competitive. From Table 7.8, it is clear that the choice between a higher threshold[467] and a lower threshold[468]

465 Significantly 100%.
466 More than 75%, but not significantly 100%.
467 Favouring neutrality, fairness, simplicity, efficiency, and the single enterprise principle.
468 Favouring anti-avoidance and competitiveness.

depends on the policy objectives that are considered to be most important from the viewpoint of the specific jurisdiction.

Table 7.8: Comparison of the different degrees of ownership requirement and the related policy options in loss-transfer and consolidation models

Countries:	***United Kingdom***	***United States***	***Netherlands***	***Australia***
Group tax model:	Loss-transfer	Pooling	Attribution	Absorption
Degree of common ownership	≥75%[469] *Relatively high* threshold	≥80%[470][471] *Relatively high* threshold	≥95%[472] *High* threshold	100%[473] *High* threshold
Policy objectives:				
Single enterprise principle	Strong	Stronger	Stronger	Strongest
Neutrality	Compromised	Adhered to (but to a lesser extent than in a high threshold)	Adhered to (but to a lesser extent than Australia)	Adhered to
Fairness	Compromised in respect of minority shareholders	Compromised in respect of minority shareholders	Adhered to in respect of minority shareholders	Adhered to in respect of minority shareholders
Competitiveness	Adhered to	Adhered to (but to a lesser extent than the United Kingdom)	Compromised as fewer groups will qualify	Compromised as fewer groups will qualify
Efficiency (revenue)	Compromised	Compromised (but to a lesser extent than the United Kingdom)	Adhered to (but to a lesser extent than Australia)	Adhered to
Simplicity	Compromised	Compromised	Adhered to (but to a lesser extent than Australia)	Adhered to
Anti-avoidance	Compromised (to a lesser extent than in high thresholds)	Compromised (to a lesser extent than in a high threshold)	Compromised (easy to manipulate the threshold)	Compromised (easy to manipulate the threshold)

(Own formulation)

469 If a consortium of 5% or more corporate shareholders together holds in excess of 75% of the shares in a group company, then the consortium qualifies for group relief in terms of the loss-transfer system (section 304C of the Income and Corporation Taxes Act, 1988). Only a portion of the loss (in relation to the company's holding) may be surrendered in the case of a consortium (Ault & Arnold, 2010:400).

470 In terms of section 1504 of the Internal Revenue Code, the parent company must own a minimum of 80% of the voting rights and value of shares in the subsidiary. Shares owned under employee share schemes are not excluded when calculating the percentage.

471 The effective rate can be less than 80%, depending on the depth of the group structure.

472 Section (Artikel) 15(1) of the Corporate Income Tax Act (Wet op Vennootschapsbelasting) 1969.

473 Section 703-15(2) Income Tax Assessment Act, 1997.

7.4.3 Entities eligible to participate

A key question when introducing a group tax regime arises as to which entities would be eligible for inclusion in the group tax system. The following options need to be considered: the inclusion of not only corporate entities, but also non-corporate entities; the exclusion of entities participating in specialised industries enjoying special tax treatment; and the inclusion of both resident companies and non-resident companies.[474]

7.4.3.1 The inclusion of entities other than companies

In the United Kingdom, only companies are permitted to participate in the loss-transfer group tax system. Group relief is also available between members of a consortium and a consortium company. Where two or more companies set up a joint venture company, a consortium is created [475] (Pinsent Masons, 2016). Ultimately, all taxpayers will still have to be companies to be part of the loss-transfer regime.

This is also the case in the United States, as only companies[476] are permitted to participate in the pooling consolidation system. Companies other than regulated investment companies (RICs) and S corporations[477] are permitted to join the affiliated group (Whittington, 2007:2). These entities are all flow-through entities. It is thus clear that the United States prohibits any company that is a "flow-through" entity[478] from forming part of any group (Ault & Arnold, 2010:402-403).

474 Considerations regarding the entities that should be eligible as the parent of the corporate group is discussed as part of the participation rules – see the discussion of "all-in-or-all-out" rule in Section 7.5.3.

475 Each company in the consortium must own at least 5% of the shares, and together they must own at least 75% of the shares to participate in the loss-transfer system. A consortium company can surrender or accept losses only to the extent that the company is held by each consortium group (Pinsent Masons, 2016).

476 Section 1504 of the Internal Revenue Code.

477 An "S corporation" is a special type of flow-through taxpayer that can be created through election at the Internal Revenue Service (Form 2553). Through election, an eligible domestic company can avoid double taxation (tax on the company and again on the shareholders) by electing to be treated as an S corporation. Income, losses, deductions, and credits flow through the company to the shareholders, and only the shareholders are taxed (United States, Internal Revenue Service, 2016).

478 New Zealand has similar restrictions applying to companies taxed as "flow-through" entities. However, in contrast to the United States, some of these companies (referred to as "qualifying companies") are allowed to form a group with one another (Ting, 2011:435).

In the Netherlands, a parent company can be a public limited company ("naamloze vennootschap"), a limited liability company ("besloten vennootschap met beperkte aansprakelijkheid"), a cooperative (coöperatie), or a mutual insurance company ("onderlinge waarborgmaatschappij"), while a subsidiary can only be a public limited company or a limited liability company.[479] Similar entities[480] incorporated under the laws of certain other countries are also allowed as group members in terms of the Netherland's fiscal unity rules (Maisto, 2008:383). Evidently, only companies may participate in the consolidation regime of the Netherlands.

The consolidation system of Australia is unique, as it allows partnerships and trusts to act as subsidiary members in a group. Fixed trusts and 100% partnerships can, therefore, be members of a group. The parent, however, must be a company[481], except for certain trusts that may elect to be parent companies[482] (Ting, 2010: 164).

It is obvious that non-corporate entities, like trusts and partnerships, are not readily allowed to join groups. This is because it would be difficult to conclude whether such entities meet the minimum shareholding requirements for membership in a corporate group (Canada, Department of Finance, 2010:11). Flow-through entities are generally also excluded from group taxation because of their unique tax treatment – income is normally distributed and only taxed in the hands of the beneficiaries. In certain jurisdictions, trusts and equivalent non-corporate entities qualify for inclusion in their group tax regime, provided that the non-corporate entities are taxed using the same rules as companies (Canada, Department of Finance, 2010:11). The inclusion of non-corporate entities is, however, the exception to the rule.

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479 Art. 15(3)(d) and (e) of the Corporate Income Tax Act (*Wet op Vennootschapsbelasting*) 1969.

480 Similar entities means entities of a "similar nature and set-up" as a public limited company ("naamloze vennootschap") or a limited liability company ("besloten vennootschap met beperkte aansprakelijkheid"), meaning that it is an entity with equity divided into shares; it is subject to income tax in its country of incorporation; it is not a flow-through entity; the shareholders are not liable in excess of their shares; and shareholders have voting powers in proportion to their shares in equity (Müller, 2008:265-266).

481 Section 703-15(2) of the Income Tax Assessment Act, 1997 (Australia).

482 Section 713-C of the Income Tax Assessment Act, 1997 (Australia).

7.4.3.2 *The exclusion of taxpayers enjoying special tax treatment*

Companies that are granted special tax concessions are normally not allowed to participate in group tax regimes (Masui, 2004:37). These are normally companies taxed at a reduced rate or companies that are exempt from tax (Ting, 2013b: 117), and include companies that are taxed in terms of special tax regimes, for example special investment companies and companies in the insurance industry[483] (Ault & Arnold, 2010:397). Some regimes also exclude companies in bankruptcy and liquidation from participation in the country's group tax regime.[484]

In the United Kingdom,[485] unit trusts (specifically unit trusts known as "open-ended investment companies"[486]) are taxed at a special tax rate and cannot take part in the loss-transfer regime (Pinsent Masons, 2016).

The same provision applies in the United States, where companies subject to special tax treatment may not be included in the "affiliated group" for consolidation purposes. In terms of its consolidation system, companies that are tax-exempt companies, insurance companies and real estate investment trusts (REITs) are excluded because of their special tax treatment (McMahon, 2012:135).

In the Netherlands, all the companies in the group must be subject to the same tax rules. For example, an insurance company and a business corporation cannot form a fiscal unit, although more than one insurance company can form a fiscal unit (Ault & Arnold, 2010:400).

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483 In terms of section 1504 of the Internal Revenue Code, insurance companies and real estate investment companies are specifically excluded from entering into an affiliated group in the United States.

484 Examples of such regimes are Italy, Japan and Spain (Ting, 2013b: 117).

485 As the taxable unit is the company in the United Kingdom, the definition of the group is not always used to exclude certain companies from utilising the loss-transfer system. There are instances where the tax base limits the group relief provided by the loss-transfer model so as to prohibit the transfer of losses between certain taxpayers. For example, companies in the oil and gas industries will not be allowed group relief on the profits arising from its oil and gas extraction business. Another example is a life assurance company, which may only accept the offset of a group member's tax loss against its profits that are taxed at the standard tax rate (United Kingdom, HM Treasury and HM Revenue & Customs Department, 2015).

486 These companies are used in the United Kingdom for investments in the share markets. It provides for the pooling of investors' money and investing the money in wide range of instruments, such as equities or fixed-interest securities.

The rules of the Australian group tax system are more relaxed than those of the other three regimes. In Australia, most types of companies may become part of the group, including companies subject to special tax regimes like insurance companies (Ault & Arnold, 2010:398).

7.4.3.3 The inclusion of non-resident companies

In a group context, the following are possible alternatives: firstly, a non-resident company can be a group member,[487] secondly, a permanent establishment of a non-resident company can be a group member, and thirdly, a resident subsidiary held through a non-resident *intermediary* company can be a group member[488] (Ting, 2013b:102). A fourth possibility that can be added is that resident subsidiaries of a non-resident *parent* company[489] can be group members, regardless of the fact that the parent company is a non-member.

Internationally, most group tax systems[490] only allow resident companies to be part of the group (Oestreicher *et al*., 2011:9). Because of the freedom of establishment principle applied in European Union law,[491] however, various countries, mostly European countries, have amended their group tax laws to include permanent establishments of non-resident companies as group members (PricewaterhouseCoopers, 2016b).

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487 When including a non-resident company as a group member, the requirements can further be differentiated by stipulating whether the non-resident is included as a parent company or as a subsidiary (Masui, 2004:37).

488 It is also referred to as an intermediary holding company, but for purposes of this submission, the term "intermediary company" will be used. An intermediary company is a company that is interposed between one company and another, ideally an ultimate parent company and operating subsidiaries. It is therefore both a subsidiary and a parent company in relation to different companies (Olivier & Honiball, 2008:297). Without benefiting from group tax relief, itself an intermediary company can therefore hold shares in a consolidated group's subsidiaries. In determining common ownership, the shares held by the ultimate parent via the intermediary company in the subsidiaries will be considered to determine the eligible group (Olivier & Honiball, 2008:297).

489 The purpose of the non-resident parent in such a case is to ensure that the subsidiaries, through common control, qualify as part of the group (Ting, 2013b:104-105).

490 Non-resident subsidiaries can be part of a tax group only in Austria, Denmark, France and Italy (Oestreicher *et al*., 2011:9). There are normally strict anti-avoidance measures to prevent abuse. For example, a non-Danish controlled company may be included in a group if the group also includes all its foreign subsidiaries and permanent establishments (PricewaterhouseCoopers, 2016b).

491 Refer to Chapter 4 for a discussion of the freedom of establishment principle.

In the United Kingdom, both the company surrendering the loss and the company claiming the loss must be based in the United Kingdom, either by being resident in the United Kingdom or by carrying on a trade though a permanent establishment in the United Kingdom (PricewaterhouseCoopers, 2016b). An exception to the rule[492] allows any company that is resident or carrying on a trade in the European Union and the European Economic Area[493] to surrender its tax loss to a group company resident in the United Kingdom, in certain limited circumstances[494] (PricewaterhouseCoopers, 2016b). This exception to the rule relates to the European Court of Justice's decision in the *Marks & Spencer* case.[495]

In the Netherlands, one of the main requirements of forming a fiscal unit is that eligible companies should be based in the Netherlands, either by:

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492 See sections 111 to 128, read together with sections 403 and 404 of the Income and Corporation Taxes Act, 1988.

493 The European Economic Area includes the member states of the European Union as well as Iceland, Liechtenstein and Norway (Deloitte, 2015).

494 All possibilities of setting of the tax losses must have been exhausted and it is not possible to carry over any tax loss to future years (PricewaterhouseCoopers, 2016b).

495 *Marks & Spencer v David Halsey (HM Inspector of Taxes)*, Case 446/03. In 2001, the Marks & Spencer group decided to expand into European markets by setting up subsidiaries in Belgium, France, Germany and elsewhere. These ventures were not successful and the group incurred substantial tax losses in the overseas subsidiaries, for which it had no way of obtaining tax relief within the subsidiaries' jurisdictions (Morgan & Whitehead, 2014). The United Kingdom parent company claimed the tax losses of the foreign subsidiaries against its taxable profits in the United Kingdom. At the time, group relief could only be claimed in respect of losses of United Kingdom resident companies or trade carried on through a permanent establishment in the United Kingdom (European Commission, 2005). Marks & Spencer's parent company relied on the freedom of establishment principle and argued that by allowing loss relief for United Kingdom-resident subsidiaries, but denying it for those resident in other member states, the United Kingdom was restricting Marks & Spencer's freedom to establish subsidiaries in the other member states (Morgan & Whitehead, 2014). The European Court of Justice agreed that the group should not be allowed to claim the same loss twice, in the subsidiary's country of residence, for example by carrying the loss forward to set off against future profits, and by offset against the profits of the United Kingdom parent. The court accepted that there is a risk of tax avoidance whereby a group could maximise the value of its tax loss by transferring it to a higher tax jurisdiction like that of the United Kingdom (Morgan & Whitehead, 2014). It was finally decided that the Marks & Spencer parent company should be allowed relief for losses arising in European Union and the European Economic Area member states, but only if the non-resident subsidiary has depleted all other possibilities of offsetting the losses, either by the subsidiary itself or by an outside party (European Commission, 2005). The court decided that it is contrary to the freedom of establishment principle to disallow the Marks & Spencer parent company to deduct the losses of its non-resident subsidiaries (European Commission, 2005). The United Kingdom Government responded to the European Court of Justice's decision by amending its legislation accordingly, with effect from 1 April 2006 (Morgan & Whitehead, 2014). Because of Brexit, this provision might be amended again.

- being resident in the Netherlands[496] or
- by carrying on a trade though a permanent establishment in the Netherlands[497] (the permanent establishment of a foreign company[498] is thus included in the fiscal unit[499]).

In addition, the head of the fiscal unit should hold at least the minimum ownership threshold in any subsidiary company, and the head of the fiscal unit should also qualify as an eligible entity. If the head of the fiscal unit holds the minimum ownership threshold in a second-tier subsidiary through an intermediary company, the intermediary company also needs to qualify as an eligible company (i.e. by being a Dutch resident or carrying on trade through a permanent establishment in the Netherlands). It follows, then, that the fiscal unity rules exclude fiscal unities between a Dutch parent and a Dutch second-tier subsidiary that is held by an intermediary company in another country (Ernst & Young, 2014). However, legislative amendments to this rule were announced in October 2015. This amendment now allows intermediary companies from any member state of the European Union or of the European Economic Area to be part of the Dutch fiscal unit with effect from 1 January 2016 (PricewaterhouseCoopers, 2016a). This amendment and others follow numerous rulings by the European Court of Justice.[500]

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496 Members must be resident under both domestic tax law and in terms of any double tax agreement (Section (*Artikel*) 15(3)(c) of the Corporate Income Tax Act (*Wet op Vennootschapsbelasting*) 1969). This implies that a company established in the Netherlands cannot be a group member if it is effectively managed outside the Netherlands (International Fiscal Association, 2004:469). This avoidance measure prevents the use of dual-resident loss companies.

497 Permanent establishments of foreign companies were not always included. Before 2003, fiscal unity was only allowed between domestic group members. This rule was extended in accordance with the European Union's "freedom of establishment" principle to include non-resident companies with a permanent establishment in the Netherlands as part of a fiscal unit. See section (a*rtikel*) 15(4) of the Corporate Income Tax Act (*Wet op Vennootschapsbelasting*) 1969.

498 There are also requirements with regard to the foreign company. In terms of section (*artikel*) 15(3)(c) of the Corporate Income Tax Act (*Wet op Vennootschapsbelasting*) 1969, the foreign company's place of residence must be in the European Union or in a country with which the Netherlands has a double tax agreements with a non-discrimination provision. The foreign company must further be a limited liability company or a similar entity.

499 In the case of a permanent establishment, only the profits and losses of the permanent establishment that are subject to tax in the Netherlands will be included in the group's consolidated income (Section (*Artikel*) 15(4) of the Corporate Income Tax Act (*Wet op Vennootschapsbelasting*) 1969.).

500 In 2008, the European Court of Justice ruled in the *Papillon* case, that a French parent and a French subsidiary company should be able to benefit from the French group tax relief rules, despite the intermediary being situated in another member state (Ernst & Young, 2014). The compatibility of Netherland's fiscal unity rules with the freedom of establishment principle was challenged in 2010 in the *X Holding BV* case and again in 2014 in the *SCA Group Holding and others* cases. In the *X Holding BV* case the Dutch regime did not allow two Dutch subsidiary sister companies held by a parent in another

In the United States, foreign companies and permanent establishments of foreign companies are excluded from consolidation, with the only exception being Canadian and Mexican subsidiaries[501] that are permitted to join affiliated groups (PricewaterhouseCoopers, 2016b).

Australia is equally strict, excluding foreign companies and their permanent establishments from groups. All members of consolidated groups must be Australian residents, both in terms of domestic law and in terms of any double tax agreement.[502] While Australia's consolidation system excludes any non-resident from being a group member, it does allow foreign-owned groups, i.e. where the ultimate parent company is a non-resident, to participate in its consolidation system.[503] These groups are known as "multiple entry consolidated groups"[504] (Ting, 2013b:104-105).

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member state to form a group. In this instance the European Court of Justice ruled that the fiscal unity regime in the Netherlands does not go against European Union law by not allowing companies established in other Member States to be included in the fiscal unit. However, in the *SCA Group Holding and others* cases, the European Court of Justice decided that the Dutch fiscal unity regime violates the freedom of establishment principle of European Union law (PricewaterhouseCoopers, 2014). The *SCA Group Holding and others* cases (joint cases) concern two practical situations. The first situation involves a Dutch parent company with an indirectly held Dutch subsidiary, where the shareholding in the Dutch subsidiary is held through a German intermediary company. The second situation involves a German parent company holding three Dutch sister subsidiaries. The Dutch companies in both situations had applied for fiscal unity, but it had been rejected. The reason for rejection in the first case was because the intermediary company was resident in Germany and in the second case it was because the parent company was resident in Germany. In both cases, the companies would have been considered a fiscal unit had the companies been resident in the Netherlands (van der Jagt, 2014). Following the court decision in the *SCA Group Holding and others* cases, the Dutch Minister of Finance announced in 2015 the amendment of fiscal unity rules in order to be compliant with European law (PricewaterhouseCoopers, 2018). Nonetheless, in 2018, following two more recent European Court of Justice rulings (*X BV & X NV v Staatssecretaris van Financiën*), the Dutch Government has announced its intention to cancel various benefits of its Dutch fiscal unity with retroactive effect to 25 October 2017 in order to protect the country from tax base erosion (PricewaterhouseCoopers, 2018). It appears, however, that the 2018 amendments are aimed at disallowing excessive interest and foreign exchange losses within Dutch fiscal unity and will not affect the tax-free transfer of assets or the set-off of losses within a corporate group.

501 Section 1504(b) of the Internal Revenue Code.

502 Section 703-15(2) of the Income Tax Assessment Act, 1997.

503 The non-resident parent company may, however, not act as the "head company" of the group. The group has to elect a lower-level *resident* company to act as parent company of the consolidated group (Ting, 2013b:105).

504 Division 719 Income Tax Assessment Act, 1997.

7.4.3.4 Policy objectives influencing the eligibility to participate

Where anti-avoidance forms a main policy objective of a jurisdiction, it will impose rules to ensure that group tax systems are not abused. By including only entities that are similar to companies and by excluding entities that are subject to lower tax rates or exempt from tax and non-residents, the opportunity for groups to engage in tax planning schemes is reduced. Non-corporate entities like trusts and partnerships are generally excluded from the definition of groups because it would be difficult to determine whether they satisfy the minimum shareholding requirements. Australia's regime is the only exception, allowing partnerships and trusts to participate as subsidiary members of a group. Furthermore, companies that are granted special tax concessions are normally not allowed to participate in group tax regimes. Again, Australia's regime is the only exception, allowing companies subject to special tax regimes, like insurance companies, to participate. Lastly, it is generally unusual for jurisdictions to extend group tax relief to non-resident group members. In line with this general rule, none of the four group tax regimes referred to in this analysis allows non-resident companies to be part of the group. Because the freedom of establishment principle is applicable to most European countries, however, the United Kingdom and the Netherlands allow permanent establishments of non-resident companies to participate in their group tax regimes. The only other exception is the Australian regime that allows subsidiaries with a non-resident parent company to consolidate. It is submitted that by extending the group to include non-residents, the opportunity is created for the group to obtain double tax relief by claiming tax losses and certain expenses in the home country and in the foreign country.

It is also submitted that by including only equivalent entities, the tax calculation is more certain and simpler, and it protects tax revenue. The same argument applies for including only resident companies in the group – the tax treatment of resident companies is certain, simple and clear. According to Princen and Gérard (2008:183), a resident member computes its financial accounts according to local rules and in its local currency; however, including a non-resident entity in a tax group would require some re-computations and conversions to be made. It is thus clear that the tax objective of simplicity favours the inclusion of only resident members.

The tax objectives of preventing tax avoidance and of simplicity stand in conflict with neutrality and the single enterprise principle. Princen and Gérard (2008:175) are of the opinion that, from the tax policy perspective of neutrality (which includes the single enterprise principle), decisions regarding the geographical distribution of entities should not be influenced by taxation. Therefore, a number of European countries, possibly encouraged by the European Union's non-discrimination rules and by certain decisions of the European Court of Justice[505] on the application of the neutrality principle,[506] have extended the scope of their group tax regimes to cover permanent establishments of non-resident companies (Princen & Gérard, 2008:175). Following court decisions,[507] two of the four regimes considered in this chapter (the United Kingdom and Netherlands) now allow permanent establishments of non-resident companies to enter the consolidated group. It is clear that group tax systems in European countries are moving towards achieving cross-border neutrality, whereas the United States is still not neutral towards non-resident companies, as it only allows resident companies to participate in its group tax regime. The Australian regime is more neutral by allowing subsidiaries with an ultimate non-resident parent company to be consolidated in a group. Apparently, this specific exception was driven by competitiveness as a policy objective (Ting, 2013b:275). Ting (2011:434) is furthermore of the opinion that political issues are also at stake and extending group relief, generally available only to residents, to non-resident companies can be problematic and also raises efficiency (tax revenue) and anti-avoidance concerns. A government's stance on the provision of tax relief to non-residents should therefore also be considered. An example of the political issues at stake is the United Kingdom,[508] which was a particularly

505 The decision of the European Court of Justice in *Marks & Spencer* identified an urgent need for multinational groups to be able to offset tax losses on a Europe-wide basis.

506 There are commentators (De la Feria & Fuest, 2011) who question the tendency of the European Court of Justice and other European courts to invoke neutrality as a motivation for their tax discrimination decisions. It is, however, beyond the scope of this study to question the correctness of the courts to continuously interpret non-discrimination consistent with neutrality.

507 Following the *Marks & Spencer* case, the United Kingdom now also permits the offset of losses from subsidiary companies that are resident or carrying on a trade in the European Union and the European Economic Area against profits of United Kingdom member companies, provided the losses cannot be claimed in the member states of the European Union and the European Economic Area. From 1 January 2016, the Netherlands also allows sister companies to form a fiscal unit where the parent company is based in the European Union and the European Economic Area, and intermediary companies to be based in the European Union and the European Economic Area. These amendments to the fiscal unity of the Netherlands are the result of several decisions handed down by the European Court of Justice.

508 Before June 2016, the then Prime Minister of the United Kingdom, David Cameron, on several occasions argued that the Consolidated Corporate Tax Base project would further dilute national sovereignty, making the United Kingdom's tax system less competitive, and that the United Kingdom would refuse to be part of the CCCTB project of the European Commission (tax-news.com, 2016).

vocal opponent of the CCCTB before deciding to leave the European Union in June 2016 (Allen & Overy, 2016).

The policy options relating to the eligibility to participate are summarised in Table 7.9.

Table 7.9: Comparison of the entities eligible to participate and the related policy options in loss-transfer and consolidation models

Countries:	***United Kingdom***	***United States***	***Netherlands***	***Australia***
Group tax model:	Loss-transfer	Pooling	Attribution	Absorption
Inclusion of entities other than companies:	Not allowed	Not allowed	Not allowed	Allows partnerships and trusts
Inclusion of taxpayers enjoying special tax treatment:	Not allowed (open-ended investment companies are excluded)	Not allowed (tax-exempt, insurance companies and REITs are excluded)	Not allowed (only allowed if all group members are subject to the same tax rules[509])	Allowed
Inclusion of non-residents as group members:				
- ***Parent companies***	Not allowed, except for a permanent establishment of a foreign co	Not allowed	Not allowed, except for a permanent establishment of a foreign co or an EU/EEA co	Not allowed, but multiple entry groups[510] are allowed
- ***Subsidiary companies***	Not allowed, except for a PE of a foreign co and companies based in the EU/EEA	Not allowed, except for Canadian or Mexican subsidiaries	Not allowed, except for a PE of a foreign co	Not allowed
- ***Intermediary companies***	Not allowed, except for a permanent establishment of a foreign company	Not allowed	Not allowed, except for EU/EEA based companies and permanent establishments of foreign companies	Not allowed
Policy objectives:[511]				
Single enterprise principle and Neutrality	Less compromised (extended by allowing group relief to certain non-resident companies)	Compromised (Not neutral towards non-residents)	Less Compromised (extended by allowing certain non-residents to participate in fiscal unity)	Less Compromised (extended by allowing non-residents as parent companies, partnerships and trusts as subsidiaries and special taxpayers)

509 This implies that similar taxpayers are allowed to form a group.

510 Multiple entry consolidated groups are groups of companies where the ultimate parent company is a non-resident. By nominating a resident parent company (which then consists of only Australian group members), the group is permitted to participate in Australia’s consolidation group tax system.

511 Competitiveness stands opposite anti-avoidance with regard to this structural element. For example, it was competitiveness that moved Australia to allow foreign-owned corporate groups to participate.

Anti-avoidance, efficiency and simplicity	Compromised	Adhered to	Compromised to a certain extent	Compromised to a certain extent
Competitiveness	Adhered to	Compromised	Adhered to	Adhered to

(Own formulation)

7.5 THE PARTICIPATION RULES

The participation rules form an important structural element in the design of a group tax regime. This refers to the degree to which participation is voluntary or compulsory, whether participation applies for a minimum period, or indefinitely, and also to the freedom that a group has in choosing which members to include or not to include ("all-in-or-all-out" rule). Some group tax regimes require that the parent company may not be controlled by another company. Therefore, only the company at the highest level of the shareholding chain is entitled to be the parent company and to form a group. Where a lower level holding company is permitted as a parent company, this can also be considered a participation rule as a higher level parent can then be excluded.

7.5.1 Mandatory versus elective application of the regime

In general, when the requirements for the group tax regime are met, its application is elective. This is the case in most jurisdictions employing group tax systems (Endres, 2007:89). It is also the case in all four group tax regimes (the United Kingdom, the United States, the Netherlands, and Australia) discussed in this chapter, as none of these group tax regimes is mandatory. According to Ting (2013b:87), it will only be in extremely limited circumstances that an Australian group will decide not to consolidate. Because of the related advantages, most qualifying corporate groups in Australia elect consolidation relief. A prominent exception to the rule comprises small and medium-sized enterprises, which seldom opt for consolidation because of the perception that the compliance costs are extremely high (Ting, 2011:439).

Because group taxation is normally elective by the taxpayer, group companies will only elect for the application of group taxation if it reduces the overall tax liability of the group. Denmark is the only country with a compulsory tax consolidation system, which forces all

Danish resident companies and branches of the same Danish group or same international group to participate in its group tax regime[512] (PricewaterhouseCoopers, 2016b). The European Commission (2016) believes that an *optional* CCCTB would limit its effectiveness as a tool for preventing profit shifting. With the re-launch of the CCCTB, the European Commission recommended that the project should be made mandatory for all multinational enterprises (European Commission, 2016).

If some of the criteria used to define the group can be amended effortlessly and without considerable cost, companies could choose which entities to include and which not. In this case, the fact that the group tax system is mandatory will have little effect (Schön, Schreiber & Spengel, 2008:43). For example, a share ownership requirement of 100% can easily be avoided by selling 1% of the shares, or by inserting a non-resident intermediary company, where the criterion does not allow for it. In such a case, anti-avoidance measures are needed to ensure that the minimum threshold is maintained. Obviously, where the application of the group tax system is optional, the importance of anti-avoidance measures in defining the group becomes less important (Schön *et al.*, 2008:43).

7.5.2 Irrevocable or revocable consolidation (with or without a minimum period)

Where a group elects to consolidate, several group tax systems require the election to be irrevocable, in other words, to apply indefinitely. There are, however, group tax systems that allow revocability, while other group tax systems require annual elections or require that group tax elections remain in force for only a few years (Canada, 2010:33). In two of the four countries investigated in this chapter, the election to consolidate is revocable (the United Kingdom and the Netherlands) and in one country it is irrevocable (the United States).

The United Kingdom's loss-transfer regime is revocable. The surrendering company decides on an annual basis whether to surrender its losses, the amount of the losses it wishes to surrender, and to which group company or companies it wishes to surrender its losses (Panayi, 2011:32).

512 Strict all-in-or-all-out rules apply in Denmark to ensure that international groups do not include only specific hand-picked (normally lossmaking) foreign group members in their Danish group (PricewaterhouseCoopers, 2016b).

Fiscal unity in the Netherlands is revocable by joint request of a parent and a subsidiary.[513] The end of fiscal unity between the parent and the subsidiary will not affect fiscal unity between the parent and other group members (Ting, 2013b:89).

Because of the United States' strict anti-avoidance measures, the election to consolidate in the United States can be seen as irrevocable and applicable for an indefinite term. An election to file a consolidated return may not be revoked without the consent of the Commissioner, which is only provided in one of two limited situations. Firstly, consent will be granted only on the showing of "good cause", which includes an amendment to legislation that has a "substantial adverse effect" on the tax liability of the group, as compared with the aggregate tax liability if the group members were to file separate returns.[514] Secondly, the Commissioner may grant blanket permission to all groups or to a class of groups to discontinue consolidation, if an amendment to legislation will have a "substantial adverse effect on the filing of consolidated returns" by the group [515] (McMahon, 2012:133).

Australia does not deal consistently with this issue. The election to be included in the consolidation regime is irrevocable in the case of domestically owned groups. It is, however, revocable in the case of foreign-owned groups[516] (Ting, 2011:439). For domestic groups, the choice is irrevocable until the group ceases to exist.[517] This would be the case if the parent company ceases to qualify as parent company or becomes a member of a multiple entry consolidated group[518] (Ting, 2013b:87). Where the nominated parent company of a multiple entry consolidated group exits the group and the group does not nominate a new parent company within 28 days, the multiple entry consolidated group ceases to exist[519] (Ting, 2013b:88).

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513 Section (*Artikel*) 15(6) of the Corporate Income Tax Act (*Wet op Vennootschapsbelasting*) 1969.

514 Section 1502-75(c)(1)(ii) of the Internal Revenue Code.

515 Section 1502-75(c)(2) of the Internal Revenue Code.

516 For group tax purposes, known as multiple entry consolidated groups.

517 Section 703-50(4) of the Income Tax Assessment Act, 1997.

518 Multiple entry consolidated groups were designed specifically for foreign-owned groups (section 703-50(2) of the Income Tax Assessment Act, 1997).

519 Section 719-60 read together with section 719-80 of the Income Tax Assessment Act, 1997.

7.5.3 The "all-in-or-all-out" rule

In terms of the "all-in-or-all-out" rule, all group companies that fulfil the eligibility requirements for forming a group must consolidate. This implies that a member company will not be entitled to elect to have its individual tax results computed outside the group once it qualifies to be part of the group. There are thus two possibilities: under the "all-in-or-all-out" approach, either an "all-in" treatment where, if the group decides to apply for the regime, all the members who meet the ownership requirements must participate, or an "all-out" treatment, where none of the group companies apply for consolidation, even though they may qualify. Corporate groups will clearly determine the optimal option for tax purposes and then choose accordingly.

Another approach is to allow "cherry-picking" of eligible members that meet the shareholding requirements. In other words, where a group member qualifies to be part of a group but elects to have its individual tax results computed outside the group[520] (Masui, 2004:39). Again, corporate groups and group members will choose the best option for tax purposes. The reason why governments often allow "cherry-picking" for corporate groups is to enhance the attractiveness of their tax systems in order to improve competitiveness. Under the "cherry-picking" approach, subtle differences exist in the way members can be chosen. For instance, Australia adopts the "all-in" rule for domestically owned groups, while allowing "cherry-picking" for foreign-owned groups (Ting, 2013b:91).

The United Kingdom's loss-transfer system extends the tax base, and not the taxable unit (the separate company). It is therefore not possible to apply an "all-in-or-all-out" rule, as the rule relates to the taxable unit and not the tax base.

In the United States, all eligible companies of an "affiliated group" are required to participate in consolidation.[521] A subsidiary of the top parent company can be elected as parent company, thereby excluding the top parent company from the "affiliated group". The only requirement is that the lower-level parent company must meet the 80% vote and value test.[522] There is no requirement that the parent company may not be held by another

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520 This approach was reported in Japan, Spain, France, Italy, and New Zealand, among others (Masui, 2004:39).

521 Section 1502-75(a) of the Internal Revenue Code.

522 Section 1504(a)(1) of the Internal Revenue Code.

company eligible to be the parent company, as is the case with Australia's group tax regime.

The fiscal unity regime of the Netherlands allows for the "cherry-picking" of subsidiaries as well as the forming of a consolidated group with a lower-level parent company,[523] similar to the group tax system of the United States, which makes its group tax system highly competitive.

In Australia, the "all-in-or-all-out" rule only applies to domestic groups and not to foreign-owned groups. In terms of Australia's consolidation regime, a foreign-owned group, in other words a group where the ultimate parent company is a non-resident, has the option to consolidate its Australian subsidiaries as they are under the common control of the non-resident parent company.[524] These foreign-owned groups are referred to as multiple entry consolidated groups, and are allowed to nominate a lower-level Australian company (one of the Tier-1 companies in Figure 7.2 below) to act as parent company because all group members need to be Australian residents.

Because "cherry-picking" is allowed for foreign-owned groups, the following alternatives are available, as reflected in Figure 7.2:

- all six resident companies can form a multiple entry consolidated group by nominating either Company A, B or C as the parent company;
- any two resident companies out of subgroups A, B or C can form a multiple entry consolidated group with its parent company as head company; or
- any four resident companies can form a multiple entry consolidated group, combining either subgroups A and B, or A and C, or B and C, by nominating the parent from one of the two subgroups as head company.

523 Section (*Artikel*) 15 of the Corporate Income Tax Act (*Wet op Vennootschapsbelasting*) 1969.
524 This dispensation is known as "multiple entry consolidated groups".

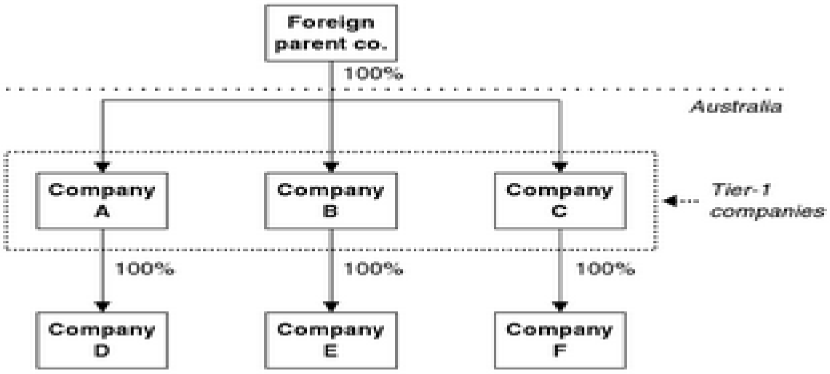

Figure 7.2: Multiple entry consolidated groups in Australia

(Source: Ting, 2013b:93)

Ting (2013b:91) is of the opinion that the Australian system discriminates against its domestic groups by not only disallowing cherry-picking to their domestic groups, but also by disallowing them to move the top parent company[525] to a lower-level parent company.[526]

7.5.4 Policy objectives influencing participation

This structural element is mainly influenced by three policy considerations: the single enterprise principle, simplicity, and competitiveness. The policy options for this structural element are summarised in Table 7.10 below.

In practice, group tax regimes are normally elective, as group tax regimes are generally introduced to promote competitiveness. This is not the case with the other elective components. Once a group tax regime is elected, it should have fewer elective components and require participation of all eligible members in order to align the group tax system more closely with the taxable unit. A group tax system with fewer elective components, requiring participation of all eligible members, supports the single enterprise

525 A consolidated group must have a single parent company that is an Australian resident company, and it must not be regarded a non-resident in terms of any double tax agreement.

526 Section 703 – 15 of the Income Tax Assessment Act, 1997, of Australia.

principle. In addition, it adheres to the requirement of simplicity because the introduction of a group tax regime with less flexibility is simpler to administer. The objectives of the single enterprise principle and simplicity can be further promoted with a condition that participation endures indefinitely or at least for a minimum period. To impose such a requirement would also add to the stability and certainty of a group tax regime for both the taxpayers and government (Department of Finance, Canada: 2010).

On the other hand, a group tax system with more elective components may increase the competitiveness of the group tax system, but may also create greater flexibility for tax planning schemes, which eventually may lead to greater opportunities for tax avoidance. The introduction of anti-avoidance rules to counter these opportunities will complicate the group tax system, thus sacrificing simplicity. It is clear that tax authorities need to make difficult compromises between conflicting policy objectives. For example, the choice between a revocable and irrevocable system is dependent on the compromise between anti-avoidance (irrevocable election) and competitiveness (the election can be revoked) (Ting, 2013b:274).

Table 7.10 below illustrates the point that the regimes of Australia and the United States, with their irrevocable electives that oblige all eligible entities to participate, suggest an approach favouring anti-avoidance and efficiency (tax revenue) and not competitiveness. On the other hand, allowing “cherry-picking” serves the competitive policy objective, of which the highly flexible regime of the Netherlands serves as an example. From Table 7.10, it is also clear that of the four countries, only one requires the top parent company to consolidate (Australia, and only with regard to domestic groups). It seems that the policy objective of competitiveness plays a role with regard to foreign-owned groups in Australia, which has a strict approach to domestically-owned groups, but a more relaxed approach to foreign-owned groups. The loss-transfer regime of the United Kingdom extends the tax base and not the taxable unit. Electives, like the “all-in-or-all-out” rule and allowing a lower-level company as parent company, therefore play no role in the United Kingdom’s group regime.

Table 7.10: Comparison of the participation rules and the related policy options in loss-transfer and consolidation models

Countries:	***United Kingdom***	***United States***	***Netherlands***	***Australia***
Group tax model:	Loss-transfer	Pooling	Attribution	Absorption
Mandatory vs Elective:	Elective	Elective	Elective	Elective
Revocable or non-revocable	Revocable	Irrevocable[527]	Revocable	Irrevocable for domestic groups[528]
Minimum period	None, election is annually	Not applicable as it is irrevocable	None, election is for an indefinite term but revocable	Not applicable as it is irrevocable
The "all-in-or-all-out" rule or "cherry picking"	Not applicable (only the tax base is extended)	"All-in-or-all-out" rule	"Cherry picking" rule	"All-in-or-all-out" rule for domestic groups and cherry-picking for foreign-owned groups
Allowing a lower-level holding company as parent company	Not applicable (only the tax base is extended)	Allowed	Allowed	Not allowed, except for multiple entry consolidated groups
Policy objectives:[529]				
Single enterprise principle	Weak (the group relief system is an elective group tax system)	Strong (consolidation is irrevocable with an "all-in-or-all-out" rule[530])	Weak (numerous electives)	Strong (apart from foreign-owned groups there are fewer electives[531])
Simplicity	Less compromised (no all-in-all-out rule or cherry picking)	Less compromised (fewer electives)	Compromised	Less compromised (fewer electives)
Competitiveness	Adhered to (competitive)	Compromised	Adhered to (highly competitive)	Less compromised (competitive in relation to foreign-owned groups)
Anti-avoidance	Compromised	Adhered to	Compromised	Adhered to
Efficiency (tax revenue)	Compromised (revocable)	Adhered to	Compromised (revocable)	Adhered to

(Own formulation)

527 Subject to certain exceptions.
528 Non-resident groups may revoke.
529 It is submitted that this structural element is not noticeably affected by neutrality.
530 The top parent company may, however, be excluded as a lower-level holding company is allowed.
531 There are, however, more electives available to foreign-owned groups.

7.6 THE TREATMENT OF TAX LOSSES[532]

An important tax attribute that should be incorporated into a group tax regime is the application of tax losses. This is because the offset of losses within the group is one of the objectives of a group tax regime. The ability to offset losses between group members is probably the most important benefit of consolidation (Ting, 2013b:139). Without it, tax losses are stuck in the company, available for offset only against its own taxable income.

To understand how tax losses may be offset in a group context, it is important to first understand how tax losses can be utilised by a single company (Harris, 2013:113). Firstly, the tax loss can be used in the year in which it is incurred; secondly, if a loss cannot be absorbed by a company in the current year, tax law may permit that the loss be carried backwards to reduce the profits of previous years (Harris, 2013:114). However, many countries do not permit this treatment, which often involves the refund of tax paid in previous years. Finally, any excess loss that cannot be used in the current year or carried backward is usually permitted to be carried forward. For how long losses may be carried forward and against what type of income they may be set off, depends on a jurisdiction's tax laws (Harris, 2013:113). The design of tax loss rules in a group tax regime is important and there are two types of tax losses that need to be considered when designing a group tax system: pre-entry tax losses that refer to tax losses incurred by a subsidiary before entering the group (in other words, while the company was still a separate entity); and group losses that refer to the tax losses incurred after entry into the group (in other words, after becoming a single enterprise for group tax purposes).

7.6.1 <u>Pre-entry tax losses</u>

A common practice with pre-entry tax losses is to provide a special restriction on losses incurred before a member enters the group. The motivation for the special restriction rule on pre-entry tax losses is an anti-avoidance tax policy which, according to the International Fiscal Association report, stems from the fear that companies might trade in losses in a group context (Masui, 2004:46). Clearly, it poses a revenue threat for governments to allow pre-entry tax losses.

532 Non-capital tax losses.

Previously accumulated tax attributes are treated differently in loss-transfer systems than in consolidation systems. In loss-transfer systems, pre-entry tax attributes do not form part of the single enterprise and remain with the subsidiary as a separate entity. Generally, the tax base is extended to allow for the utilisation of only post-entry tax attributes[533] in the group. In the United Kingdom, restrictions on pre-entry tax losses are simple and straightforward, as the taxable unit remains the company. The tax base is extended to allow only for the offset of current-year losses between the company and other members of the group. Losses brought forward cannot be surrendered (Pinsent Masons, 2016). Pre-entry losses do not form part of the loss-transfer system and remain with the subsidiary. The subsidiary is therefore still entitled to utilise any pre-entry loss against its own profits. This indicates that the United Kingdom's loss-transfer system follows a strong separate entity principle in relation to pre-entry tax losses, despite the fact that the member is now part of a group tax system. In the United Kingdom, losses are permitted to be carried back one year and carried forward indefinitely, provided losses are utilised against profits in the same trade.[534]

In consolidation systems, the restriction of pre-entry tax losses is far more complex. When a company enters a group, the treatment of its pre-entry tax losses should be determined. Ting's comparison of consolidation models (2013b:277-279) revealed three[535] alternative treatments. Firstly, the pre-entry tax losses can be cancelled, but this stringent approach is not followed by any of the countries considered in this analysis. Secondly, the pre-entry losses can be quarantined, meaning that they are allowed for setoff only against profits produced by that subsidiary. This approach is followed by most tax jurisdictions using the consolidation method, among these are two of the countries considered in the analysis in this chapter, namely, the Netherlands and the United States (Canada, 2010:16). Thirdly, the pre-entry tax losses can be transferred to the parent. This method is applied by Australia.

533 In the United Kingdom, the following tax attributes can be surrendered: trading losses, unclaimed capital allowances, non-trading losses on loan relationships, unclaimed management expenditure, unclaimed non-trading losses on intangible fixed assets, and other unclaimed charges (Panayi, 2011:32).

534 Sections 99–100 of the Corporate Tax Act, 2010.

535 A fourth possibility exists where the pre-consolidation loss of a subsidiary can be suspended during consolidation, but become available again when the subsidiary exits consolidation. This approach is followed under Germany's *Organschaft* regime (Ault & Arnold, 2010:401). This option is not considered further, as this model is not one of the models analysed in this chapter.

In the Netherlands, losses may be carried back one year, and nine years forward.[536] Pre-entry tax losses remain with the group member upon entering into the fiscal unit. Losses of group members generated during consolidation should first be offset within the group, before allowing the offset of any member's pre-entry tax losses (Müller, 2008:273). This indicates that the Netherlands follows a strong single enterprise principle, favouring the single enterprise principle over the separate entity principle. The offset of pre-entry tax losses is furthermore only permitted where the entire consolidated group has a net taxable income for the year (Müller, 2008:273). Numerous rules provide the order in which pre-entry tax losses can be utilised and carried forward. These rules are contained in a decree[537] published in 2004 to ensure that the profits and losses of the consolidated group take priority over the pre-entry tax losses of the individual members, and that the allocation of losses in the group are such that the maximum pre-entry tax losses are carried forward (Müller, 2008:273). Anti-avoidance rules are also in place to avoid the accelerated utilisation of pre-entry tax losses.[538]

The following example (Table 7.11 below) illustrates the working of the quarantine approach of utilising pre-entry tax losses in the Netherlands. Assume that Company A has a pre-consolidation loss of €100 000 upon entering the fiscal unit. After consolidation, Company A incurs a loss of €130 000 in year 1 and a profit of €170 000 in year 2. Assume further that the only other member company is the parent company, which made a profit of €90 000 in year 1 and a profit of €150 000 in year 2. Under the fiscal unity rules, Company A does not have a taxable income in year 1 and therefore the pre-consolidation loss may not be utilised in year 1. In year 2, Company A realises a profit of €170 000. In order to utilise the pre-consolidation loss, there is an additional requirement that the group, as a whole, must also make a profit, which is the case in this example. The cumulative profit of the group as a whole in year 2 is €280 000 (€320 000 profit in year 2 less €40 000 loss in year 1). Company A's pre-consolidation loss of €100 000 may therefore be fully utilised in year 2 against its profit of €170 000, which means that the consolidated taxable income in year 2 will be €180 000 (€280 000 less €100 000).

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536 Section (*Artikel*) 20 of the Corporate Income Tax Act (Wet op Vennootschapsbelasting) 1969.
537 Decree No. IFZ2004-192M.
538 Section (*Artikel*) 15ae(2) of the Corporate Income Tax Act (Wet op Vennootschapsbelasting) 1969.

Table 7.11: Example of the working of the quarantine approach in the Netherlands of utilising pre-entry tax losses

	Company A	Parent	Total	Pre-consolidation loss utilised	Group taxable profit/loss
Year 1:	(€130 000)	€90 000	(€40 000)	Nil	Nil
Year 2:	€170 000	€150 000	€320 000 - €40 000[539] = €280 000	(€100 000)	€180 000

(Own formulation)

In the United States, losses may be carried back for two years, and to be carried forward for 20 years.[540] The net operating losses of a group member can be carried over from a pre-entry period to be offset against the consolidated income of the group.[541] This rule is subject to two limitations: firstly, if the loss was originally incurred in a "separate return limitation year",[542] the loss may be carried forward and claimed only against the income of the group member that generated the loss; and secondly, the carry-overs could be limited [543] (McMahon, 2012:137).

In terms of the "separate return limitation year" rule, the loss of the subsidiary is clearly quarantined. The subsidiary is therefore permitted to offset its pre-entry tax losses against its own taxable income incurred during consolidation, but only to the extent of the

539 The post-consolidation loss of €40 000 is first applied to reduce the group profit, before the pre-consolidation loss of €100 000 of Company A can be utilised.

540 Section 172 of the Internal Revenue Code.

541 Section 1502-21(b) of the Internal Revenue Code.

542 In its abbreviated form, known as a "SRLY" and refers to any loss incurred by the subsidiary while it was still a separate entity (not part of the affiliated group). The parent company is not subject to the "separate return limitation year" rule (McMahon, 2012:137).

543 The carry-overs are limited if the section 382 rule is applicable. The section 382 rule is a limitation of loss rule and is triggered when there is a significant change in ownership, and the consolidated group acquires a loss company entering consolidation at the same time. The amount of the loss is then limited to the value of the company at the time of change in ownership, multiplied by a deemed rate of return. The principle behind this limitation is that the "buyers" of the company should not make greater use of the losses than that the "sellers" would have enjoyed if there had been no change in ownership (Ault & Arnold, 2010:394). The section 382 rule overrides the "separate return limitation year" rule in cases of overlap, for instance, where a company becomes a member of a group within six months from the date of an ownership change (see section 1502-21(g) of the Internal Revenue Code). There are, however, limited circumstances where both the "separate return limitation year" rule and the section 382 rule may apply (McMahon, 2012:169).

subsidiary’s net taxable income generated during consolidation.[544] For example, when Company J joined the affiliated group at the beginning of the year, it had a pre-consolidation loss of $100. The group has a consolidated income of $500 for the year, of which $80 taxable income is attributable to Company J. Therefore, of the $100 pre-consolidation loss, only $80 can be set off against the $500 taxable income of the group in terms of the “separate return limitation year” rule.

Anti-avoidance rules apply where transactions take place that are designed to absorb losses that are subject to the “separate return limitation year” rule.[545] These rules prevent situations where transactions are entered into to ensure that income accrues to the member company with the pre-consolidation loss in order to absorb the pre-consolidation loss. Specific examples include the transfer of property to a partnership and the use of sale-and-leaseback transactions (McMahon, 2012:168).

The following example (Table 7.12 below) illustrates the working of the quarantine approach of utilising pre-entry tax losses in the United States. Assume that Company A has a pre-consolidation loss of $100 000 upon entry into the affiliated group. After consolidation, Company A incurs a loss of $130 000 in year 1 and a profit of $170 000 in year 2. Assume further that the only other member company is the parent company, which made a profit of $90 000 in year 1 and a profit of $150 000 in year 2. Under the consolidation rules of the United States, Company A does not have a taxable income in year 1. Therefore, the pre-consolidation loss may not be utilised in year 1. In year 2, Company A’s cumulative profit after consolidation equals $40 000 ($170 000 profit in year 2 less $130 000 loss in year 1). This means that in year 2, Company A is entitled to utilise a pre-consolidation loss of $40 000. The balance of $60 000 is carried over. There is thus a larger risk in the United States that a loss may expire, as pre-entry tax losses are utilised at a slower rate than in the Netherland (compare Table 7.12 to Table 7.11).

544 In terms of section 1502-21(c) of the Internal Revenue Code, a group company's contribution to the group’s combined taxable income is calculated on an aggregate basis covering the whole consolidation period. Therefore, the group company’s pre-entry losses may be utilised in any combined return year to the extent of the group company's aggregate net contribution to combined taxable income in all combined return years. This method is followed, despite the fact that the group company may not have any taxable income during the year that the loss is utilised (McMahon, 2012:173).

545 Section 1502-13(h)(2) of the Internal Revenue Code.

Table 7.12: Example of the working of the quarantine approach of utilising pre-entry tax losses in the United States

	Company A	**Parent**	**Total**	**Pre-loss allowed**	**Group taxable profit/loss**
Year 1:	($130 000)	$90 000	($40 000)	Nil	Nil
Year 2:	$170 000 $130 000 = $40 000	$150 000	$280 000	($40 000)	$240 000

(Own formulation)

The third possibility, to transfer all pre-entry tax losses of subsidiary companies to the parent company when entering consolidation, is only applied by Australia. Australia's absorption method of consolidation applies this option because all subsidiaries are deemed to have ceased to function upon entry into the consolidated group. In terms of this option, pre-entry tax losses of the subsidiaries are carried over to the parent where the losses are set-off against the combined taxable income of the group (Ting, 2011:442). It is deemed that the parent company incurred the pre-consolidation loss itself in the year that the subsidiary enters the group and the loss is transferred.[546] After the loss is transferred, the loss is regarded as not incurred by the joining subsidiary itself.[547] Even if the subsidiary later exits the group, the loss remains with the parent company. The pre-entry tax losses can then be utilised by the parent if it has taxable income remaining after utilising its own losses.[548] Group losses therefore have priority over pre-entry tax losses, in other words, the single enterprise principle prevails over the separate entity principle (Ting, 2013b:145-146).

The unrestricted utilisation of pre-entry tax losses could have a substantial impact on tax revenue. Therefore, to prevent the unrestricted utilisation of such transferred pre-entry tax losses, the Australian Government introduced a special rule that restricts the rate at which pre-entry tax losses transferred to the parent company can be used post-consolidation (Masui, 2004:46). In terms of this rule, the "available fraction" rule,[549] a joining subsidiary's

546 Section 707-140(1)(a) of the Income Tax Assessment Act, 1997.
547 Section 707-140(1)(b) of the Income Tax Assessment Act, 1997.
548 Section 707-305(2) and section 707-310(3)(b) of the Income Tax Assessment Act, 1997.
549 In its abbreviated form, referred to as the "AF rule".

pre-entry tax losses are limited to an amount representing the loss that the joining subsidiary could have utilised "had it not become a member of the consolidated group".[550] This limited amount is calculated in relation to the joining subsidiary's market value when the loss was transferred.[551] It is assumed that the market value of the subsidiary at that stage reflects its capacity to earn income in the future. The pre-consolidation loss is therefore limited to the following ratio:[552]

$$\frac{\text{Market value of the subsidiary at entry time}}{\text{Market value of the group at entry time}}$$

This "available fraction" ratio is applied to the income of the consolidated group to determine the amount of pre-entry tax losses that the parent company can utilise. For example, assume that Company A has a pre-consolidation loss of $100 000 upon consolidation. After consolidation, the group earns a consolidated profit of $60 000 in year 1. Assume an "available fraction" ratio of 0.5. The amount of maximum losses that the parent may utilise in a tax year equals the product of the available fraction and the combined profits of that group for the tax year (Ting, 2011:443). The parent can therefore utilise up to a maximum of $30 000 ($60 000 x 0.5) of the bundle[553] of pre-entry tax losses in year 1 (Ting, 2013b:148).

The "available fraction" rules are complex and arbitrary and according to Ting (2013b:148), suffer from a multitude of problems. One of these problems is that the rules assume that the market value of a company is a reflection of its capacity to generate income in the future, which is not necessarily the case. Another problem is that the "available fraction" ratio is based on market values at entry time, and can therefore become outdated fairly quickly. The system does not provide for any reassessment on a regular basis. The cost of the compliance and policing of the application of the "available fraction" is extremely high, and numerous anti-avoidance rules are required to protect this approach,[554] which raises serious questions about its effectiveness in dealing with pre-entry tax losses.

550 Section 707-305(3) of the Income Tax Assessment Act, 1997.
551 Section 707-305(4)(b) of the Income Tax Assessment Act, 1997.
552 Known as the "available fraction" ratio. See section 707-320 of the Income Tax Assessment Act, 1997.
553 All pre-consolidation losses of all subsidiaries in the group are summed.
554 Section 707-320(2) and section 707-325(2) – (4) of the Income Tax Assessment Act, 1997.

7.6.2 Group losses incurred during consolidation

With respect to the treatment of group losses during consolidation, all four group tax regimes discussed in this chapter apply the enterprise principle and treat group losses as those of a single company, albeit to a very limited extent in the loss-transfer regime applied in the United Kingdom. In the United Kingdom, group members remain separate taxpayers and integration is limited to the surrendering and claimant group members, and only upon bilateral arrangement. Only current year losses are surrendered and the surrendering of losses applies only to losses incurred in overlapping accounting periods. By contrast, with consolidation systems, a single tax base is created where profits and losses of group members are set off against one another. In line with the single enterprise principle, the overall net loss of the group incurred during consolidation is considered to belong to the group, and as such is taken into account in combining the group results.

In the United States, the consolidated losses of the group, known as the "consolidated net operating losses"[555] can be carried forward or backward in terms of the normal loss rules, i.e. two years back or 20 years forward. The United States' consolidation system is unique, as it even allows group losses incurred during consolidation, known as "consolidated net operating losses", to be allocated to a specific subsidiary in order to be transferred back or forward to the subsidiary's separate tax return years[556] (McMahon, 2012:168-169). The portion of consolidated net operating losses that can be attributed to the member is calculated using the following formula:[557]

$$\text{"Consolidated net operating losses" x } \frac{\text{Separate net operating loss of member.}}{\text{Sum of separate net operating losses of all members}}$$

When a company exits a consolidated group, its portion of the consolidated net operating losses may be transferred to its separate return.[558] When deconsolidation takes place, the same formula is again used to calculate the portion of the consolidated net operating

555 In its abbreviated form referred to as CNOLs.
556 Section 1502-21(a) and section 1502-21(b) of the Internal Revenue Code.
557 Section 1502-21(b)(2) of the Internal Revenue Code.
558 Section 1502-21(b)(2) of the Internal Revenue Code.

losses that should be transferred to the separate return years of the subsidiaries[559] (McMahon, 2012:175).

In the Netherlands, losses incurred by the group are subject to the general loss carryover rules, i.e. one year back or nine years forward. It is also possible to carry back group losses to pre-consolidation profits of separate group members in terms of the fiscal unity rules.[560] Where there is a change in composition of the fiscal unit (in other words a group member enters or exits the group), the new fiscal unit is taxed as a different taxpayer for loss utilisation purposes. The consolidated loss of the old fiscal unit will then be treated as a pre-consolidation loss of the new fiscal unit (Müller, 2008:277). When a group member exits the group, the group losses normally stay with the consolidated group. The parent company and the subsidiary can request an allocation of the group losses to the subsidiary.[561] Upon deconsolidation, any unused pre-entry tax losses of the subsidiary remain with the subsidiary. The group losses are also allocated to the exiting group member upon deconsolidation.[562] Specific anti-avoidance provisions[563] apply to ensure that these measures are not applied in an abusive manner (Müller, 2008:285).

In Australia, all subsidiary members are treated as part of the parent company, and losses generated by subsidiaries are treated as losses generated by the parent company (Ting, 2013b:164). When a subsidiary exits the group, group losses remain with the parent company.[564] The same applies upon deconsolidation (the members of the group stop submitting a combined tax return and revert to filing separate tax returns as separate taxpayers) (Ting, 2013b:169).

559 Section 1502-21(b)(2) of the Internal Revenue Code.

560 Section (*Artikel*) 15ae(1)(b) of the Corporate Income Tax Act (*Wet op Vennootschapsbelasting*) 1969.

561 Section (*Artikel*) 15af(1)(b) and section (*Artikel*) 15af(2) of the Corporate Income Tax Act (*Wet op Vennootschapsbelasting*) 1969.

562 Section (*Artikel*) 15af(1)(b) of the Corporate Income Tax Act (*Wet op Vennootschapsbelasting*) 1969.

563 Section (*Artikel*) 15af(4) and section (*Artikel*) 15ag of the Corporate Income Tax Act (*Wet op Vennootschapsbelasting*) 1969.

564 Section 707-410 of the Income Tax Assessment Act, 1997.

7.6.3 Policy objectives influencing the treatment of tax losses

This structural element is probably the most significant benefit of any group tax system and is also one of the objectives that a group tax regime ideally aims to achieve. It is submitted that, by allowing for the set-off of group tax losses in all four regimes analysed in this chapter, the objectives of the single enterprise principle and neutrality are promoted. It appears that fairness as a tax objective is also promoted, as transactions between companies in the same group are taxed equally in similar entities (group members compared with the divisions of a single company). There are two types of tax losses that need to be considered when designing a group tax system: pre-entry tax losses that refer to tax losses suffered by a subsidiary before entering the group, and tax losses incurred during consolidation.

- Pre-entry tax losses:

The structural element of pre-entry tax losses reveals the tension that exists between the separate entity principle and the single enterprise principle.[565] The policy options of the four regimes in relation to this structural element are summarised in Table 7.13 below. Because of the United Kingdom's group tax approach of continuing to treat group members as separate entities after entering the group, the treatment of pre-entry losses is a non-issue in the United Kingdom.[566] With regard to the consolidation regimes, the application of the single enterprise principle suggests that it would be inappropriate to offset pre-entry tax losses against group profits, if those losses were incurred in years when the company was still taxed as separate entity. The quarantine policy applied by the United States and the Netherlands supports this principle that indicates that it is inappropriate to offset pre-entry losses against group profits if those losses were incurred in years when the company was taxed as a separate entity. This viewpoint is furthermore supported by the way in which group members are treated when exiting the group, as unused pre-entry tax losses revert to the exiting entity. In contrast, Australia's "single entity

565 The pre-entry loss illustrates the tension, as it is incurred when the taxpayer is still a separate entity, but needs to be dealt with after the taxpayer becomes part of the single enterprise. The issue of pre-entry losses becomes even more difficult when the taxpayer exits the group (single enterprise) to become a separate entity again.

566 It is clear that pre-entry losses create more problems in consolidation regimes than in loss-transfer regimes. The reason for this appears to be the shift between the separate entity and the single enterprise doctrines.

rule"[567] deems the subsidiary to have disappeared upon consolidation. Pre-entry tax losses are transferred to the parent company and treated as tax losses incurred by the parent company. Furthermore, the pre-entry tax losses never revert to the group member, even upon later exiting the group. It appears that the Australian regime opposes the viewpoint that it would be inappropriate to offset losses incurred when group members were still separate taxpayers.

- Group losses incurred during consolidation:

The structural element of group losses incurred during consolidation is mainly influenced by the single enterprise principle. The treatment of group tax losses during consolidation is also summarised in Table 7.13 below. The United Kingdom's loss transfer system is simple and straightforward, as it continues to treat group members as separate taxpayers. Combination is limited to the surrendering and claimant group members. Again, the typical consolidation regime, where a strong single enterprise principle is upheld, creates more problems. Its strict application of the enterprise principle suggests that group losses should be treated as losses incurred by the enterprise as a whole. Group losses should, therefore, not be apportioned between individual group members. This rule is followed by the Australian regime. However, in the United States, a portion of the group loss is allocated to an exiting subsidiary. This implies higher compliance costs because the separate losses need to be recorded throughout the consolidation process in order to perform the apportionment when a subsidiary exits the group. In the Netherlands, groups are also allowed to elect to allocate group losses to a exiting subsidiary, which increases complexity, but enhances competitiveness.

Table 7.13 below demonstrates that the three consolidation regimes differ with regard to the treatment of group losses at deconsolidation time. Again, the single enterprise principle does not appear to provide a clear answer as it was primarily developed to treat a corporate group as a single company. The Australian regime requires group losses to stay with the parent company, while the regimes of the Netherlands and the United States apportion group losses to individual group members at deconsolidation time.

567 Referred to as the "SER" in its abbreviated form.

Table 7.13: Comparison of the loss rules and the related policy options in loss-transfer and consolidation models

Countries:	***United Kingdom***	***United States***	***Netherlands***	***Australia***
Group tax model:	Loss-transfer	Pooling	Attribution	Absorption
- Carry-forward:	Indefinite	20 years	9 years	Indefinite
- Carry-back:	1 year	2 years	1 year	None
Pre-entry tax losses:				
Upon entry into the system	Not applicable[568]	Quarantined[569]	Quarantined[570]	Transferred to parent
During consolidation: (offset before/after aggregation)	Not applicable	Offset of pre-entry tax losses only *after* group losses are utilised	Offset of pre-entry tax losses only *after* group losses are utilised	Pre-entry tax loss of subsidiary is transferred to parent
When subsidiary exits group	Not applicable	Unused pre-entry tax losses revert back to subsidiary	Unused pre-entry tax losses revert back to subsidiary	Unused pre-entry tax losses remain with parent
Policy objectives:				
Single enterprise principle[571]	Not an issue – all losses remain with subsidiary	Not an issue - pre-entry loss incurred while separate enterprise	Not an issue - pre-entry loss incurred while separate enterprise	Not an issue - pre-entry loss incurred while separate enterprise
Group losses incurred during consolidation:				
During consolidation	Losses set off between claimant & surrendering company	Single tax base - profits & losses of group members are set off[572]	Single tax base - profits & losses of group members are set off	Single tax base - profits & losses of group members are set off
When group member exits	Not applicable	Elect to have group losses apportioned to exiting member /remain with group	Group losses can be apportioned to exiting member on request	Group losses remain with parent
Upon deconsolidation	Not applicable	Group losses apportioned to separate member	Group losses apportioned to separate member	Group losses remain with parent
Policy objectives:[573]				
Single enterprise principle	Strong (limited to participating members)	Stronger	Stronger	Strongest (losses remain with the parent even after a subsidiary exits)
Simplicity	Adhered to	Compromised	Compromised	Compromised

(Own formulation)

568 Pre-entry losses remain outside the system. Only current year group losses are surrendered.

569 Limited to profits of separate entity for tax year.

570 Limited to cumulative net profit after consolidation.

571 It seems inappropriate to apply the single enterprise principle to pre-entry losses. The single enterprise principle was, however, considered in respect of group losses.

572 Option to apportion to separate member exists.

573 As anti-avoidance measures have been introduced in all regimes to avoid trafficking in losses, it is not considered separately. The same applies to competitiveness, neutrality, efficiency, and fairness, which appear to be adhered to in all regimes equally. These policy considerations were, therefore, not considered for each regime separately.

7.7 THE TREATMENT OF ASSETS

The tax-free intragroup transfer of assets between members within a group is one of the objectives that a group tax regime aims to achieve. It is also one of the advantages of the consolidation model as a group tax regime. In loss-transfer regimes like that of the United Kingdom, only one objective, namely the set-off of losses within the group, is achieved. The treatment of assets is therefore not an issue in a loss-transfer system. The United Kingdom is, however, unique as separate statutes[574] provide relief in the case of restructuring transactions. Intragroup asset transfers are deemed to be made for a consideration equal to the tax cost, which gives rise to neither a gain nor a loss. The tax on the unrealised gain or loss is effectively deferred until the assets are disposed of outside the group, or the member now owning the assets exits the group within a period of six years from date of transfer.[575] In this case, the exiting member is treated as having sold the asset and repurchased it at its market value on the date of the intragroup transfer. The group is defined differently for the purpose of these separate statutes[576](Panayi, 2011:43). Various anti-avoidance measures also had to be introduced as part of the separate statutes, which include the six-year exit charge (already referred to), the ring-fencing of pre-entry capital losses,[577] the realisation of losses stemming from transfers within a group on the subsequent disposal of shares,[578] and provisions to prevent dividend stripping[579] (Panayi, 2011:44).

The structural element of the treatment of assets relates specifically to consolidation systems and will be discussed in that context. Intragroup shares, which are also part of the assets of group companies, raise different issues and are discussed separately (see Section 7.8 of this chapter).

574 Sections 170 -192 of the Taxation of Chargeable Capital Gains Act, 1992.
575 Section 179 of the Taxation of Chargeable Capital Gains Act, 1992.
576 According to the separate statutes of the United Kingdom, a group comprises a parent holding at least 75% interest in its subsidiaries. However, second-tier 75% subsidiaries are also included in the group if they are at least 51% effectively held subsidiaries of the parent company (Panayi, 2011:43).
577 See sections 177A and Schedule 7A, 184A–184F of the Taxation of Chargeable Capital Gains Act, 1992.
578 Section 176 of the Taxation of Chargeable Capital Gains Act, 1992.
579 Section 177 of the Taxation of Chargeable Capital Gains Act, 1992.

According to Ting (2013b:176), tax legislators must decide on the treatment of the assets of a group of companies at three different points in time: on entry of a subsidiary into a group, during consolidation, and when the subsidiary exits the group.

7.7.1 Treatment of assets on entry of a subsidiary into a group

Pre-consolidation assets potentially carry with them unused tax attributes.[580] Pre-consolidation assets also potentially incorporate unrealised gains or unrealised losses (Harris, 2013:418-419). The fundamental problem at entry time relates to how these issues should be dealt with when moving from a separate entity to a single enterprise.

Ting's comparative analysis of consolidation systems (2013b:280-281) reveals three alternatives[581] for the treatment of assets (other than intragroup shares) on entry. Under the first alternative, the deemed sale option, assets are regarded as having been sold to the group at their market values. When the subsidiary enters the group, all unrealised profit and losses on pre-entry assets must be recognised at once. The immediate liability for taxation has a negative effect on the attractiveness of this option for any consolidation regime (Ting, 2011:446). None of the consolidation regimes analysed in this chapter have fully adopted this option.[582] In the Netherlands, this option is applied, but only in respect of intercompany receivables and interests held by the parent company in its subsidiaries.

The second alternative, the rollover approach, provides for the rollover of pre-consolidation tax attributes to the group. When a subsidiary enters the group, all its pre-entry assets are regarded as owned by the consolidated group, at their original cost bases. This means that, upon entry, there are no immediate tax consequences in respect of the assets of joining subsidiaries, and the entire unrealised gain or loss is attributed to the group (Ting, 2013b:180). This approach has been adopted by the Netherlands, but is not used in

580 Tax attributes are features of a tax system can be carried forward from one tax period to another, for example unused capital allowances.

581 According to Ting (2013b:176), a fourth possibility exist: a quarantine option, where any unrealised gains or losses attributable to the pre-consolidation period are quarantined and reserved for the subsidiary, and are not passed on to the parent company of the group. This option has a high compliance cost, as the unrealised gain is determined at entry time, and the movement of assets has to be traced throughout the consolidation cycle (Ting, 2013b:178). None of the three consolidation regimes investigated in this chapter have adopted this option.

582 Japan has adopted the deemed sale approach (Ting, 2013b:179).

respect of all assets, as the deemed sale approach[583] is applied for certain assets only, namely intercompany receivables and interests held in subsidiaries (Müller, 2008:263).

Finally, in terms of the third alternative, the asset-based model, the tax costs of a joining subsidiary's pre-entry assets are reset. When the subsidiary joins the group, the cost bases of its pre-entry assets are cancelled and permanently replaced by the reset cost bases (Ting, 2010:170). This option is only applied in Australia. The objective of applying this approach is that, because of the multiple levels of ownership,[584] the recognition of the same economic gain or loss should not occur more than once in a corporate group, (Ting, 2011:446). This approach is also in line with Australia's "single entity rule", which determines that the subsidiary is deemed to disappear upon consolidation and becomes part of the parent company. The "single entity rule" effectively collapses the multiple ownership levels into one. The subsidiaries' pre-entry assets are now deemed to be owned by the parent company. Together with the disappearance of the subsidiaries, the "tax cost setting"[585] rules of the Australian consolidation regime provide for the replacement of the original cost bases of assets of subsidiaries with artificially created new cost bases (Ting, 2013a:584).

According to Ting (2013a:584), the replacement of historical costs with the reset cost bases is hazardous and creates loopholes for taxpayers to manipulate. The rules are

583 Section (*Artikel*) 15ab of the Corporate Income Tax Act (*Wet op Vennootschapsbelasting*) 1969.

584 The term "multiple levels of ownership" refers to the cascading effect of tax on assets in multi-tier corporate groups, which is discussed in detail in Section 7.8 of this chapter. It is also sometimes referred to as the "dual cost base issue".

585 In its abbreviated form, known as the "TCS" rules. The "TCS" rules are designed to reconstruct new cost bases for the underlying assets of the subsidiary upon entering the consolidated group. The reset cost base amount is computed in an eight-step process stipulated in complicated tax legislation (section 705-60 of the Income Tax Assessment Act, 1997). The process starts by recognising the cost that the parent company incurred in order to become the holder of the subsidiary's assets, by calculating an amount known as the "allocable cost amount" (in its abbreviated form known as the "ACA" amount). The subsidiary's liabilities (in terms of accounting rules) are added to the cost of the group member's interest. This amount is then adjusted by the joining entity's accumulated profits and losses in order to arrive at the "allocable cost amount". The "allocable cost amount" is then allocated to the assets in the subsidiary according to their market values at entry time (section 705-35(1)(c) of the Income Tax Assessment Act, 1997). Certain assets retain their original cost bases. According to section 705-25 of the Income Tax Assessment Act, 1997, the cost bases of assets such as Australian currency and receivables are not reset at entry time. These assets' cost bases are subtracted from the "allocable cost amount" before the balance is allocated to the remaining assets. This "tax cost setting" process is repeated for every level of shareholding in the consolidated group until the cost of all shareholdings is allocated to individual assets. After resetting the remaining assets' cost bases, the original cost bases of the subsidiary are lost forever (Ting 2013b:184-185).

extremely complex, artificial and problematic, and suffer from a multitude of problems. Firstly, the cost bases of shares in a subsidiary are aggregated with the accounting liabilities,[586] which provides the potential for manipulation, as accounting standards normally allow for a choice between alternative accounting policies (Ting, 2013b:184). Secondly, the "tax cost setting" rules are notoriously complex and cover more than 100 pages of legislation.[587] According to Ting (2013b:183), the rules are so complex that the Australian Government itself still struggles to fully understand how the "tax cost setting" rules work. Thirdly, the rules provide tax avoidance opportunities because they rely on valuations which are inherently subjective. Finally, the rules have a substantial revenue impact because the rules can "magically" transfer the cost of a capital asset (a share) into the cost of a revenue asset, which is fully deductible when the asset is sold[588] (Ting, 2013b:187).

The remaining consolidation regime, the United States, applies none of these options precisely as described to account for assets in affiliated groups. This is because the hybrid nature of the United States regime treats consolidated group members as separate entities for some purposes, and as part of the single enterprise for other purposes. For group tax purposes, assets owned by the subsidiary will still be treated as assets of the subsidiary after consolidation. There is therefore no specific tax implication for the assets when a subsidiary enters the affiliated group, although there are specific rules dealing with adjustments[589] in respect of intragroup asset transactions (McMahon, 2012:136). Any profit or loss on assets is only recognised when a subsequent event takes place, and not upon entry into consolidation. In this regard, because there is no immediate tax effect in respect of the pre-entry assets of joining subsidiaries on entry into a consolidated corporate group, the approach most closely resembles the rollover approach.

586 The accounting liabilities include provisions and other estimates determined in terms of accounting standards (2013b:184).
587 Divisions 705 and 713 in the Income Tax Assessment Act, 1997.
588 The reset cost base can furthermore be higher than the original cost base was (Ting, 2013b:186-187).
589 Section 1502-11(a) of the Internal Revenue Code.

7.7.2 During consolidation: intragroup asset transfers

In terms of the pooling consolidation system applied in the United States, controlled members are taxed as departments of the parent. Intragroup asset transfers during consolidation are therefore treated as transfers between divisions of a single company, and have no tax implication for the consolidated group. Intragroup gains and losses are excluded from consolidated income until a subsequent event (such as the disposal of the asset to a third party) triggers recognition (Anderson *et al*., 2011:8-16). Although not precisely the same as the rollover approach applied in the Netherlands, this approach most closely resembles the rollover approach.

The rollover approach is applied in the Netherlands, in terms of its fiscal unity regime, where intragroup asset transfers are ignored at group level and tax bases are rolled over. No gain or loss on intragroup asset transfers is therefore recognised (Ting, 2011:449). The deferred gain or loss is only recognised once the asset is sold to a third party outside the consolidated group. Anti-avoidance measures[590] have been introduced to prevent any abuse of the rollover method (Müller, 2008:280-292).

There are also no tax implications for intragroup asset transfers in the Australian regime. Because the assets are regarded as being owned by the parent company after consolidation, there are no intragroup transfers to consider after consolidation. There is also no need to keep record of any assets transferred within the group, as all assets belong to the parent company. Where the consolidated group disposes of an asset to a third party, any capital gain or loss is recognised by the parent company, using the reset cost base as tax cost of the asset, which was calculated when the subsidiary entered the group.[591]

7.7.3 At exiting time (when the subsidiary exits the group)

Issues at exiting time are complex and arise mainly because of the changeover from the single enterprise principle to the separate entity principle. The different options adopted at entry time and during consolidation influence the method to be used at exiting time. An

590 Section (*Artikel*) 15ai of the Corporate Income Tax Act (*Wet op Vennootschapsbelasting*) 1969.
591 Section 705-55(5) of the Income Tax Assessment Act, 1997.

exiting subsidiary may take away from the group certain assets that have appreciated in value during consolidation, and the question is whether the group should be taxed on the unrealised gain. In his comparative analysis of consolidation regimes, Ting (2013b:282) identified the following four alternatives at exiting time:[592] the recapturing of tax bases, the resetting of the cost bases, the rollover of tax bases, and the deemed sale method.

In terms of the recapturing alternative (the first option), the tax bases are recaptured by the subsidiary upon exiting the group. Previously, gains or losses on intragroup asset transfers would have been deferred in terms of the rollover approach. When either the transferor company or the transferee company exits the consolidated group, the single enterprise relationship ceases to exist and the deferred gain or loss is realised. This option is applied in the United States. During consolidation, unrealised profits and losses on intragroup asset transfers have no tax implications for the consolidated group and are deferred (rolled over) until the happening of a subsequent event. The departure from the group by the buyer or seller member is considered as a subsequent event (Anderson *et al*., 2011:8-17). Unrealised gains and losses will therefore be recognised where a group member exits the group.

Another alternative at exiting time (the second option) applies where “tax cost setting” provisions had previously been applied. There are no immediate tax implications at exiting time. The cost bases are re-determined, and the amount allocated is attributed to the assets of the exiting subsidiary[593] (the third option) (Ting, 2013b:282). This alternative is applied in Australia. In terms of the “tax cost setting” rules, the process that was applied at entry time is reversed. At entry time, the original costs of the assets are lost. When a subsidiary exits the group, the shares are again recognised in the group member’s hands,

592 A fifth possibility exists, namely the quarantine approach, where the gains or losses attributable to the consolidation period are quarantined at group level, meaning that gains and losses attributable to the pre-consolidation period are dealt with at subsidiary level, and gains and losses during consolidation, at group level. A record needs to be maintained of market values at date of entering the group as well as at date of exiting the group in order to determine which portion of the gain or loss upon eventually selling the asset should be taxed at group level, and which portion at subsidiary level. It is clear that this option has a high compliance cost, as unrealised gains and losses and the movement of assets throughout the consolidation cycle have to be traced. The complexity of this option makes it undesirable (Ting, 2013b:198). None of the countries explored in this chapter have adopted this option and it is therefore not explored further.

593 Section 711 of the Income Tax Assessment Act, 1997.

and the cost bases of assets need to be reconstituted.[594] This process is almost the opposite of the calculation applied at entry time, as the "allocable cost amount" for the assets is calculated, which is then allocated to the membership interest in the subsidiary. This process is repeated for each level of ownership until the level is reached at which the interest is disposed of by the group. The exiting subsidiary then receives the reset cost bases of its assets[595] from the parent company (Ting, 2013b:199-200).

The third alternative (also where rollover provisions were previously applied) is to have no immediate tax implications at exiting time by rolling over the tax base. The consolidated group's base cost is rolled over to the subsidiary, and any gains or losses on the subsequent disposal of the assets are attributed wholly to the subsidiary (Ting, 2013b:198). The main advantage of this option is simplicity, as it is not necessary to keep record of any of the assets or to value any assets. Nonetheless, it goes against the single enterprise principle because the exiting subsidiary is no longer part of the group, but must bear the burden of the deferred gain.

Under the fourth option (the deemed sale approach) assets are deemed to be sold to the subsidiary at their respective market values at exiting time (Ting, 2013b:198). This option is simple, but not attractive as unrealised profits are taxed at exiting time.

In the Netherlands, the rollover option (the third option) is applied, unless anti-avoidance provisions apply, in which case the deemed sale option (the fourth option) is applied. Because the consolidated group's tax base is rolled over to the exiting subsidiary, there are no immediate tax implications at exiting time. The unrealised gain or loss is simply deferred. The Netherlands is the only regime that consistently applies the rollover option: at entry time, during consolidation, and at exiting time. The anti-avoidance objective is compromised in terms of this option, as it is prone to abuse by taxpayers. Previously in the Netherlands, it was possible to transfer assets with hidden reserves,[596] tax free in terms of the rollover relief provisions. Thereafter, the asset could be sold to a third party, also tax free in terms of their participation exemption. The result was that an asset could be disposed of, free of tax, to a third party (Müller, 2008:289). Specific anti-avoidance

594 Section 701-15 of the Income Tax Assessment Act, 1997.
595 Section 701-40 of the Income Tax Assessment Act 1997.
596 Assets that have appreciated in value.

measures had to be introduced to counter this scheme.[597] In terms of the anti-avoidance measures, the rollover rules that normally apply to intragroup asset transfers are ignored, as the asset is deemed to have been sold[598] and a gain on disposal is realised at market value (Müller, 2008:290-292). It is evident that anti-avoidance measures would be necessary if the tax base is rolled over in terms of this option.

7.7.4 Policy objectives influencing the treatment of assets

The treatment of assets is mainly influenced by the single enterprise principle. The policy options in relation to the single enterprise principle, as applied in the four regimes, are summarised in Table 7.14 below.

In loss-transfer regimes like that of the United Kingdom, only one objective, namely the set-off of losses within the group, is achieved. The treatment of assets is therefore not an issue in a loss-transfer system. The United Kingdom is, however, unique as separate statutes[599] provide relief for the intragroup transfers of assets in the case of restructuring transactions, which reflects the weakest application of the single enterprise principle. The tax-free intragroup transfer of assets is, however, achieved in all consolidation systems, which indicates a stronger application of the single enterprise principle. Clearly, the treatment of assets relates specifically to consolidation systems.

The treatment of assets must be considered at three different points in time: on entry of a subsidiary into a group, during consolidation, and when the subsidiary exits the group. Pre-entry assets potentially carry with them unused tax attributes, as well as unrealised gains or losses. The fundamental problem at entering time relates to how these issues should be dealt with when moving from a separate entity to a single enterprise. Two alternatives for the treatment of pre-entry assets are applied in the three consolidation regimes analysed in this chapter. The first alternative, the rollover approach, provides for the rollover of pre-entry tax attributes to the group. In terms of this approach, the entire pre-entry unrealised gain or loss is attributed to the group, with no immediate tax consequences. This method

597 Section (*Artikel*) 15ai of the Corporate Income Tax Act (*Wet op Vennootschapsbelasting*) 1969.

598 This means that the roll-over option is switched to the deemed sale option in certain avoidance situations (Ting, 2013b:201).

599 Section 171 of the Taxation of Chargeable Capital Gains Act, 1992.

for treating assets[600] of joining subsidiaries on entry into a consolidated corporate group has been adopted by the Netherlands and the United States, although this method is not applied in precisely the same way in these jurisdictions. Because of the hybrid nature of the United States regime, assets owned by the subsidiary will still be treated as assets of the subsidiary after consolidation. This means that unrealised profits or losses are deferred or rolled over and are only recognised when a subsequent event takes place. In this regard, the approach resembles the rollover approach. In terms of the second alternative for treating pre-entry assets, the cost bases of assets in a subsidiary are permanently erased and replaced by reset cost bases.[601] Australia is the only regime that has adopted this alternative, which reflects the strongest application of the single enterprise principle. According to Ting (2013b:206), the “tax cost setting” rule “encourages taxpayers’ creativity” and has had a negative impact on tax revenue, which has “far exceeded what the government had originally anticipated”. It appears that, in the process of applying a stronger single enterprise principle, anti-avoidance is sacrificed.

Of the three consolidation regimes, the United States reflects the weaker application of the single enterprise principle. During consolidation, the rollover method continues to be applied in terms of the pooling regime applied. To a large extent subsidiaries maintain their separate entity status apart from the parent company. Gains or losses on intragroup asset transfers are eliminated when individual companies’ results are pooled together at the parent company level. Clearly, intragroup asset transfers during consolidation are treated as transfers between divisions of a single company, without any tax implications. Deferred gains and losses are only realised once the asset is disposed of to a third party. Under the rollover option in the United States, the compliance cost is higher than under the rollover option of the Netherlands, as each member applying the pooling method must keep track of deferred gains and losses on intragroup asset transfers.

The treatment of assets during consolidation in the Netherlands represents a stronger application of the single enterprise principle. The Netherlands continues to apply the rollover method, in terms of which tax bases are rolled over. Gains and losses are

600 All assets, except intercompany receivables and interests held in subsidiaries which are dealt with in terms of the deemed sale approach.

601 “Tax cost setting” rules are used where the cost bases of a joining subsidiary’s assets are reset. This approach is in line with the “strong entity rule” applied in Australia, whereby the subsidiaries disappear upon consolidation.

deferred, and are only recognised when the asset is sold to a party outside the group. Specific anti-avoidance measures are necessary if this option is elected, specifically at exiting time.

The treatment of assets in Australia represents the strongest application of the single enterprise principle. During consolidation, there are also no tax implications on intragroup asset transfers in the Australian regime, because all the assets of subsidiaries are regarded as being owned by the parent company after consolidation. This indicates a strong application of the enterprise principle.

Issues at exiting time are complex and arise mainly because of the changeover from the single enterprise principle back to the separate entity principle. Three alternatives are applied in the three regimes analysed. In terms of the first alternative, the tax bases are recaptured by the subsidiary upon exiting the group. Previously, gains or losses on intragroup asset transfers would have been rolled over. Now, when either the transferor or the transferee exits the group, the single enterprise relationship ceases to exist and the deferred gain or loss is realised. This option is applied in the United States, representing a weaker application of the single enterprise principle. The second alternative is to roll over the group's cost bases to the exiting subsidiary. This has no immediate tax implications. In the Netherlands, the rollover option is applied unless anti-avoidance provisions apply, in which case the deemed sale option is applied. In terms of the deemed sale option, assets are deemed to be sold to the subsidiary at their respective market values at exiting time. The deemed sale alternative was enacted because, in terms of the rollover alternative, it was possible to transfer assets with hidden reserves, tax free, and thereafter sell these to a third party, also tax free, in terms of their participation exemption. It appears that the stronger the application of the single enterprise principle is, the more likely that the objective of anti-avoidance will be sacrificed. Specific anti-avoidance measures will therefore be necessary if rollover, like that of the Netherlands regime, is elected. The third alternative at exiting time is applied in the Australian regime, where cost bases are re-determined, and the re-determined amounts allocated to the assets of the exiting subsidiary. There are therefore no immediate tax implications at exiting time. It appears that the objective of anti-avoidance is also sacrificed under the Australian approach in resetting the cost bases of assets, because of its subjectivity. Although this approach represents the strongest application of the single enterprise principle, it encourages anti-avoidance schemes and has had a negative impact on tax revenue in Australia. The method used in a group tax regime when a subsidiary exits the group depends, to a large extent, on the methods applied upon entry into the group and during consolidation.

Table 7.14: Comparison of the treatment of assets and the related policy options in loss-transfer and consolidation models

Countries:	***United Kingdom***	***United States***	***Netherlands***	***Australia***
Group tax model:	Loss-transfer	Pooling	Attribution	Absorption
Upon entry into the system	Rollover (in terms of separate statutes)	Similar to rollover (no immediate tax consequences as assets remain with separate group members)	Rollover (except for intragroup shares and receivables where it is a deemed sale)	Cost bases are re-determined in parent company's hands
During consolidation	Rollover (in terms of separate statutes)	Similar to rollover (intragroup profits and losses are deferred until a subsequent event, like a third party sale)	Rollover	Not applicable (the subsidiaries have disappeared and are treated as part of the parent company)
At exiting time	Not applicable (group members are treated as separate companies)	Recapture (exiting the group is considered a subsequent event)	Rollover (no tax implications as the tax base is rolled over from the group to the exiting subsidiary[602])	Cost bases are reset and the exiting subsidiary receives the reset cost bases from the parent company
Policy objectives applicable to treatment of assets:[603]				
Single enterprise principle	Weak (dealt with in terms of separate statutes)	Weak (asset remains with the group members, i.e. part of the separate entity principle)	Strong (rollover provisions are applied consistently)	Strongest (assets are deemed to belong to the parent – no intragroup transactions to consider).
Anti-avoidance	Anti-avoidance is sacrificed to a lesser extent than in full consolidation (because of the separate statutes)	Neutral	Anti-avoidance is sacrificed and thus strict anti-avoidance measures would be necessary if this option is chosen.	Anti-avoidance is sacrificed. Uncertain if anti-avoidance measures are able to curb revenue loss
Simplicity	Adhered to (separate statutes deal with asset transfers)	Compromised (each member keeps track of deferred gains and losses)	Adhered to (tax base costs are rolled over consistently)	Compromised (complex "tax cost setting" rules)
Efficiency	Neutral	Neutral	Neutral	Compromised

(Own formulation)

602 Anti-avoidance measures provide for a switch to the deemed sale option in certain circumstances.

603 It appears that this structural element is not affected noticeably by the policy considerations of neutrality, competitiveness and fairness.

7.8 THE TREATMENT OF INTRAGROUP SHAREHOLDING

The treatment of intragroup shareholding relates broadly to the treatment of assets (discussed in Section 7.7 of this chapter). Where the discussion in Section 7.7 concerns assets *other than intragroup shares*, the present discussion concerns *only intragroup shares*. The treatment of intragroup shareholding is discussed separately because of the complex issues involving intragroup shareholdings.

According to Masui (2004:39), treating the group as a single entity has significant consequences, as the treatment of shares held by a parent company in a subsidiary creates one of the most important issues in corporate income tax. The complexity is even more severe in consolidation systems, like that of Australia. This stems from the recognition of the same economic gain or loss more than once in a group because of the multiple levels of ownership.[604]

To understand the complexities, the background to the multiple levels of ownership needs to be explained. Shareholders invest in a company to receive returns in the form of dividends and/or capital gains. When a shareholder invests in the equity shares of a company, tax may be imposed on two levels: firstly, corporate income is taxed at company level, and secondly, at shareholder level, either in the form of tax on dividends or tax on the capital gains when the shares are disposed of by the shareholder. According to Bird (1996:11), this “double taxation” is a feature of corporate tax. Without coordination in a system, there will be more than one layer of tax imposed on the same economic profits earned by the company (Bird, 1996:11).

The same double tax phenomenon is present in a corporate group setting where the parent company is the shareholder of the subsidiary. This problem of the multiple layers of tax is a consequence of the fact that each company in a multi-layered group is treated as a separate taxpaying entity[605] where tax is imposed both at company and shareholder (parent company in a group context) levels. Consider the following example: assume that in year 1, parent company (P) purchases the shares in a subsidiary (S) at the price of $100. Company S holds an asset at a cost of $100. In year 2, Company S sells the asset

604 Also referred to as the “dual cost base issue”.

605 This relates back to the separate entity doctrine, although the problem is not necessarily solved by a group tax system.

for $130, thereby realising a gain of $30. Company S retains the profit and does not make a distribution to Company P. Company P continues to record the same amount of $100 as base cost of its shares in Company S, despite having earned taxable profits of $30 (increasing the value of the Company S share to $130). When Company P sells the Company S share in year 3 at its market value of $130, its capital gains/losses will be computed after deducting the base cost of $100. Company P will therefore be taxed on the same economic gain of $30 realised by Company S in year 1 (on which corporate income tax was paid in year 1 in Company S's hands). Therefore, the same economic gain of $30 is first taxed in the hands of Company S (corporate tax on profits from the disposal of assets) and the again in the hands of Company P (capital gains tax from the disposal of a share). Figure 7.3 below illustrates the tax effect where a consolidation regime applies to the group in the preceding example.

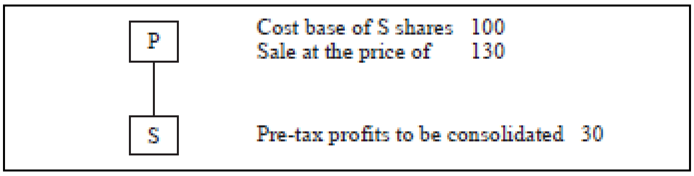

Figure 7.3: Double taxation due to multiple levels of ownership

(Source: Masui, 2004:41)

Assume that Company S again earns profits of $30, but this amount is now consolidated with Company P's profits. Consolidation leads to the immediate taxation at Company P's level of the portion of profits earned by Company S. The timing of taxation at Company P's level is therefore accelerated by consolidation. If Company P later sells the Company S share it is at this point that capital gains tax creates the same problem of "double taxation". Company P's base cost is kept intact at $100. If Company P sells the shares at a price of $130, the amount of the gain is $30. However, Company S's profit of $30 has already been consolidated and taxed once as part of the consolidated income of the group. Capital gains tax on the disposal of the Company S share means a second imposition of tax on the same profit of $30 within the same group (Masui, 2004:41). The problem of "double tax" is therefore not necessarily removed by implementing a group tax system. Furthermore, this issue of double taxation has a cascading effect. Assume that the parent company in Figure 7.3 above is wholly owned by another parent company (a grandfather company). Through the multiple ownership levels, the gain of $30 is then recognised and taxed at three levels.

The same problem exists with the double deduction of *losses* within a single group (Masui, 2004:41). In practice, though, the double deduction of *losses* is likely to be a more of a burning issue for governments, due to the revenue concerns.

The tax treatment of assets, particularly intragroup shareholdings, is affected by the multiple layers of tax. In a group context, the historical cost of assets held are recorded at two levels: at the company level the company's assets (for example property) have their own base cost ("inside basis"); at the shareholder level the company's shares have their own base cost ("outside basis"). If the assets held at the company level increase in value, the shares owned by shareholder also increase in value[606] (Masui, 2004:40). When intragroup transfers of these assets occur in a group context, the issue of double tax should be considered. It is obviously extremely difficult to address this issue accurately.

Nonetheless, the problem of double taxation has been addressed by modern corporate tax systems, and sophisticated solutions have been developed to attempt to deal with this complex problem. It is, for example, extremely difficult to provide effective relief from tax on unrealised gains or losses on intragroup share transfers (Ault & Arnold, 2010: 358-362). A comprehensive solution to deal with double taxation is the participation exemption regime (PEX regime).[607] The PEX regime aims to effectively remove double taxation at the level of the shareholder (parent company) by providing tax relief[608] on dividends and/or capital gains (Nikolakakis, 2008:27). The benefit of having of a PEX regime is that it usually relates to all group tax models and not only to consolidation models. It also applies whether the group qualifies for the group tax system or not. It is furthermore equally relevant to resident shareholders and non-resident shareholders. It offers a

606 Because the fair market value of the shares generally reflects the returns expected from the company, the increase in value would not necessarily be the same.

607 In its abbreviated form, referred to as the "PEX" regime.

608 The participation exemption can either be partial or in full. Several possibilities exist (Ault & Arnold, 2010:358-362): In some regimes, the shareholder is exempt from tax on the dividends received, or the shareholder can take advantage of tax credits for the amount of tax suffered at the level of the company. In other jurisdictions, the participation regime provides that capital gains and losses arising from the disposal of the shares are excluded from tax, or that the shareholder is exempt from tax. Relief at the shareholder level can also be provided by taking into account profits already taxed at company (subsidiary) level when determining the base cost of the share in the hands of the shareholder (parent) (Masui, 2004:40).

comprehensive and impartial solution to the problems experienced with intragroup shareholdings. A disadvantage of the participation exemption regime is that it is inclined to encourage tax avoidance schemes. Special anti-avoidance measures are therefore required to guard against abuse[609] (Ting, 2011:451).

The general PEX regime of the Netherlands provides comprehensive exemption to shareholders (parent companies) in respect of intragroup share transactions.[610] Its participation exemption not only provides for the exemption of tax on dividends, but also on any gains made on the sale of shares (Ault & Arnold; 2010:362). Intragroup share transfers qualify for exemption, as the minimum ownership level requirements under their consolidation regime are more stringent than those under the PEX regime.[611] A benefit of the PEX regime is that it is straightforward, and the introduction of further measures to deal with intragroup share transfers in the consolidation regime is not necessary. In the Netherlands, the participation exemption system relates to companies, in general, whether they are members of a group or not (Müller, 2008:187-188).

The PEX regime of the Netherlands is applied consistently during the process of consolidation: when entering the fiscal unit, during the consolidation period, and when exiting the fiscal unit (Ting, 2011:452). When a subsidiary enters the fiscal unit, the broad rollover policy for assets is not extended to intragroup shares held by the parent company and other group members. Instead, such shares are marked-to-market in terms of the deemed sale option.[612] In other words the base cost is reset to market value and any unrealised gains or losses are therefore realised at entering the group. These gains or losses can be exempt from tax under the PEX regime. This approach is obviously an anti-avoidance measure adopted to prevent taxable gains from escaping tax through consolidation on the shareholdings that do not qualify for participation exemption[613] (Ting,

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609 Most systems require a minimum ownership threshold in order to qualify for the participation exemption.

610 Section (*Artikel*) 13 of the Corporate Income Tax Act (*Wet op Vennootschapsbelasting*) 1969.

611 The participation exemption in the Netherlands provides full exemption from tax of all dividend income and capital gains on shares if participation is at least 5%; thus, if the taxpayer holds at least 5% of share capital in the company. Neither the shareholder nor the entity in which the interest is held may be an investment fund (or an investment in a low-taxed portfolio) (Müller, 2008:187).

612 Refer to Section 7.7.

613 An example of such a situation is where a parent company that originally owned 3% in the subsidiary acquires all the shares in the subsidiary and forms a fiscal unit with the subsidiary. In terms of the deemed sale approach, the capital gain on the shareholding is taxed at entry time. The capital gain will not be exempt in terms of the participation exemption regime as a minimum threshold of 5% is required

2011:451). Because the Netherlands' PEX regime applies throughout the consolidation period until the exiting of the fiscal unit, there is no further tax implication on the disposal of intragroup shareholdings[614] (Müller, 2008:283).

Some jurisdictions without a general PEX regime offer alternative forms of tax relief to corporate groups which are designed to achieve similar results to a participation exemption,[615] but these measures are often complex. In response to the problem of multiple layers of taxation, various solutions have been implemented as part of the group tax systems of the United States and Australia (Masui, 2004:41).

In terms of the "single entity rule" of Australia, all subsidiaries are regarded as divisions of the parent company, and their assets are regarded as being owned by the parent.[616] This means that there are no tax effects for intragroup share transfers during consolidation, since these transfers are considered not to have occurred. As the multiple levels of ownership are now "folded" into one level of ownership, the double taxation issue is not considered a problem within a consolidated group in Australia (Masui, 2004:42). The approach, again, necessitates the application of the complex "tax cost setting" rules to recalculate the cost base of shares when a subsidiary exits the group (Ting, 2011:452).

In the United States, every group company reports the gain or loss on an intragroup transfer in its individual tax return. Any intragroup transfer of shareholdings is then eliminated at group level. The elimination is done when the parent files the consolidated tax return. This approach is like the approach followed upon intragroup transfers of non-share assets during consolidation. The deferred gain or loss on intragroup transfers is recognised only when either the transferor or the transferee exits the group. Consequently, there are no specific implications with respect to intragroup shareholdings at entering time. The United States pooling system, however, has a unique approach, since adjustments to the base cost of shares are made constantly during the consolidation process (McMahon,

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to qualify for exemption. If the deemed sale provisions did not apply, the capital gain would have escaped taxation. This example is based on the example provided by Ting (2013b:212).

614 Upon exiting the fiscal unit, a disposal is deemed to have taken place after the subsidiary exits the fiscal unit. This is a necessary requirement to ensure that the participation exemption regime can apply again (Müller, 2008:283).

615 In Japan, the tax basis in a subsidiary is adjusted when the share is sold to a party outside the group. The adjustment is based on the increase or decrease of reserved profits after tax in the subsidiary during the consolidation period (Masui, 2004:41).

616 Also refer to the discussion in Section 7.7.

2012:131-132). The cost bases of shares in a subsidiary are adjusted continuously for various items, which include taxable income and losses of the subsidiary, tax-exempt income, disallowed expenses and losses, and amounts distributed in respect of the subsidiary's shares.[617] The elimination of potential double tax consequences is the aim of these adjustments because the individual member's taxable income or loss is already combined in the consolidated return.[618] Therefore, the base cost of the intragroup shareholdings needs to be adjusted to ensure that there is no double taxation when the shares are subsequently sold (McMahon, 2012:132). The following example is provided:[619] A parent company (P) acquires a subsidiary (S) for $100, and together they form a consolidated group. If Company S earns a taxable income of $40, the amount will be included in the group's combined taxable income, and taxed at the group level. In terms of the investment adjustment rules, the cost base of Company S's shares must be adjusted to $140 ($100 plus $40). If Company P then disposes of its Company S shares, the adjusted cost base of $140 will be used, and the taxable income of $40 will not be taxed a second time.

These investment adjustments normally start at the lowest level of any corporate structure with the lowest-tier subsidiary, and are made all the way up the structure, to the level of the ultimate parent.[620] Where losses suffered in a subsidiary and/or distributions in respect of a subsidiary exceed the original cost base of the subsidiary, an "excess loss account" is created, which is the equivalent of a negative cost base.[621] If the shares are ultimately sold, or the group member no longer forms part of the group, or its shares become worthless, the excess loss account is taxed as a capital gain[622] (McMahon, 2012:132).

Because the investment adjustment rules of the United States require constant adjustments throughout the consolidation period, this leads to high compliance costs. These rules are as complex as the "tax cost setting" rules of Australia. The only difference is the timing. The investment adjustments of the United States need to be made

617 Section 1502-32 of the Internal Revenue Code.
618 Section 1502-32(a)(1) of the Internal Revenue Code.
619 The example is based on an example provided in section 1502-32(a)(1) of the Internal Revenue Code.
620 Section 1502-32(a)(3)(iii) of the Internal Revenue Code.
621 Section 1502-32(a)(3)(ii) of the Internal Revenue Code.
622 Section 1502-19(a)(1) and section 1502-19(b) of the Internal Revenue Code.

continuously during consolidation, while the “tax cost setting” rules of Australia are only applied when a subsidiary enters or exits the group (Ting, 2013b:222).

7.8.1 Policy objectives influencing the treatment of shareholdings

The treatment of shareholdings is mainly influenced by the single enterprise principle. The application of the single enterprise principle to this structural element as applied in the four regimes, together with their policy options, is summarised in Table 7.15 below. In the United Kingdom, intragroup shareholdings are not dealt with in terms of the country’s loss-transfer regime, and the concept of intragroup shareholdings is therefore a non-issue. The United Kingdom does, however, have a separate system in place to provide relief in the case of restructuring transactions. This represents a very weak application of the single enterprise principle. Unlike the United Kingdom regime, the regime of Australia represents a very strong application of the single enterprise principle with regard to intragroup shareholdings. After consolidation, the parent company is the only company remaining, and all assets are held directly by the parent company. Shares in subsidiaries have ceased to exist. Because of the complexity of this regime,[623] the tax objective of simplicity is sacrificed in the process.

Weaker applications of the single enterprise principle are in force in the United States and the Netherlands. In the United States, group members maintain their separate entity, and gains or losses on intragroup transfers are deferred. Because the United States does not have the benefit of a general PEX regime for domestic corporate groups, taxation is imposed on the disposal of shares in the exiting subsidiary. To avoid double taxation of profits already taxed, the cost bases of intragroup shares are continuously adjusted during consolidation. This policy is, like the policy of Australia, extremely complex, and because it must be maintained throughout consolidation, it also entails high compliance costs. In the Netherlands, shares in a subsidiary are deemed to be sold at market value upon entering the group.[624] Any unrealised gain or loss is therefore realised, but under the Netherlands’ general PEX regime, these gains and losses are normally exempt. The Netherlands

623 Difficult “tax cost setting” rules are applied.

624 The roll-over approach that applies to non-share assets (see Section 7.7 of this chapter) is not extended to shares in a subsidiary.

depends on the general PEX regime to exempt intragroup share transfers in consolidated groups, and no additional provisions are required. The tax objective of this PEX regime is neutrality, as all groups, whether consolidated or not, are treated equally. This is a simple way to deal with double tax arising with intragroup shareholdings, thereby adhering to the tax objective of simplicity. Unfortunately, the PEX regime of Netherlands is prone to abuse, and extensive anti-avoidance rules are necessary.

Table 7.15: Comparison of the treatment of intragroup shareholding and the related policy options in loss-transfer and consolidation models

Countries:	***United Kingdom***	***United States***	***Netherlands***	***Australia***
Group tax model:	Loss-transfer	Pooling	Attribution	Absorption
Upon entry into the system:	Rollover (in terms of separate statutes)	Not applicable (assets remain with separate group members)	Deemed sale and comprehensive PEX regime[625]	In the hands of the parent, shares of the subsidiary are deemed to be replaced by the assets of the subsidiary.[626]
During consolidation:	Rollover (in terms of separate statutes)	Intragroup profits and losses are not recognised, but cost base adjustments are recorded in the case of intragroup shareholdings.	Comprehensive PEX regime	Not applicable (the subsidiaries have disappeared and are treated as part of the parent company)
At exiting time:	Not applicable (group members are treated as separate companies)	Adjusted cost bases are adopted upon the selling of a subsidiary to ensure that there is no double taxation	Comprehensive PEX regime	The cost base of the share interest in the subsidiary is reconstituted, using the "tax cost setting" rules.
Policy objectives applicable to group losses:[627]				
Single enterprise principle	Weak (dealt with in terms of separate statutes)	Weak (assets remain with the group members, i.e. part of the separate entity principle)	Weak (shares are deemed to be sold at market value upon entry, on intragroup transfers, and at exiting time, but the PEX regime provides full exemption).	Strong (assets are deemed to belong to the parent and there are thus no intragroup transactions to consider).
Anti-avoidance	Neutral	Neutral	Sacrificed (strict anti-avoidance rules need to be introduced if this option is elected)	Sacrificed (strict anti-avoidance rules need to be introduced if this option is elected)
Simplicity	Adhered to	Compromised	Adhered to	Compromised

(Own formulation)

625 PEX is the abbreviation for the "participation exemption regime".

626 In terms of tax cost setting rules.

627 It appears that this structural element is not affected to a large extent by the policy considerations of neutrality, efficiency, competitiveness and fairness.

7.9 PRACTICAL CONSIDERATIONS

Practical considerations refer to the liability for tax, the member responsible for the filing of tax returns, and uniform tax years for members. The group's tax liability can be allocated between group members in terms of an agreement,[628] particularly where a minority shareholder has a stake in a subsidiary member of the group (Masui, 2004:45).

In the United Kingdom, each group member remains liable for its own income tax, and there is no joint liability for taxation of the group. Agreements are sometimes entered into with minority shareholders in terms of which compensation payments are made in order to satisfy the claim of minority shareholders. Although it is not a requirement of the legislative rules of the loss-transfer regime, the claimant company will normally pay the surrendering company an amount in respect of the tax saving. Assuming a company tax rate of 20% in the United Kingdom, the claimant company will pay the surrendering company 20% of the tax losses surrendered (Pinsent Masons, 2016). Any such payment is ignored for tax purposes.[629] This practical arrangement between group companies ensures an economically neutral situation for both companies,[630] including minority shareholders (Pinsent Masons, 2016). Group members will still have to file individual self-assessment returns separately (Panayi, 2011:34). A qualifying group member normally claims the transfer of losses in its tax return. Claims for the transfer of losses between group companies can be submitted for up to two years after the end of the accounting period[631] (Pinsent Masons, 2016). The claimant company needs to state the amount of relief claimed and provide the name of the surrendering company. The surrendering company then submits its written consent when submitting its tax return. Alternatively, a group may enter into arrangements with the tax authority, in terms of which claims and consents can

628 This also applies to the *Organschaft* model adopted in Germany. The practice in Germany is for members to agree on an apportionment based on the amount actually paid by the parent (Masui, 2004:45).

629 In other words, it will not be taxable as income earned by the surrendering company, nor will it be deductible for tax purposes by the claimant company. Section 410 of the Income and Corporation Taxes Act, 1988.

630 From the viewpoint of the surrendering company, the tax loss that it would have carried forward and used in later years is surrendered and turned into a cash amount. From the viewpoint of the claimant company, the transaction is economically neutral as it now pays the tax that it would have paid to the revenue authorities to its fellow group member (Pinsent Masons, 2016).

631 Claims for relief must be made by one year after the filing date, which normally means within a two-year period from the end of the accounting period. If there is an enquiry into the tax return, the time limit is extended to 30 days after the enquiry is concluded (Panayi, 2011:34).

be included in a single document[632] (Panayi, 2011:33). The amount that is claimed can be less than the amount surrendered, but if the amount claimed exceeds the surrendered amount, then the claim will be ineffective (Pinsent Masons, 2016). Group members are permitted to have different accounting periods (fiscal years). Where the surrendering and the claimant companies' accounting periods do not agree, the loss transfer amount should be apportioned, taking into account any overlapping losses and profits.[633] Where a member company enters or exits the group, the losses of the applicable accounting period are apportioned to make sure that only losses that relate to the consolidation period are used (Panayi, 2011:33).

In consolidation regimes, for administrative convenience, the parent company is liable for tax payment and filing, while the group members remain jointly and severally liable for any default by the parent company (Ting, 2013b:83). In the United States, each group member remains liable for the entire federal income tax of the group, computed on the consolidated return,[634] even though the corporate parent acts as the group's agent for the purpose of filing the consolidated tax form and paying the federal tax liability (Spaulding, 2016). This tax liability cannot be reduced by any agreement between the members of such group or with any other person[635] (McMahon, 2012:136). A single return is completed for all group members. When a consolidated return for a group is filed for the first time, consent from all of the corporations within the group is required.[636] Thereafter, the affiliated group is referred to as a consolidated group, and is required to file a single return each year. Even though a single return[637] is filed, each group member's individual taxable income (or loss) and intragroup transactions are declared. The combined return is based on the combined taxable incomes of the group members. The consolidated return provides for the reconciliation of each member's separate income with the consolidated income. The individual tax identity of every group company is respected by maintaining separate profit

632 Referred to as a "joint amended return".

633 Section 408 of the Income and Corporation Taxes Act, 1988, provides for situations where the companies do not have the same accounting periods, to allow for the transfer of losses on a time-apportioned basis.

634 Section 1502-6(a) of the Internal Revenue Code.

635 Section 1502-6(c) of the Internal Revenue Code.

636 Form 1122, Authorization and Consent of Subsidiary Corporation To Be Included in a Consolidated Income Tax Return.

637 Form 1120, which provides a columnar schedule, reconciling consolidated income with members' separate incomes (Anderson *et al*., 2011:8-47).

and loss accounts, and investment adjustments in respect of intragroup shares. By maintaining separate tax records in respect of each member, accurate tax consequences can be determined when a member company exits the affiliated group[638] (McMahon, 2012:131). All members of the group must use the same tax year as the parent company.[639]

In the Netherlands, the parent company is liable for filing the return (Müller, 2008:267). All taxpayers must request consolidation, when consolidation is sought for the first time. In the case of consolidation with an existing group, the parent company files the request. In terms of the fiscal unity regime of the Netherlands, the tax liability of the group is levied on all group members as if the group members constituted a single taxpayer. All group members are also jointly and severally liable for the tax of the group.[640] The tax years for which tax is levied must be the same for all taxpayers (Müller, 2008:263).

In Australia, all group members are jointly and severally liable for the group's tax liability.[641] This seems to be a contradiction of Australia's "single entity rule", in terms of which the parent company is considered the only taxpayer after consolidation. There is an exception: where a group member has entered into a valid tax-sharing agreement, the subsidiary's liability is limited to the amount determined in terms of the agreement.[642] Because the parent company is deemed to be the only taxpayer, it follows that the parent is responsible for submitting the returns, and that all subsidiaries must have the same tax year as the company does.

7.9.1 Policy objectives influencing practical considerations

The practical considerations are mainly influenced by the single enterprise principle. The policy options relating to this structural element are summarised in Table 7.16 below. The single enterprise principle is adhered to strongly in all consolidation regimes where group members, now acting as a single enterprise, are jointly and severally liable to pay tax, with

638 Also refer to the discussion in Section 7.8 of this chapter.
639 Section 1052-76 of the Internal Revenue Code.
640 Section (*Artikel*) 15(1) of the Corporate Income Tax Act (*Wet op Vennootschapsbelasting*) 1969.
641 Section 721-15(4) of the of the Income Tax Assessment Act, 1997.
642 Section 721-30 of the of the Income Tax Assessment Act, 1997.

the parent company being responsible for submitting a single return on behalf of all the group members, and where group members are required to have a uniform tax year. The United Kingdom's loss-transfer regime does not have these requirements, which indicates a weaker application of the single enterprise principle.

Table 7.16: Comparison of the practical considerations and the related policy options in loss-transfer and consolidation models

Countries:	***United Kingdom***	***United States***	***Netherlands***	***Australia***
Group tax model:	Loss-transfer	Pooling	Attribution	Absorption
Group members' liability	Severally liable	Jointly and severally liable	Jointly and severally liable	Jointly and severally liable[643]
Submission of tax return	Each company	Parent	Parent	Parent
Uniform fiscal year	Not required	Required	Required	Required
Policy objectives:[644]				
Single enterprise principle	Weak	Strong	Strong	Strong

(Own formulation)

7.10 CONCLUSION

It was found in the previous chapter that the taxonomy of a group tax system affects the way in which the structural elements are applied. The two main design options identified as relevant in the South African context should therefore be considered when analysing the structural elements. The first main design option is to extend the tax base (not the taxable unit) by introducing, for example, a loss-transfer model like that of the United Kingdom. The second main design option is to extend the taxable unit (and therefore also the tax base). This can be achieved by introducing a consolidation model. The aim of the present chapter was two-fold: firstly, to identify and analyse the structural elements in

643 Except where the group member has entered into a valid tax sharing agreement.

644 In respect of this structural element, it appears that the policy considerations of neutrality, efficiency, competitiveness, simplicity, anti-avoidance, and fairness are adhered to or compromised in all regimes, equally. These policy considerations were therefore not considered for each country separately.

terms of these two design options, and secondly, to determine how these structural elements are influenced by the different policy objectives that are essential to consider when contemplating the introduction of a formal group tax regime. By using the list of common features identified in Chapter 3 as starting point, the following structural elements were identified: the rules used to compute the tax base of an eligible group on a combined basis (including the proportion of a member's tax base to be included in the combined tax base); the definition of the group of companies (including common ownership requirements and eligibility requirements); the participation rules (whether inclusion in the group tax regime is compulsory or voluntary, whether revocable following a certain period, and whether inclusion relates to all qualifying members); the treatment of losses, including pre-entry tax losses (when entering the group, during consolidation, and when exiting the group); the treatment of assets (when entering the group, during consolidation, and when exiting the group); the treatment of intragroup shares (when entering the group, during consolidation, and when exiting the group); and other practical considerations (the liability of group members, fiscal year end, and submission of tax returns).

From the analysis in this chapter it is obvious that all these structural elements relate differently to the two main design options. It is also clear that the structural elements are influenced by the different policy objectives. In the following chapter, these structural elements will be considered from a South African viewpoint, taking account of South African policy considerations.

CHAPTER 8: A FORMAL GROUP TAX SYSTEM FOR SOUTH AFRICA

8.1 INTRODUCTION

This study has concluded that South Africa needs to introduce a formal group tax system, as the current regime does not deal appropriately with corporate groups in South Africa and which, therefore, cannot be considered a suitable group tax system. It is furthermore clear that it would not be best practice to simply apply another jurisdiction's group tax model in South Africa, because the tax policies on which the model of the foreign jurisdiction is based would also be introduced into the South African tax system. The optimal formal group tax system for South Africa should be one that is developed through a process in which the structural elements underlying international group tax regimes are identified and adapted for the South African context, taking into account of the policy objectives of the South African Government.

In this chapter, the structural elements of formal group tax systems identified in the previous chapter will be examined in a South African context. These structural elements could potentially be used as design parameters, should the government decide to introduce a formal group tax system in South Africa. Furthermore, in this chapter, the various design options for each structural element will be examined and their viability considered in a South African context. In order to determine the most viable design options in a South African context, the recommendations of the Katz Commission on group taxation in South Africa, with regard to each structural element, are taken into account and their recommendations expanded on. It is important to consider that the structural elements relate differently to the two main design options (either extending the tax base (the *company* as the taxable unit) or extending the taxable unit (the *group* as the taxable unit). It is furthermore important to consider the fact that the design options are influenced by related policy objectives. The policy objectives that are relevant when designing a group tax system were identified in Chapter 4, with the single enterprise principle being the core tax objective because it promotes the taxation of multinational corporate groups in line with economic reality. In this chapter, all the policy objectives will be considered in relation to the design options identified as appropriate in the South African context. The Davis Tax Committee (2016a) recently considered the tax objectives of the South African tax system. It is these policy objectives that need to be taken account of. The more closely a design option adheres to the relevant policy objectives, the more suitable the option will be for a South African group tax system. The most suitable design option is then suggested for each structural element, and the chapter concludes by suggesting the optimal group tax system for South Africa.

8.2 SOUTH AFRICAN POLICY CONSIDERATIONS

In Chapter 7, the structural elements underlying group tax systems were discussed in detail. It is submitted that these key structural elements can be used to develop a framework as a starting point for designing a formal group tax system. Seven structural elements were identified:

a) the rules used to compute the tax base of an eligible group on a combined basis (including the proportion of the member's tax base to be included in the combined tax base);
b) the definition of the group of companies (including common ownership requirements and eligibility requirements);
c) the participation rules (whether inclusion in the group tax regime is compulsory or voluntary, whether revocable following a certain period, and whether inclusion relates to all qualifying members);
d) the treatment of losses, including pre-entry tax losses (when entering the group, during consolidation, and when exiting the group);
e) the treatment of assets (when entering the group, during consolidation, and when exiting the group);
f) the treatment of intragroup shareholdings (when entering the group, during consolidation, and when exiting the group); and
g) other practical considerations (the liability of group members, fiscal year end, and the submission of tax returns).

Most of these elements consist of sub-elements and have several design options. The design options adopted by four regimes (the United Kingdom's loss transfer regime, the United States' pooling approach to the consolidation regime, Australia's absorption approach to the consolidation regime, and the Netherlands' attribution approach to the consolidation regime) were analysed in Chapter 7. Generally, the choice of design option depends on the policy objectives of a particular jurisdiction and its application of the enterprise doctrine. In Chapter 4, the following policy objectives were identified as being relevant: the single enterprise principle, competitiveness, anti-avoidance, fairness, efficiency, neutrality, and simplicity, with the single enterprise principle. Competitiveness, and fairness were identified as the dominant objectives, while the single enterprise principle was considered the core objective. Although considered the core tax objective, a strong application of the single enterprise principle does not necessarily imply a better group tax regime, as the stronger the application of the single enterprise principle, the more complex and problematic the group tax system will be. Clearly, no single policy objective can provide for a model group tax regime. Where South Africa must choose between different possibilities, and the ultimate choice will depend on the policy objectives or, simply stated, the South African government's reasons for introducing a formal group tax system. Where there are conflicting policy objectives, the most acceptable policy option[645] will prevail. South Africa's policy objectives, as well as the extent to which the country intends to apply the enterprise doctrine, will most likely determine the most suitable option for the South African corporate tax system.

The Davis Tax Committee (2016a) recently discussed the tax policy objectives of the South African tax system. The single enterprise principle as a tax objective, although not considered as a separate tax objective, appears to be in line with the tax objectives of neutrality[646] and competitiveness[647] Firstly, the Davis Tax Committee (2016a:97) found that the primary focus of tax reform in South Africa should be to move towards greater neutrality by removing "distortions" in the current tax regime. In this regard, it appears that

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645 Where trade-offs exist, the best "second-best" option, used in optimal tax theory, can be applied to determine the most acceptable policy option (see Chapter 4, Section 4.2.8).

646 Neutrality is consistent with taxing the corporate group as a single enterprise (see Chapter 4, Section 4.2.6).

647 Providing tax relief to groups in South Africa that is similar to the relief measures provided by international tax regimes would promote competitiveness as a policy objective (National Treasury 2001:6).

the objectives of the South African Government are in line with both the single enterprise objective and neutrality. Competitiveness is furthermore considered by the Davis Committee (2016a:84; 113) as being part of economic efficiency, and an important objective of South Africa's corporate income tax system. In its report, the Davis Tax Committee (2016a:14), however, warns against pursuing international competitiveness as a main driver if there are "more important" objectives to consider, such as the cost of doing business in South Africa. It appears, therefore, that competitiveness will be compromised in favour of other objectives considered "more important". Thirdly, fairness and efficiency, as tax principles, were used by the Davis Tax Committee (2016a:95) as two of four criteria to assess the South African corporate income tax system in Section 14 of its report. This indicates that the South African Government regards these principles as being important objectives that it needs to achieve in corporate income tax. Anti-avoidance is considered by the Davis Tax Committee (2016a:65) to be of importance, integrated with efficiency (tax revenue) and fairness: "Large scale systematic tax avoidance or evasion by large MNEs not only diminishes the revenues available to governments and inhibits their ability to implement policy objectives but also, by creating perceptions of unfairness, undermines the legitimacy of the tax system as a whole". Fourthly, simplicity as a tax principle was adopted by the Davis Tax Committee (2016b:7) as a design guideline. It was also used by the Davis Tax Committee (2016a:97) to assess the South African tax system overall, indicating its importance as a tax objective. According to the Davis Tax Committee (2016b:7), any decision to introduce more complexity into the South African tax system must be convincingly supported by indisputable proof, as this will lead to higher compliance costs which should be avoided in the South African tax system. This implies that if simplicity is compromised in a group tax system, the South African tax authorities would only introduce the group tax system if the other objectives it achieves outweigh the objective of simplicity.

It is submitted that the same policy objectives regarded relevant by countries that have introduced group tax regimes (as identified in Chapter 4) are also considered to be important from a South African point of view. It is furthermore clear that the policy objectives reported on by the Davis Tax Committee provide for important trade-offs in respect of these policy objectives. Each of the structural elements with their various design options and trade-offs are now considered in a South African context.

8.3 THE RULES USED TO CALCULATE TAX BASE

This structural element, referring to the rules used to combine or consolidate the tax base and the proportion of the subsidiary's taxable profit or loss, is discussed from a South African viewpoint.

8.3.1 Rules used to combine or consolidate the tax base

From the analysis in Chapter 6, the following two main options were identified to calculate the tax base of a group tax system in South Africa: firstly, a group tax model, where the *taxable unit* remains the company but only the *tax base* is extended; or secondly, a group tax model, where the *taxable unit* is extended to include all group companies that qualify, as in the consolidation models. In the second option, not only the extended *taxable unit* (the qualifying group) should be considered, but also the extended *tax base*, in other words, the tax base of the *group*.

8.3.1.1 Group tax models using the company as taxable unit

To calculate the tax base of a formal group tax system in South Africa, one of the possibilities is to consider each company in a group as a separate taxable entity for tax purposes and to calculate its tax base separately but extending it to include profits and losses of other group companies. The introduction of the United Kingdom's loss-transfer model, where each company in a group remains a separate taxable entity for tax purposes and calculates its tax base separately, can be considered. The tax base is extended by allowing one group company, the surrendering company, to surrender its tax loss to another company, the claimant company, to be set off against the profits of that company. These rules that are used to calculate the extended tax base of the group company will clearly result in the least interference with the current South African corporate tax system. In its report, the Davis Tax Committee (2018:84) recommends that, if a group tax system is implemented, the rules of the loss-transfer model should be implemented as an initial group tax system in South Africa. The Davis Tax Committee recommends that a full group tax system should only be implemented once the economy is strong enough to withstand the risk of revenue loss.

8.3.1.2 Group tax models using the group as taxable unit

Using the group as a taxable unit, one of the three international approaches to the consolidation model[648] can be considered for calculating the tax base in a South African context. The three approaches were Australia's absorption approach, the Netherland's attribution approach, and the United States' pooling approach. Before discussing the three different approaches in applying the consolidation model in a South African context, the simplified method of consolidation as suggested by the Katz Commission must first be considered.

a) The simplified approach suggested by the Katz Commission

When the Katz Commission (1995:§10.6.1) reported on group tax in South Africa, they recommended that "a simplified consolidation method" should be introduced first, before progressing to a "full consolidation system" (similar to the Netherlands or Australian models). With regard to the simplified consolidation method, the Katz Commission proposed the following step-by-step consolidation mechanism: in step one, current tax provisions are applied to calculate the taxable income or assessed loss[649] of each group company, separately (Katz Commission, 1995:§10.5.28). This is referred to as the sub-return (Katz Commission (1995:§10.5.28). In addition to the information normally required in the company's separate tax return, the following information relating to intragroup transactions must also be provided in the sub-return: intragroup sales, purchases, dividends, interest, rentals, asset transfers, administration and other service fees, royalties, dividends and pre-acquisition profits set-off against the cost of investments, and write-offs on group share investments (Katz Commission (1995:§10.5.29).

648 Refer to the analysis in Chapter 7.

649 The assessed loss carried forward from the previous year of assessment is taken into account in the normal way, as well as all other deductions (including sections 24, 24C and 18A) (Katz Commission, 1995:§10.5.30).

Thereafter, in step two, adjustments must be made in respect of the following:

- Assets transferred between group members are deemed to be transferred at tax value (rolled over) and any recoupment or capital gain should be disregarded.
- Recoupments on allowances provided for in sections 24 and 24C must be disregarded in respect of intragroup transactions (it is submitted that the transferee and the transferor must be deemed one and the same person in respect of these allowances, as with the current corporate restructuring provisions).
- Bad debt allowances must be disregarded in respect of intragroup transactions.
- Unrealised profits or losses on inventory transferred between group members must be disregarded in the current year of assessment (but reversed in the following year of assessment[650]).
- Deductions in a group context should be apportioned between the relevant group companies and must be prohibited in terms of section 23(g) to the extent that monies are not laid out or expended for the purposes of trade. (Katz Commission, 1995:§10.5.41)

The Katz Commission (1995:§10.5.42) suggested that the following adjustments should be introduced at a later stage, in addition to the adjustments referred to above:

- adjustments, only to the extent that there are mismatches in respect of sections 11(f), 11(g), 11(gA) and 11(h), and the gross income definition;
- adjustments involving capital/revenue mismatches, where differences in tax treatment between two group members occur (for example, the seller is taxed on the profit but the purchaser cannot claim the deduction as it is considered to be capital in nature);
- adjustments in respect of capitalised intragroup interest that is not subject to a tax deduction in the hands of the borrower; and
- interest adjustments in respect of intragroup loans, only to the extent that there are mismatches in terms of section 24J.

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650 It is unclear why intragroup profits on inventory should be reversed in the following year of assessment. No reason is given in the Katz report. The only apparent reason is to keep track of all intragroup profits until the inventory is sold to an outside party, which in the case of inventory is likely to happen in that following year. These intragroup profits will be eliminated again during the consolidation process in the following year, provided the inventory is still on hand. It might, however, lead to a great deal of administration and cost to the taxpayer in keeping track of inventory acquired in intragroup transactions.

All unearned intragroup profits and losses must therefore be eliminated in step two (1995:§10.5.31). In the third step proposed by the Katz Commission, any assessed loss carried over from the previous year of assessment must be added back in each company's separate sub-return to obtain a notional profit or loss figure that will be used in the next step, where all profits and losses are combined (Katz Commission, 1995:§10.5.32).

In step four, the profits and losses of group companies that do not have an assessed loss carried over from the previous year of assessment are consolidated (Katz Commission, 1995:§10.5.33). According to the examples in Appendix 1 of the Katz Commission's report, companies that carry over assessed losses from the previous year of assessment should initially be excluded from consolidation in order to apply the ring-fencing provisions.

These companies' notional profits and losses are only combined in step five, subject to certain limitations:

- Where the company has a notional profit, the profit may be transferred to the consolidated taxable income or assessed loss.
- Where a consolidated assessed loss was calculated, the transfer of the notional profit is limited to the consolidated assessed loss. In other words, the company may only contribute income to the consolidated return up to, but not exceeding, the consolidated loss (Katz Commission, 1995:§10.5.33).
- When all consolidated assessed losses are depleted, any notional profit would be available to be set off against the balance of assessed loss brought forward from the prior year of that individual company.

In step six, the company's balance of assessed loss carried over from the previous year is set off against any remaining profit of the individual company. If a balance of assessed loss remains, it is carried forward by the individual company to the following year of assessment.

Finally, if a consolidated assessed loss is calculated for the group, but there is no notional profit available to transfer from any other group company to offset the loss, the consolidated assessed loss should revert to a group company. If more than one company has incurred an assessed loss in the current year, a decision has to be made as to which group company or companies will carry forward the assessed loss, and to what extent (Katz Commission, 1995:§10.5.33). The Katz Commission (1995:§10.5.33) proposed that the decision should be left to the taxpayer.

As a result there could never be a consolidated assessed loss in the group, as all assessed losses revert to the group company itself (Katz Commission, 1995:§10.5.34). Furthermore, apart from the current year losses, any balance of assessed loss would be ring-fenced and thus be available only to the company in question (Katz Commission, 1995:§10.5.34).

The following example uses information like the examples in Chapter 7 to illustrate the working of the simplified method of consolidation as suggested by the Katz Commission. Assume that Company A earns a net trading profit of R500 000 for an accounting period of 12 months, after taking account of a donation of R50 000 to a public benefit organisation. Company A also has an assessed loss of R100 000 carried over from the previous year of assessment, thus a taxable income for the year of assessment of R400 000. Company B incurs a net trading loss of R300 000 for the same accounting period of 12 months. Assume further that Companies A and B form a group (Company B is a subsidiary of Company A). Included in the net trading profits and losses of both Company A and Company B are intragroup profits on inventory amounting to R20 000. Company A made the profit of R20 000 on stock sold to Company B. Both companies accounted for the intragroup transaction in the same accounting period, Company A as income and Company B as a deduction of expenses. As illustrated in Table 8.1, each company's separate taxable income should first be determined using normal income tax rules. In the second step, these profit and loss amounts are adjusted by eliminating the effects of intragroup transactions, in this case, the intragroup profit of R20 000. Thereafter, in the third step, any assessed loss carried over by an individual company from the previous year of assessment must be added back to obtain a notional profit or loss for each group company to be used in the consolidation process. Only current year losses will be taken into account in the consolidation process, and that prior year losses will be ring-fenced. The consolidation process only starts after this (in step four), when the separate taxable incomes or losses of the members that do not have an assessed loss carried over from the previous year are consolidated first (in this instance, only Company B). Then, in step five, notional profits or losses from members with assessed losses from the previous years are transferred to the consolidated income or loss, subject to certain limitations. As illustrated in Table 8.1 below, the notional profit transferred from Company A is limited to the consolidated assessed loss of R280 000. The rest of Company A's profit remains in the company (R200 000). In step six, the prior year's assessed loss is set off against the remaining profit of R200 000, and Company A is taxed on a taxable income of R100 000. It is submitted that group members will be jointly and severally liable for the taxation on Company A's taxable income of R100 000 (Katz Commission, 1995:§10.5.46). The sub-return of Company A will furthermore be filed and assessed as part of the group return (Katz Commission, 1995:§10.5.43).

Table 8.1: Example of the calculation of the tax base using the simplified method suggested by the Katz Commission

	Company A	Company B	Consolidated
Step 1: Taxable income or (assessed loss)	R400 000[651]	(R300 000)	N/a
Step 2: Elimination of unearned intragroup profits	(R20 000)	R20 000	N/a
Step 3: Assessed loss carried over from the previous year of assessment must be added back	R100 000		
Adjusted profit / (loss)	**R480 000**	**(R280 000)**	**N/a**
Step 4: Consolidation of profits/losses of companies that do not have an assessed loss carried over from the previous year	N/a[652]	R280 000	(R280 000)
Step 5: Transfer of taxable income (from companies with an assessed loss from the previous year) up to, but not exceeding, any consolidated assessed loss	(R280 000)	N/a	R280 000
Separate and consolidated profit / (loss) after consolidation	**R200 000**	**Rnil**	Rnil
Step 6: Deduction of assessed loss brought forward	(R100 000)	N/a	Rnil
Separate and consolidated taxable income / (assessed loss)	**R100 000**	**Rnil**	**Rnil**

(Own formulation)

651 The assessed loss carried over from the previous year of assessment of R100 000 is taken into account in the normal way, as well as all other deductions (including the s 18A donation of R50 000, provided it meets the requirements of the section) (Katz Commission, 1995:§10.5.30).

652 Company A has an assessed loss carried over from the previous year of assessment, and its profit or loss should therefore not be consolidated in the first step of consolidation (step four in this calculation).

Although the calculation of the tax base using the simplified method was suggested by the Katz Commission in 1995, it can still be recommended for South Africa today. It provides for the elimination of intragroup transactions, while limiting the potential negative consequences of assessed losses carried over from previous years. The consolidation of only current year profits and losses, after intragroup transactions have been eliminated, makes it difficult for the taxpayer to manipulate the results of the group to utilise assessed losses carried forward from prior years of assessment. The only challenge posed by the Katz Commission's simplified method is the manner in which intragroup transactions should be eliminated.

In the first place, the question of which intragroup transactions to eliminate must be addressed. The Katz Commission did not envision the elimination of all intragroup transactions in the initial system (Katz Commission, 1995:§10.5.41) but suggested that the elimination of certain intragroup adjustments (intragroup lease premiums, lease improvements, etc.) be postponed to later (Katz Commission, 1995:§10.5.42). It is, however, submitted that all intragroup transactions need to be eliminated from the outset to ensure certainty and, ultimately, a simpler system. In the second place, the elimination of intragroup transactions should be accurate. To eliminate intragroup transactions correctly, the individual member companies must be relied on to provide accurate records and to report all intragroup transactions. Where the financial statements are compiled by different accountants, using financial reporting standards that are subject to choice, without full knowledge of each intragroup transaction that occurred during the year of assessment, this poses a revenue risk to the *fiscus*. This is possibly the reason why the Katz Commission (1995:§10.5.41) suggested that intragroup profits on inventory should be reversed in the following year of assessment. By reversing the adjustments, all intragroup transactions can be traced until the inventory is eventually sold to an outside party. Due to the inherent nature of inventory, the realisation of the profit would probably occur in the same year in which it is reversed. The Katz Commission also emphasized the point that all intragroup transactions should be conducted at arm's length and should be subject to the general anti-avoidance rules and the connected person rules (Katz Commission, 1995:§10.5.37).

The Katz Commission's simplified method has characteristics of the consolidation model (elimination of intragroup transactions) and the group contribution model (allowing for the transfer of losses and profits). In the end, it uses a unique method to calculate the tax base of the group which most resembles the pooling approach of the consolidation models. It is submitted that, with a few amendments and if proper anti-avoidance measures[653] are put in place, as suggested by the Katz Commission, it could be considered in a South African context.

b) International consolidation models

Of the three consolidation approaches, the pooling approach is most like the Katz Commission's simplified approach,[654] except for four major differences:

- With the United States version of the pooling approach, consolidated losses are assessed in the group, i.e. consolidated assessed losses do not revert to the group members which is a simpler, more certain method and in line with the single enterprise principle.
- Not all intragroup transactions are eliminated with the United States approach. Where the net effect of the intragroup transaction is nil, there are no adjustments. It is only where the net effect of the intragroup transaction is not nil that an adjustment is made, for example, where the amount is not included as income in the hands of the recipient company but the same amount is claimed as deduction by the other group company.[655] The deduction is then added back and postponed until the amount is included in the recipient company's income in a subsequent tax year. It is submitted that to eliminate intragroup transactions (also a net effect of nil) provides more certainty and adheres to simplicity which may be preferable in a South African context.

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653 Reversing of intragroup transactions and dealing at arm's length.

654 In terms of the pooling approach of the United States, the tax base is calculated by applying the separate entity principle first - each group company's tax base is calculated separately. Thereafter the single enterprise principle is applied in order to calculate the tax base of the extended taxable unit (consolidated taxable income of the corporate group).

655 This is referred to as the matching rule as it matches corresponding items between group members over time. If it is no longer possible to achieve single-entity treatment under the matching rule, for example when the selling or buying member ceases to be a member of the consolidated group, the intragroup transaction is recognised.

- With the United States approach, it is not necessary to keep track of unrealised intragroup profits on inventory because intragroup transfers are treated as transfers between divisions of a single company, and are excluded from consolidated income until their disposal outside the group.
- To test the limitations of certain deductions, like the donations deduction, the computed consolidated tax base of the group is used[656] in the United States approach. This is a simpler method, which is more in line with the single enterprise principle.

When considering a group tax system for South Africa, it makes sense to initially follow the rules as set out in the Katz Commission's simplified method: by not permitting consolidated assessed losses in order to trace all assessed losses back to a specific group company, and eliminating intragroup transactions to avoid the manipulation of group results in order to utilise assessed losses carried forward from prior years of assessment. It is, however, suggested that the limit should be calculated using the consolidated tax base, and not the individual member company's tax base. In this instance, the United States pooling method is superior in treating the group as a single enterprise, while avoiding the manipulation of deductions within the group. It is also suggested that it is unnecessary to keep track of unrealised profits on intragroup transfers of inventory if the intragroup transactions are eliminated. It is proposed that the complexity of the United States pooling regime, which stems from its treatment of intragroup shareholding, can be simplified and adjusted to suit the South African context. If integrated with the Katz Commission's simplified method, the pooling approach can offer a possible solution.

In terms of the Netherland's attribution approach, the tax base of the group is calculated by consolidating the income and expenses of all group members and eliminating all intragroup transactions. Thereafter, only the parent company, as the taxpayer for domestic tax law purposes, remains.[657] This method relies to a large extent on the financial statements and the reporting of intragroup transactions. The consolidation process used in

656 The individual member's donation deduction is excluded when calculating its separate taxable income, and the deduction is then later computed on a consolidated basis by using the sum of all the members' donation contributions, but limiting the deduction to 10% of consolidated taxable income.

657 For double tax agreement purposes, the subsidiaries are still considered to be independent taxpayers, separate from the parent company.

this approach requires a thorough knowledge of both the financial reporting standards applied in determining the accounting profit of each member company and of each intragroup transaction that occurred during the year of assessment. Firstly, accounting standards often permit flexibility in applying alternative interpretations, which cannot be allowed in taxation.[658] Secondly, not all companies in South Africa comply with the full International Financial Reporting Standards. Different standards are prescribed for different categories of companies.[659] This approach to the consolidation model was suggested as a final stage group tax system by the Davis Tax Committee (2018:79), if group tax is to be introduced, because this approach "allows groups to file as one entity, much like the system for accounting". Although this approach represents a strong version of the single enterprise concept, it is suggested that strict anti-avoidance rules need to be put in place first to ensure that reliable information that is certain, complete and not based on differing principles,[660] is used in the calculation of the group's tax base. As anti-avoidance rules will complicate the South African tax design and lead to high monitoring costs, this option is not suggested for South Africa.

The absorption approach applied in Australia in the calculation of the tax base represents a very strong application of the single enterprise concept, based on highly complex rules.[661] If these rules are adopted in South Africa, accounting systems and reporting systems will have to be adjusted, and both the revenue authorities and the taxpayer, particularly small and medium-sized companies, may find the transition to such a tax

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658 The tax principle of certainty is challenged. Taxpayers may furthermore exploit these accounting disclosure choices to obtain a maximum tax benefit, which will result in a revenue loss for the government.

659 Section 29(5) of the Companies Act, 71 of 2008.

660 The Davis Tax Committee (2018:84) acknowledges the problem of differing accounting principles in their submission when they refer to the banking industry, where subsidiaries are allowed to use diverging accounting systems. The Davis Tax Committee (2018:84) is of the opinion that the level of complex adjustments needed to adapt the accounting profits or losses of the various banking group members to determine its consolidated or combined tax base will outweigh any potential benefit it may have. The Davis Tax Committee (2018:84) also refers to the cost to SARS of changing its systems and obtaining the necessary skills in order to understand the adjustments and the manner in which group members' profits and losses have been consolidated. They warn that this could place a heavy burden on SARS that is unjustifiable. The Davis Tax Committee (2018:84) concludes that the implementation of a group tax system for banking groups may, therefore, not be beneficial.

661 Using complicated rules, consolidated subsidiaries cease to exist as individual companies for income tax purposes, and the parent company accounts for all income and expenses. If a group member later exits the group, the group member acquires a fresh identity by becoming a completely new entity for income tax purposes.

system extremely difficult and costly to deal with. Another problem that needs to be considered is that mismatches[662] could easily be created when implementing rules that apply the strong version of the single enterprise doctrine, as is the case with the absorption approach. These complex rules also create the opportunity for the manipulation of results by the taxpayer[663] and provide avoidance opportunities for taxpayers. It is submitted that the potential mismatches and avoidance opportunities could be prevented by introducing anti-avoidance measures, but it would then also lead to high compliance and monitoring costs. Because of the many problems and complexities of this approach, together with the high emphasis placed on simplicity in the South African tax design, it is not recommended that South Africa use these rules to calculate the tax base of the group when implementing a group tax model.

8.3.1.3 South African policy considerations for rules to combine or consolidate the tax base

It is evident from the Davis Tax Committee Report that South African tax policy places a high premium on neutrality (in line with the single enterprise principle) and on simplicity, which are the two tax objectives that have a significant influence on this element. Of the two main possibilities available, using the *company* to calculate tax base, constitutes a simpler yet weaker application of the single enterprise principle. As is the case in South Africa, the United Kingdom has separate corporate restructuring rules in place in terms of which profits and losses on intragroup asset transfers are deferred until disposed of to an outside party. By adding the loss transfer model to the South African system, a stronger application of the single enterprise principle is established because both objectives of the ideal group tax system are then achieved. It is furthermore cost-effective, as group companies and SARS will not have to adjust their accounting systems significantly. The addition of the loss-transfer model to the current restructuring regime is the option which

662 Mismatches are created because of the interactions between the consolidation regime and other parts of the income tax system that are still based on the separate entity doctrine.

663 Pre-entry losses of a joining subsidiary are limited to an amount representing the loss that the joining subsidiary could have utilised "had it not become a member of the consolidated group". This limitation amount is calculated with reference to the joining subsidiary's market value at the time that the loss was transferred using the "available fraction" rule. The Australian approach also makes use of highly complex rules, known as the "tax-cost-setting" rules, when subsidiaries enter the group in order to adjust the cost bases of their assets and shares. These rules, together with the rules on pre-consolidation losses, can produce inconsistent and arbitrary results as market values are used.

corporate taxpayers in South Africa, particularly small- and medium-sized companies, could most easily transition to. This possibility was suggested as an initial group tax system by the Davis Tax Committee (2018:79) in its report on South Africa's corporate income tax system. It is, however, submitted that this option of having two separate regimes, does not promote simplicity as a policy objective.

Both the Margo Commission (1987:§10.102) and the Katz Commission (1995:§10.3.2) were of the view that, *prima facie,* the loss-transfer model appears to be a simple method, but in actual fact it creates uncertainty and delays, in comparison with the consolidation method. As intragroup transactions are not eliminated, various permutations and combinations during the period in which an election should be made may influence the future results of the companies, and ultimately the decision whether or not to transfer losses (Margo Commission, 1987:§10.102).[664] Because intragroup transactions are not eliminated, the Katz Commission (1995:§10.3.2) was of the opinion that the loss-transfer method does not promote the single enterprise principle and potentially creates an environment for the manipulation of intragroup transactions, the engineering of timing differences, the manipulation of cost bases, and the exploiting of capital/revenue mismatches. Furthermore, as companies are assessed separately, the group companies' results are never submitted together, which would ordinarily provide an audit trail (Katz Commission, 1995:§10.3.2).

It is submitted that, even if South Africa were to supplement its corporate restructuring regime with a loss-transfer approach, as recommended by the Davis Tax Committee (2018:85) once the economy is "strong enough", none of the problems of the current regime would be solved. The current restructuring regime contains serious structural defects and is considered extremely complex. It is submitted that adding to this already flawed regime might create even more problems and further tensions. It appears, therefore, that this option does not adhere to the principle of simplicity, and should therefore not be considered as a viable option.

664 The Katz Commission (1995:§10.3.2) concurred with this viewpoint of the Margo Commission, and in this regard even quoted from the report of the Margo Commission.

The consolidation method, on the other hand, represents a sounder approach to group taxation and the single enterprise principle. The Katz Commission (1995:§10.3.2) was furthermore of the view that the *fiscus* would benefit more from the implementation of a consolidation system because revenue collection would improve in the long run.[665] Initially, the cost of implementing one of the consolidation methods would be higher for both the taxpayer and SARS than the cost of implementing a loss-transfer method would.[666] In its report, the Davis Tax Committee (2018:83) concluded that the approaches followed by Australia and the United States are highly complex, and their rules "extend to hundreds of pages of legislation". Their rules would only add complexity to the tax system and cannot be considered suitable in the South African context (Davis Tax Committee, 2018:83). The Netherlands' regime, considered by the Davis Tax Committee (2018:79) as the simpler approach, is then recommended as a final stage group tax system. It is submitted that this finding of the Davis Tax Committee does not take account of the other pooling regimes, or reasons for the perceived difficulty of the United States pooling regime.

Nevertheless, most of the countries that have introduced the consolidation model as a formal group tax system have implemented the rules of the *pooling* approach to consolidation, probably because of its simplicity. Ting (2013b:271-272) is of the opinion that simplicity is the major advantage of the pooling regime, where the subsidiaries are treated to a large extent as separate entities before adjusting and consolidating the separate taxable profits or losses at group level. Internationally, most corporate tax rules are designed in terms of the separate entity principle, and therefore group tax systems that use the pooling approach can be applied more easily (Ting, 2013b:272).

In addition, the rules of the pooling approach are similar to the simplified method recommended by the Katz Commission. It is suggested that this is a feasible design option that South Africa should consider. Although both the attribution approach and the absorption approach apply the single enterprise doctrine in a much stronger form, these approaches add substantial administrative complexity to corporate tax systems, and the

665 The Katz Commission (1995:§10.3.2) was of the opinion that revenue collection will improve in two ways: manipulations aimed at tax avoidance are limited (only transactions with outside parties are relevant) and a full audit trail is available, as the results of all group companies will have to be presented to SARS.

666 The implementation of a loss-transfer method will, at first, be easier and cause fewer disruptions to tax and accounting systems.

implementation of their rules to calculate the group tax base is not recommended for South Africa, at least not initially. The summary in Table 8.2 below sets out how the different design options relate to South Africa's policy objectives.

Table 8.2: The design options for calculating a tax base in a South African context and the related policy objectives

Design options:	**Loss-transfer method while retaining separate statutes allowing for tax-free transfer of intragroup assets**	**Pooling method (integrated with the Katz Commission's approach)**	**Attribution approach**	**Absorption approach**
Viable option?	NO	YES	NO	NO
Policy objectives:				
Single enterprise principle	Weaker than the other options	Strong	Stronger	Strongest
Neutrality	✓	✓	✓	✓
Competitiveness	✓	✓	✓	✓
Efficiency	Low cost implications for SA initially, but not considered cost efficient in the long run	High cost implications initially[667] Becomes cost-efficient later on	High cost implications initially[668] Becomes cost--efficient later on	High cost implications initially[669]
Simplicity	Compromised (Transition appears relatively simple, but complex in the long run)	Adhered to (relatively simple)	Compromised (Complicated)	Compromised (Complicated)

(Own formulation)

667 Group members need to adjust their accounting systems to ensure the elimination of all intragroup transactions.

668 Group members need to adjust their accounting systems to ensure the elimination of all intragroup transactions.

669 Group members need to adjust their accounting systems to ensure the elimination of all intragroup transactions.

8.3.2 <u>The proportion of the subsidiary's taxable income or loss included in tax base</u>

In most group tax regimes, once a member company qualifies for the group tax regime, 100% of its taxable income or loss is combined or consolidated. This is a simple approach, which is in line with the single enterprise principle and therefore meets the South African policy objectives. It is submitted that the South African group tax system should also include 100% of a group member's taxable gain or loss.

8.4 DEFINITION OF THE GROUP

From the analysis in Chapter 7, it is evident that, to determine which groups will be eligible for group tax relief in South Africa, the provisions of the formal group tax regime should set out the rules to define an eligible group. A group tax system can, however, not function in isolation, as the Companies Act and the Income Tax Act are interdependent and cognisance must be taken of the definition of a group of companies from a company law perspective as well. Presently, in South Africa, the Companies Act defines a "group of companies" as a parent company and all of its subsidiaries.[670] "Control" can be obtained by directly or indirectly exercising the majority of voting rights, or by having the right to appoint the directors who control a majority of the votes at the board meetings.[671] From a company law viewpoint, the reason to define a group of companies is to regulate any possible abuse of control[672] or misconception of the business as a whole[673] (Delport, 2014:164). The focus is not on recognising the group as a single enterprise. Because of this, the definition of a group of companies in terms of the Companies Act should not be used as a starting point when considering eligibility requirements for a group tax system in

670 Section 1 of the Companies Act, 71 of 2008.

671 "Control" in section 2(2)(a) should be read together with section 3(1)(a) of the Companies Act, 71 of 2008.

672 Refers to the control by the parent company over the subsidiary, and examples of sections where the "abuse of control" are regulated can be found in sections 44 and 45 of the Companies Act, 71 of 2008.

673 By providing for consolidated financial statements of the group in addition to the financial statements of the individual companies due to the holding of different assets in different subsidiary companies, any misleading impression of the business as a whole is avoided (Delport, 2014:164).

South Africa, as the recognition of the group as single enterprise should be one of the main objectives for introducing a group tax system.

Presently, the Income Tax Act contains two definitions of a “group of companies”, namely a wider definition[674] that applies in general, and a narrower definition[675] that specifically applies for the purposes of the corporate restructuring rules, but is also applied in other sections in the Act. A “group of companies” is defined in the wider, general definition in the Act by using direct and indirect holding of equity shares to determine common ownership. Currently, an ownership threshold of 70% is required. A “group of companies” consists of two or more companies where the parent company (the “controlling group company”) holds[676] shares in at least one other subsidiary company (the “controlled group company”) to the degree that:

- a minimum of 70% of the “equity shares”[677] in each subsidiary (controlled group company) are directly held by the parent (controlling group company) or one or more subsidiaries (controlled group companies), or any combination thereof; and
- the parent (controlling group company) directly holds a minimum of 70% of the equity shares in another subsidiary (controlled group company).

In relation to the corporate restructuring rules, this wider definition of a “group of companies” is used as a starting point, but is then narrowed[678] by excluding the following companies:

a) any co-operative;

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674 Section 1(1) of the Income Tax Act, 58 of 1962.

675 Section 41(1) of the Income Tax Act, 58 of 1962.

676 The holding can be a direct or an indirect holding.

677 Section 1(1) of the Income Tax Act, 58 of 1962, defines an “equity share” as any share in a company, excluding any share that neither regarding dividends nor regarding returns of capital, carries any right to participate beyond a specified amount in a distribution. In other words, ordinary shares usually qualify as equity shares, while preference shares do not generally qualify as equity shares. Preference shares with unlimited dividend rights will, however, qualify as equity shares.

678 The general, wider definition of section 1(1) of the Income Tax Act, 58 of 1962, is narrowed by the proviso paragraphs to the definition of “group of companies” contained in section 41(1) of the Income Tax Act, 58 of 1962. It is not permissible to interpret the proviso paragraphs as “independent enacting clauses”. The provisions of the proviso paragraphs must be read as if they form “part of the opening words of the definition in section 41(1)” (SARS, 2014:6).

b) an association formed for the advantage of the general public;
c) a foreign collective investment scheme in securities or participation bonds;
d) any non-profit company as defined in the Companies Act, 2008;
e) any company whose gross income is exempt from tax;
f) any tax-exempt public benefit organisation or tax-exempt recreational club incorporated as a company;
g) any company incorporated in a foreign country, unless the company has its place of effective management in South Africa; and
h) any company that has its place of effective management outside South Africa[679] even if it is incorporated in South Africa.

According to National Treasury (2007:22), the original definition of a group of companies used for corporate restructuring was too inclusive and created undue opportunities for tax avoidance. The definition of a group of companies had to be narrowed by providing for certain exclusions. Two main reasons were provided for the exclusion of certain companies. Firstly, companies that are granted special tax concessions[680] are normally not allowed to participate in corporate restructuring relief (see (a) to (f)) (National Treasury, 2007:23). This is in line with international group tax relief.[681] Secondly, also in line with international practice,[682] only resident companies[683] are permitted to enjoy corporate restructuring relief (see (g) above). There is one exception – if the non-resident company has its place of effective management[684] in South Africa, it will be considered to be a South African resident for tax purposes and fully taxed as a South African resident company.[685] Resident companies that have their place of effective management outside

679 Part (i) of the proviso paragraph to the definition of "group of companies" in section 41(1) of the Income Tax Act, 58 of 1962.

680 Fully or partially exempt companies should not be allowed to enjoy intragroup relief (National Treasury, 2007:23; Explanatory Memorandum, Revenue Laws Amendment Bill, 2007).

681 See Chapter 7, Section 7.4.3.

682 Again, see Chapter 7, Section 7.4.3.

683 Foreign companies falling wholly or partially outside the South African tax net must not be able to participate in South African intragroup relief (National Treasury, 2007:23).

684 The place of effective management is not defined in the Act. According to SARS (2015:4), the place of effective management is "the place where key management and commercial decisions that are necessary for the conduct of its business as a whole are in *substance* made". This approach is in line with the OECD's guidance (OECD, 2014: §24.1).

685 In terms of the definition of a "resident" as defined in section 1(1) of the Income Tax Act, 58 of 1962, if such person is incorporated, established or formed in the Republic or has its place of effective

South Africa will also not be allowed to enjoy these corporate restructuring relief measures (see (h) above). The reason for this exclusion stems from the fact that the place of effective management is often used as a tie-breaker rule in double tax agreements to resolve issues of dual residency and override domestic tax laws.[686] A South African resident can be taxed as a non-resident in terms of a double tax agreement. The South African Government clearly does not wish to extend the relief provided by the corporate restructuring rules to a company that is not fully taxable in South Africa as a South African resident taxpayer.[687] This has a negative impact on the neutrality principle, and specifically cross-border neutrality.

The wider, general definition of a "group of companies" is further narrowed in the corporate restructuring rules[688] by excluding certain shareholdings when calculating the 70% threshold. Because the shareholder does not intend to hold certain shares as "a long-term extension of the group", these shareholdings should be ignored for the purposes of the corporate restructuring rules (National Treasury, 2007:23). Two types of shareholdings are ignored, namely shares held as inventory and shares held under a purchase or sale obligation[689] (National Treasury, 2007:23).

To summarise, for a "group of companies" to exist for corporate restructuring relief purposes, both definitions must be considered. In terms of the wider definition, a group must have a "controlling group company" and one or more "controlled group companies". However, if, after applying the two limitations of the narrower corporate rule definition (by excluding certain companies and certain shareholdings) the group no longer has a "controlling group company" and at least one "controlled group company", it cannot comprise a "group of companies". For example, if the 70% ownership requirement is met

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management in the Republic. The definition excludes any person that is deemed to be exclusively a resident of another country for purposes of the application of any double tax agreement.

686 The place of effective management is only one criterion of a number of criteria considered in paragraph 3 of Article 4 of the condensed version of the OECD Model Tax Convention (OECD, 2014: §24.1). .

687 National Treasury (2008:4) confirmed the government's decision to fully exclude all entities partially or fully taxed outside the South African tax net from any corporate restructuring relief.

688 Part (ii) of the proviso paragraph to the definition of "group of companies" in section 41(1) of the Income Tax Act, 58 of 1962.

689 This applies unless the obligation provides for the sale or purchase at market value. Effectively, this means that shares subject to obligations of purchase and sale must be ignored to the extent that the amounts paid differ from the market price of the shares at the time of the eventual acquisition (National Treasury, 2007:23).

but either the “controlling group company” or the “controlled group company” is a foreign company effectively managed in a foreign country, the two companies cannot comprise a group of companies that qualifies for intragroup relief in terms of the corporate restructuring rules. The same applies where the shares in the “controlling group company” are held as inventory by the “controlled group company” (SARS, 2014:2-4[690]).

It is submitted that this narrower definition of a “group of companies”, which is mainly used for corporate restructuring relief purposes in South Africa, can also be used as a starting point for purposes of South Africa’s formal group tax regime. Internationally, the definition of a group for group tax purposes can generally be split into two parts: the ownership requirements and entities eligible to be consolidated. The ownership requirements are generally based on two requirements: firstly, common ownership and control and, secondly, the degree. These requirements are now considered in a South African context.

8.4.1 **<u>Common ownership</u>**

Treating the corporate group as a single enterprise is based on the principle of common ownership. Firstly, the group is under the “control” of the parent company through which the corporate group acts as one enterprise and, secondly, common ownership refers to the “economic integration” of the group members.

Two different approaches can be used by group tax regimes to determine common ownership, namely a legal approach or an economic approach. Currently, the legal approach is used as a criterion in most international group tax systems. The *legal* approach focuses only on “control” and not on “economic integration”, whereas the *economic* approach focuses on both. The *economic* approach has a strong theoretical appeal, but because it relies on subjective measures, it is extremely difficult to apply in practice. Internationally, none of the jurisdictions with group tax systems use the economic approach,[691] and it was suggested in Chapter 7 that this approach should not be

690 Interpretation Note 75 (Issue 2) (22 September 2014).

691 When these approaches were compared as part of the CCCTB proposal, it was also suggested that the simpler, stricter legal approach should be used, rather than the economic approach (European Commission, 2011b).

considered in a South African context. It appears that in tax law, the legal approach is preferred when applying the enterprise doctrine.

Under the legal approach, two types of control can be considered for South Africa, *de jure* control (having the power, by means of shareholding or voting rights, to elect the majority of the board of directors) and *de facto* control (having the power to elect the majority of the board of directors *without* having the majority of the shareholding or voting rights). Currently in South Africa, *de facto* control can be used to determine "control" for financial reporting purposes when applying IFRS 10.[692] Van Noordwyk *et al*. (2014:24-25) are, however, of the view that IFRS 10 has the potential to result in an inconsistent application of the standard because of the complexities and the exercise of judgment that *de facto* control requires. Because of the judgement required to determine *de facto* control, it cannot be used by the tax authorities to determine control in a South African context. Revenue authorities require clear definitions and criteria to identify which entities form part of a group to protect their group tax systems from abuse.

Internationally, most countries with group tax systems have adopted *de jure* control to determine "control", with reference to *shareholding* as it is simpler to administer.[693] Although the use of shareholding to determine control is simple to calculate and easily applied in a practical situation, it is susceptible to manipulation (Ting, 2013b:290). If shareholding is used in a group tax system, anti-avoidance rules should be introduced where the shareholding differs from the voting rights. In addition, ownership thresholds can be defined on a narrow basis, taking account only of *direct* ownership, or on a wider basis, taking account of both *direct and indirect* ownership. Currently, most group tax systems take account of both *direct and indirect* ownership.

In South Africa, the right to exercise the majority of *voting rights*, whether directly or indirectly, is used to determine "control" in a group of companies[694] for purposes of the Companies Act. The Income Tax Act, on the other hand, uses *shareholding* to determine

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692 *De facto* control is recognised by the International Financial Reporting Standard (IFRS) 10, where the practical influence of the parent company is considered, rather than the majority of voting rights.

693 *De facto* control is applied on a limited basis, normally as an additional test to determine "control".

694 Please refer to section 2 (2) (*a*) and section 3 (1) (*a*) of the Companies Act, 71 of 2008, for the meaning of control. "Control" can be obtained by directly or indirectly exercising the majority of voting rights, or by having the right to appoint the directors who control a majority of the votes at the board meetings.

"control" in a group of companies, referring to both direct and indirect ownership.[695] Clearly, the current definition of a group of companies in the Income Tax Act uses provisions to determine control similar to those used by group tax regimes, internationally (shareholding; direct and indirect interest). The inclusion of an anti-avoidance rule where the shareholding differs from the voting rights can be considered in the future. In relation to determining common ownership, the current definition in the Income Tax Act can easily be used as a starting point to implement a group tax system in South Africa.

8.4.2 Degree of common ownership

Internationally, most group tax regimes provide for minimum shareholding requirements that should be regarded as the minimum requirement for common ownership, ranging from a *high* level of shareholding (significantly 100%), to a *relatively high* ownership threshold (more than 75%), to a *relatively low* ownership threshold of more than 50%. Currently in South Africa, in terms of the Income Tax Act,[696] an ownership threshold of 70% is required. It is therefore suggested the *relatively high* option in a South African context refers to an ownership level of more than 70% (not 75%). For purposes of a formal group tax regime in South Africa, it therefore appears that three options should be considered: firstly, a *high* ownership threshold (significantly 100%[697]), which avoids issues of minority interests;[698] a *relatively high* ownership threshold (more than 70% to 95%), where issues of minority interests may arise; and a *relatively low* ownership threshold of 50% to 70%, where additional requirements have to be considered to deal with issue of minority interests.

In its submission, the Davis Tax Committee (2018:79) also suggested higher ownership levels because of the issues of minority holdings. They suggested that the current 70% level must be used because this level of shareholding will ensure that Broad-Based Black

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695 See the definition of "group of companies" in section 1(1) of the Income Tax Act, 58 of 1962.

696 Section 1(1) of the Income Tax Act, 58 of 1962.

697 It is submitted that an ownership level of more than 95% could be considered to equate with significantly 100%.

698 Issues with minority shareholders arise where a company has to pay tax in a current year of assessment, when in the previous year of assessment, the company made losses which were absorbed by the group members in the tax group (majority shareholders enjoyed the advantage). Minority shareholders may require compensation in such a situation.

Economic Empowerment[699] initiatives would not be affected. The Davis Tax Committee (2018:79, 85) furthermore suggested that a 100% ownership level should be introduced at first, if a 70% level is considered to present "too much risk for SARS".

A high ownership requirement indicates that a group of companies forms a strong economic unit, and this is often required in group tax regimes with a stronger application of the single enterprise principle (Australia, 100%. and the Netherlands, ≥95%). The Katz Commission (1995:§10.5.11) recommended that group tax should be introduced in South Africa at a 100% ownership level.[700] Strict international requirements in comparable jurisdictions were given as the reason for a requirement of such a high level of ownership (Katz Commission, 1995:§10.5.14). In order to form part of a group, a subsidiary should have been wholly-owned throughout the year of assessment (Katz Commission, 1995:§10.5.18). In determining the ownership level of 100%, the Katz Commission recommended that equity shares held by full-time employees and directors in terms of share incentives schemes should be allowed, up to a maximum of 10% of share capital (Katz Commission, 1995:§10.5.12). The Katz Commission also suggested that this ownership level should be reconsidered after successful implementation of the group tax system, possibly to lower it to 75%[701] (Katz Commission, 1995:§10.5.13).

A high ownership threshold creates the possibility for a group to purposely include or exclude certain group companies for tax purposes.[702] Anti-avoidance measures should therefore be introduced with a 100% ownership threshold to ensure that subsidiaries are not excluded when consolidation is not tax optimal from the corporate group's point of view. These avoidance opportunities are also possible with other ownership levels (less than 100%), although the risk is smaller. In this regard, the Katz Commission (1995:§10.5.15) recommended that anti-avoidance legislation should be introduced to

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699 In the Broad-Based Black Economic Empowerment Act, 46 of 2013, South Africa's Government provides for its aim to advance economic transformation and the participation of black people in the South African economy.

700 The Katz Commission (1995:§10.5.11) further recommended that the term "wholly-owned" should be defined to refer to both direct and indirect interests held by the parent company, determined on the equity share capital of the companies concerned.

701 Currently (as at December 2018), the definition of a group of companies provides for an ownership threshold of 70%.

702 It is, for example, easy to exclude a group member by selling a single share to an outside party.

avoid situations where corporate groups bring companies together on an artificial basis in order to take advantage of losses and thereafter exclude those companies.

In South Africa, the protection of minority rights was incorporated for the first time in the Companies Act of 2008.[703] Although the minority protection cannot be applied in situations where minorities are disadvantaged due to tax, it indicates that minority protection is becoming increasingly important in South Africa. It also indicates the importance of providing for minority rights if an ownership level requirement of less than 100% is to be introduced in South Africa.

8.4.2.1 South African policy considerations in relation to the degree of ownership

It is suggested that a *high* to a *relatively high* ownership level should be introduced in South Africa in support of the policy objectives of the single enterprise principle that are regarded as important considerations in South Africa – neutrality, fairness, efficiency, and simplicity,. The various design options, as well as the related policy objectives, are summarised in Table 8.3 below.

703 Section 112 regulates the disposal of the greater part of the assets of the company, and provides that the disposal must be approved as determined in section 115. Minority protection is the aim of this provision.

Table 8.3: The design options for the degree of ownership in a South African context and the related policy objectives

Design options:	**50% - 70%**	**70% - 95%**	**≥95% - 100%**
Viable option?	NO, not a viable option	YES, if policy objectives permit	YES, if policy objectives permit
Policy objectives:			
Single enterprise principle	Weak	Stronger	Strongest
Neutrality	Compromised as minority interests exist	Compromised to a lesser extent as minority interests exist	Adhered to
Fairness	Minority rights are challenged to a large extent	Minority rights are challenged to a limited extent	Adhered to
Competitiveness	Adhered to	Adhered to	Compromised as fewer groups will qualify
Efficiency (revenue)	Compromised as more groups will qualify	Compromised to a lesser extent	Adhered to
Simplicity	Compromised	Compromised	Adhered to
Anti-avoidance	Small risk of avoidance (can be managed by introducing anti-avoidance rules)	Small risk of avoidance (can be managed by introducing anti-avoidance rules)	Medium risk of avoidance (can be managed by introducing anti-avoidance rules)

(Own formulation)

8.4.3 <u>Entities eligible to participate</u>

Internationally, unincorporated entities are generally not included in the group for group tax purposes. By including only entities that are similar to companies and by excluding entities that are subject to lower tax rates or exempt from tax, authorities ensure that group tax systems are not abused. The same argument applies in respect of non-resident companies: the inclusion of only resident companies in the group ensures that the group tax system is not abused, as the tax treatment of resident companies is certain and clear. Where non-resident companies are included, opportunities are created to obtain double tax relief – tax losses and certain expenses can be claimed in the home country and in the foreign country.

8.4.3.1 Inclusion of unincorporated entities

Worldwide, only a few countries include unincorporated entities as group members for group tax purposes.[704] Australia is one of the exceptions, where partnerships and trusts are allowed as subsidiaries, but not as holding companies. Currently in South Africa, the Companies Act accepts partnerships and trusts as holding companies, but not subsidiaries (the opposite approach to Australia). The Companies Act defines a "group of companies" as a parent company and all of its subsidiaries.[705] In turn, a "holding company" is defined as a "juristic person" in relation to a subsidiary that "controls" the subsidiary.[706] The definition of a "subsidiary"[707] refers only to a "company" as subsidiary, which excludes a trust or partnership or other "juristic person". For company law purposes, a trust or partnership or other "juristic person" can be a holding company, but it cannot be a subsidiary[708] (Delport, 2014:163). The Katz Commission (1995:§10.5.7) and the Davis Tax Committee (2018:79) proposed that group members should be limited to include only companies.[709] It is recommended that partnerships and trusts should be excluded from a group for South African group tax purposes, in order to promote simplicity and certainty.

8.4.3.2 Exclusion of special taxpayers enjoying concessions

In international group tax regimes, companies that are granted special tax concessions are normally not included in the group. The exclusion is aimed at companies that are taxed in terms of statutes providing specific concessions, while certain regimes even exclude companies in bankruptcy and liquidation from the group tax regime. In this regard, the Katz

704 Limited partnerships are allowed in Italy, New Zealand, and Spain (Ting, 2010:164).

705 Section 1 of the Companies Act, 71 of 2008.

706 Section 1 of the Companies Act, 71 of 2008. The definition refers to "control" as a result of circumstances contemplated in section 2 (2) (*a*) or 3 (1) (*a*).

707 The definition of "subsidiary" in section 1 of the Companies Act, 71 of 2008, refers to section 3 of the Companies Act, 71 of 2008, where it is clear that only a "company" can be considered as subsidiary.

708 Although a trust is deemed to be a "person" in terms of section 1 of the Income Tax Act, 58 of 1962, it is not recognised as a person in terms of the common law. The interest of a trust in certain assets may therefore be questioned, particularly if it involves a discretionary trust, which creates uncertainty whether a trust can be included as part of a group in South Africa.

709 In the past, a close corporation acquired legal personality and corporate status in South Africa by registering in terms of the Close Corporations Act, 69 of 1984. From the date that the recent Companies Act (71 of 2008) came into operation, a close corporation can no longer be incorporated and no company can be converted into a close corporation (Delport, 2014:344). Existing close corporations continue to exist (Delport, 2014:344). Notwithstanding this, close corporations are still included in the definition of a "company" in terms of section 1 of the Income Tax Act, 58 of 1962.

Commission (1995:§10.5.10) recommended that companies that are taxed in terms of a special tax regime, for example companies involved in long-term insurance or mining activities, should not be allowed to benefit from a group tax system. The Commission was nonetheless of the opinion that where all the companies in a group are engaged in the same specialised activity, the group should be allowed to enjoy the relief of a group tax regime (Katz Commission; 1995:§10.5.10). With regard to group companies in liquidation, the Katz Commission (1995:§10.5.21) recommended that the members' results should be taken into account until the finalisation of the liquidation process.

In its submission, the Davis Tax Committee (2018:82) expressed the view that if the taxable income of a special taxpayer is subject to tax at the current company tax rate of 28%, then that trade could be included in the group tax regime, regardless of whether the taxpayer is granted special concessions, provided that the taxable income is calculated before allowing certain special deductions and provided the loss transfer model is implemented.[710]

Presently in South Africa, the narrower definition of a group of companies in the Income Tax Act[711] excludes any co-operative, an association formed for the benefit of the general public, a foreign collective investment scheme in securities or participation bonds, any non-profit company as defined in the Companies Act, 2008, any company whose gross income is exempt from tax, and any tax-exempt public benefit organisation or tax-exempt recreational club incorporated as a company. This definition excludes companies that are granted special tax concessions from the corporate restructuring relief. It is suggested that this narrower definition should be used as a starting point for determining the eligibility requirements of a group for the purposes of a group tax system in South Africa.

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710 In terms of the loss-transfer model, the taxable income or loss of each company can first be determined separately according to the tax provisions applicable to that trade, and only thereafter will the offset of tax losses be allowed. This method allows long-term insurers, farming operations and toll road operations to calculate their taxable income before deducting certain special deductions available to them in terms of special tax concessions. At that stage, the special taxpayer's taxable income or loss is considered on the same footing as the taxable income or loss of normal taxpayers, which means that the offset of losses can be allowed in a group of companies. It is, however, recommended that other tax regimes, specifically mining, oil, and gas, be excluded from group tax relief because of the loss limitation provisions and ring-fencing rules provided for in these regimes. (Davis Tax Committee, 2018:82).

711 Section 41(1) of the Income Tax Act, 58 of 1962.

8.4.3.3 *Inclusion of non-residents*

Internationally, most group tax systems do not allow non-resident companies to become part of the group. A number of European countries, possibly encouraged by the European Union's non-discrimination rules and by certain decisions of the European Court of Justice on the application of the neutrality principle, have extended the scope of their group tax regimes to include local permanent establishments of non-resident companies.[712] In a group context, the alternatives to including only resident companies are:

- a non-resident company can be a group member,
- a permanent establishment of a non-resident company can be a group member,
- a resident subsidiary held through a non-resident intermediary company can be a group member, or
- resident subsidiaries of a non-resident parent company can be group members, regardless of the fact that the parent company is a non-member.[713]

The South African Government's policy regarding the provision of tax relief to non-residents should be considered. Extending group relief, which is generally available only to residents, to non-resident companies raises tax revenue and anti-avoidance concerns. At present, the narrower definition of a group of companies in the Income Tax Act[714] excludes any company incorporated in a foreign country, unless the company has its place of effective management in South Africa, and excludes any company that has its place of effective management outside South Africa, even if it is incorporated in South Africa. In terms of this definition, only resident companies are granted corporate restructuring relief, unless the non-resident company has its place of effective management in South Africa. At present, therefore, the South African Government does not intend that non-resident companies should have the benefit of corporate restructuring relief. It is therefore assumed that the same would apply to group tax relief.

Neither the Katz Commission (1995:§10.5.9) nor the Davis Tax Committee (2018:80-81) were in favour of including non-resident companies for group tax relief and considered it

712 Refer to Section 7.3.2 for a detailed discussion.

713 The purpose of the non-resident parent in such a case is to ensure that the subsidiaries, through common control, qualify as a group.

714 Section 41(1) of the Income Tax Act, 58 of 1962.

inappropriate to allow foreign subsidiaries to be included in group consolidation. The Katz Commission (1995:§10.5.9) and the Davis Tax Committee (2018:81) did, however, envisage that resident subsidiaries that are 100% held by a non-resident holding company should be considered for inclusion.

8.4.3.4 South African policy considerations regarding eligible entities

Where South Africa needs to choose between different alternatives, the ultimate choice will depend on the policy objectives of the South African government. It is suggested that, in view of the policy objectives of neutrality, competitiveness, efficiency, anti-avoidance and simplicity, unincorporated entities like trusts and partnerships should not qualify for South Africa’s group tax relief. In addition, it is suggested that, in support of the policy objectives of efficiency, anti-avoidance and simplicity, special concession taxpayers like mining companies should not qualify for South Africa’s group tax relief. Lastly, it is suggested that non-resident companies should also be excluded from South Africa’s group tax relief in support of the policy objectives of the single enterprise principle, neutrality, competitiveness, efficiency, anti-avoidance and simplicity. The various design options, as well as the related policy objectives, are summarised in Table 8.4 below.

Table 8.4: The design options for eligible entities in a South African context and the related policy objectives

Eligible entities:	**Inclusion of unincorporated entities? Design option: Yes/No**	**Inclusion of special concession taxpayers? Design option: Yes/No**	**Inclusion of non-residents? Design option: Yes/No**
Viable option to choose?	NO, uncertainties regarding the legal persona of trusts and partnerships exist	NO	NO
Policy objectives to consider:			
Single enterprise principle	Strong	Not applicable. These taxpayers are treated differently for tax purposes	Strong
Fairness	Compromised (to include all entities would be fairer)	Not applicable. These taxpayers already enjoy a fair dispensation	Compromised (to include all entities would be fairer)
Neutrality	Adhered to	Compromised	Adhered to
Competitiveness	Adhered to	Not applicable. These taxpayers already enjoy a competitive dispensation	Adhered to
Efficiency	Adhered to (tax revenue concerns)	Adhered to (tax revenue concerns)	Adhered to (tax revenue concerns)
Anti-avoidance	Adhered to (high risk of avoidance that cannot be managed by introducing anti-avoidance rules)	Adhered to (medium risk of avoidance unless managed by introducing anti-avoidance rules)	Adhered to (high risk of avoidance that cannot be managed by introducing anti-avoidance rules)
Simplicity	Adhered to	Adhered to	Adhered to

(Own formulation)

Apart from the effect of the policy objectives, as illustrated in Table 8.4 above, practical considerations should also be taken account of. The current definition of a group of companies in the Income Tax Act, which is used for corporate restructuring rules, is similar to provisions used by group tax regimes, internationally. For this reason, it is suggested that the current definition should be used as a starting point when implementing a group tax system in South Africa. The definition can then be adjusted for group tax purposes, depending on the government's policy objectives.

8.5 THE PARTICIPATION RULES

In the analysis in Chapter 7, the concept of "participation rules" was identified as comprising one of the structural elements of international group tax regimes. This is also an important element in designing a group tax regime for South Africa, and the tax authorities would have to determine the extent to which participation will be voluntary or mandatory, as well as the freedom of choice that a group will have in deciding which qualifying members to include or not to include. In essence, the participation rules entail the following:

- whether participation is mandatory or voluntary;
- whether participation applies to all entities that qualify ("all-in-or-all-out" rule);
- whether participation is revocable or irrevocable, and if revocable, whether a minimum period applies; and
- whether a lower-level holding company should be permitted to be a parent company.

8.5.1 <u>Mandatory or voluntary?</u>

When presented with a choice whether to apply a group tax system, group companies will only elect to apply group taxation if it reduces the overall tax liability of the group. In this regard, the Katz Commission (1995:§10.5.16) and the Davis Tax Committee (2018:81) recommended that South Africa should make its group tax relief voluntary, and only applicable upon application by the parent company. The question whether the application of a group tax system should be mandatory or elective in a South African context is closely related to the degree of common ownership (eligibility requirements or the definition of the taxable unit) chosen. If the degree of common ownership can be adjusted easily and without substantial cost,[715] companies will have an option regarding which entities are to be included. In this case, the fact that the group tax system is mandatory will have little effect. If South Africa wishes to make the group tax system mandatory, anti-avoidance rules should be introduced to ensure that the degree of common ownership cannot be adjusted easily. Currently, the corporate restructuring regime applies automatically, unless the group elects to opt out. To promote fairness and equity, it is recommended that any

715 For example, by selling 1% of the shares where the share ownership requirement is 100%.

formal group tax regime introduced to replace the current regime should provide for the same elective relief.

8.5.2 <u>Irrevocable or revocable consolidation (with or without a minimum period)</u>

Internationally, where a group elects to consolidate, several group tax systems provide that the election to participate in group tax relief is irrevocable, in other words, it applies indefinitely. There are, however, group tax systems that allow revocability, while other group tax systems require annual elections or require that group tax elections remain in force for a limited number of years. The question of revocability relates, to a large extent, to the main design option of the regime; in loss-transfer systems, elections to offset losses are made annually, while consolidation systems normally allow group members to make the election once and then apply it indefinitely or for a limited period. In this regard, the Katz Commission (1995:§10.5.17) recommended that a parent company should be entitled to apply for the group to cease being taxed as a group with effect from the following year of assessment. Thereafter, the parent company would be entitled to apply to re-enter the group tax system again, only after a period of three years has elapsed (Katz Commission, 1995:§10.5.17). The Davis Tax Committee (2018:81) recommended that, depending on the main design option of the regime, an election should be required for a minimum period and rollover periods provided for, for example three-year minimum periods, followed by three-year roll-over periods. It is submitted that a requirement that participation should continue for a minimum number of years or indefinitely would increase the stability and predictability of the South African group taxation system for both the taxpayers and the government. It supports an approach that promotes the single enterprise principle, anti-avoidance and simplicity, but not competitiveness.

8.5.3 <u>Inclusion of all eligible entities?</u>

The Katz Commission (1995:§10.5.16) and the Davis Tax Committee (2018:81) recommended that, once application has been made by a parent company for group tax relief, all companies that at the time of application or at a later stage qualify as part of the group should be obliged to be subject to the group tax system. Where companies fail to qualify, they should cease to be part of the group.

The following rules were identified in international group tax systems in Chapter 7:

- where a group tax system requires all the members who meet the ownership requirements to enter the group tax system, it is referred to as an “all-in” rule; or
- where a group tax system allows none of the group companies to enter if all the group members that meet the group tax requirements do not apply for group tax, it is referred to as an “all-out” rule.

These rules relate closely to the degree of common ownership, and where the degree of ownership can be adjusted easily to include or exclude certain entities, “all-in” or “all-out” rules would be irrelevant. If South Africa wishes to introduce “all-in” or “all-out” rules, anti-avoidance rules should also be introduced to ensure that the degree of common ownership cannot be adjusted easily.

8.5.4 South African policy considerations with regard to the participation rules

Most of the participation rules relate to the single enterprise principle. The single enterprise principle dictates that a corporate group is treated as one, single taxable unit. Therefore, a group tax system with fewer elective components, requiring participation of all eligible members, will promote the single enterprise principle. Competitiveness is the opposing tax objective, as a tax system that provides elective components will be preferred by corporate groups. The more electives that are available in the tax system, the fewer restrictions there will be in the system, which increases the tax system’s competitiveness. Where numerous electives are available, corporate groups will determine the optimal elective for tax purposes and then choose accordingly. When introducing a group tax system, the South African Government should introduce strict rules to ensure that these options are not manipulated. It appears that, as a structural element, competitiveness is opposed to the anti-avoidance and single enterprise principles with regard to participation rules. From the report of the Davis Tax Committee, it became evident that South African should not pursue competitiveness if there are “more important” objectives to consider (like simplicity, fairness and neutrality). However, because the current regime is elective, it is recommended that any formal group tax regime introduced to replace the current regime should also be on an elective basis. The Davis Tax Committee (2018:7) supports this viewpoint, provided that once the election is made, all eligible entities should be included. It appears therefore that the South African group tax system should be voluntary (supported by fairness and anti-avoidance), irrevocable (supported by the single enterprise principle, efficiency, anti-avoidance and simplicity), and include all eligible entities (supported by the single enterprise principle, fairness, efficiency, anti-avoidance and simplicity). The summary reflected in Table 8.5 below sets out how the different design options in terms of participation are influenced by the policy objectives.

Table 8.5: The design options in respect of participation rules in a South African context and the related policy objectives

Participation rules:	**Design option: Mandatory or Voluntary**	**Design option: Irrevocable or Revocable**	**Inclusion of all eligible entities? Design option: Yes/No**
Viable option to choose?	Voluntary	Irrevocable	Yes
Policy objectives to consider:			
Single enterprise principle	Weaker, if voluntary	Stronger, if irrevocable	Stronger, if all eligible entities must be included
Fairness	Promoted if voluntary because the current system is voluntary	Not applicable	To include all entities would be fairer
Competitiveness	More competitive if voluntary	Less competitive, if irrevocable	Less competitive if “all-in” or “all out” rules apply
Efficiency	Short-term tax revenue concerns if voluntary	Less tax revenue concerns, if irrevocable	Less tax revenue concerns if “cherry-picking” is not allowed
Anti-avoidance	Higher risk of avoidance if voluntary	Lower risk of avoidance if irrevocable	Lower risk of avoidance if “cherry-picking” is not allowed
Simplicity	More complex if voluntary	Simpler if irrevocable	Simpler if all eligible entities are included

(Own formulation)

8.6 THE TREATMENT OF TAX LOSSES

An important tax attribute that should be incorporated into the South African group tax regime is the application of tax losses, referred to as “assessed losses” in the South African context. This is because offsetting losses within the group is one of the objectives of a group tax regime. Furthermore, the ability to offset losses among group members is possibly the most important tax advantage of a group tax system for the members of the corporate group.

Internationally, assessed losses can be utilised in the year in which they are incurred or, if a loss cannot be absorbed by a company in the current year, it may be carried back to reduce the profits of previous years. Carrying assessed losses back to previous years of assessment is, however, not permitted in terms of the Income Tax Act in South Africa.[716] Internationally, any excess assessed loss that cannot be used in the current year or carried back is usually permitted to be carried forward. Some jurisdictions limit the period for which losses may be carried forward, but South Africa allows assessed losses to be carried forward indefinitely.[717] The design of loss rules in the South African group tax regime will be important, and there are two types of tax losses that need to be considered: pre-entry tax losses that refer to tax losses incurred by a subsidiary before entering the group, and group losses that refer to the tax losses incurred after consolidation.

8.6.1 Pre-entry tax losses

Internationally, the treatment of pre-entry assessed losses depends to a large extent on the rules used to calculate the tax base, i.e. whether the *group* is the taxable unit or the *company* is the taxable unit. Normally where the *company* is used as taxable unit (loss-transfer systems), pre-entry assessed losses remain with the company as a separate entity, and the tax base is extended to only allow for the utilisation of assessed losses incurred in the group as a single enterprise. Pre-entry tax losses are treated differently where the *group* is the taxable unit (consolidation systems). The treatment of pre-entry tax losses in group tax regimes reveals the tension that exists between the separate entity principle and the single enterprise principle. The pre-entry loss is created when the taxpayer is still a separate entity, but needs to be dealt with after the taxpayer becomes part of the single enterprise and when it exits the group. The treatment of pre-entry assessed losses should therefore be considered in a South African situation at three

716 Section 20 of the Income Tax Act, 58 of 1962.
717 Section 20 of the Income Tax Act, 58 of 1962.

different points of time: at entering, during consolidation, and when the subsidiary exits the group.

8.6.1.1 Treatment of pre-entry tax losses at entry

Internationally, it is common practice to restrict pre-entry tax losses when a member joins the group. This practice is driven by anti-avoidance as a policy objective. The treatment of pre-entry assessed losses originating in the company must be determined on entry of a company into a consolidated group. The analysis in Chapter 7, indicates that there are three design options to choose from:

- the pre-entry assessed losses can be cancelled,
- the pre-entry assessed losses can be quarantined, meaning that they are available for offset only against profits generated by that subsidiary, and lastly
- the pre-entry assessed losses can be transferred to the parent.

8.6.1.2 Treatment of pre-entry assessed losses during consolidation

If the *company* is the taxable unit (loss-transfer systems) in the South African group tax system, pre-entry assessed losses will remain with the company, even while the group exists. If the *group* is the taxable unit (consolidation systems), all assessed losses accumulated during consolidation will belong to the group as a whole, instead of individual members, while pre-entry tax losses of the subsidiary could be treated according to one of three design options:

- the pre-entry assessed losses could remain quarantined and available for offset only against profits generated by that subsidiary,
- the pre-entry assessed losses of a subsidiary could be available for offset against group profits only *after* group losses have been utilised, and
- the pre-entry assessed losses could be transferred to the parent (the absorption method).

Under the quarantine option, two possibilities exist: the pre-entry loss of the subsidiary could be applied either *before* or *after* current group losses (incurred during consolidation) are set off. Although the offset of pre-entry tax losses *before* the aggregation of group results is simpler to calculate and allows a faster rate of utilisation, it was not recommended by the Katz Commission which recommended the offset of pre-entry tax losses *after* the aggregation of group results. This seems harsh, but in South Africa where assessed losses can be utilised indefinitely, a faster utilisation rate to avoid the lapse of an assessed loss seems to be unnecessary. The report by the Davis Tax Committee (2018:7) recommended that pre-entry assessed losses may only be set off against the member's income, and not against the consolidated group's income.

8.6.1.3 Treatment of pre-entry assessed losses at exit

If the South African group tax system is designed with the *company* as taxable unit (loss-transfer systems), the assessed loss remains with the company and no special rules are needed when the group ceases to exist. If the *group* is the taxable unit (consolidation systems), two options exist:

- the balance of the pre-entry assessed losses could revert to the subsidiary, or
- the pre-entry assessed loss could remain with the group (or parent).

Two possibilities were recommended as potential group tax systems for South Africa in the Katz Commission's report: the introduction of a full consolidation system (like the Netherlands or Australian models) or a simplified method. With regard to both methods, the Katz Commission (1995:§10.5.24; §10.5.33) recommended that, upon entry of a company into the group, any pre-entry assessed loss should be ring-fenced and the pre-entry loss should only be set off against income from that specific company (in other words, any pre-entry loss should be quarantined). The philosophy behind the quarantine policy[718] is that it will be inappropriate to offset losses against group profits if those losses were incurred in years when the company was taxed as a separate entity. Under the quarantine policy, any balance of assessed losses reverts to the subsidiary upon exiting the group. The report by the Davis Tax Committee (2018:81) does not reveal any preference in this regard.

718 Also applied by the United States and the Netherlands.

8.6.1.4 South African policy considerations for pre-entry tax losses

Anti-avoidance is normally the reason for applying restrictive rules for pre-entry tax losses in international group tax systems. Allowing pre-entry tax losses poses a revenue threat to governments. The threat with regard to pre-entry tax losses in a South African context was also referred to by the Katz Commission (1995:§10.6.3) when they recommended that the anti-avoidance measures relating to assessed losses, contained in section 103(2)[719] of the Income Tax Act, should be reconsidered if a group tax system was to be introduced. This anti-avoidance provision in the South African Income Tax Act prevents trafficking in assessed losses. The Katz Commission (1995:§10.5.15) reasoned that, based on overseas experience, strict measures are required to prevent taxpayers from artificially bringing companies together to take advantage of potential losses. With the quarantine option suggested by the Katz Commission (1995:§10.6.2; §10.5.25), there is a smaller risk of trafficking in pre-entry tax losses (when compared with the absorption of pre-entry tax losses by the parent). This risk could nonetheless be managed with the introduction of anti-avoidance measures or the extension of the current section 103(2) to ensure its application in a group tax situation. The Davis Tax Committee (2018:83) is also of the opinion that offsetting assessed losses in the group may create opportunities for “aggressive tax planning”.

A South African group taxation system could potentially allow members of a corporate group to gain access to assessed losses originating with other members of the same corporate group. The more assessed losses that are introduced into the group tax, the more competitive the group tax system will become. The greater the amounts of assessed losses introduced into the group tax system, the higher the risk becomes that subsidiaries with assessed losses would only be introduced into group tax to utilise their losses. As discussed previously in this chapter, South African should not pursue competitiveness if there are “more important” objectives to consider (like simplicity, fairness and neutrality). It appears, therefore, that the South African group tax system should quarantine all pre-entry assessed losses. This option is supported by the objectives of competitiveness, anti-avoidance and simplicity.

719 If the requirements of section 103(2) of Income Tax Act, 58 of 1962, are met, a company may be prevented from set-off any assessed loss against other income derived by it.

During consolidation, the offset of pre-entry assessed losses should only be allowed against the subsidiary's profits, and then only *after* aggregation of the group results. This option is endorsed by the objectives of anti-avoidance and simplicity, while competitiveness is compromised. Upon exiting the group, the balance of pre-entry assessed losses should revert to the subsidiary, and this option supports the anti-avoidance and simplicity objectives, while competitiveness, as a trade-off, is compromised.

The summary in Table 8.6 below sets out how the different design options, which are available in terms of pre-entry assessed losses, are influenced by the policy objectives.

Table 8.6: The design options in respect of pre-entry assessed losses in a South African context and the related policy objectives

Treatment of pre-entry assessed losses:	**Upon entry into the system**	**During consolidation**	**At exiting time**
Possibilities:	• **Cancelled /** • **Quarantined /** • **Transferred**	• **Offset against subsidiary profits (before/after aggregation)** • **Offset against group profits** • **Transferred**	• **Balance of loss reverts to subsidiary** • **Balance of subsidiary's loss remains with group**
Viable option?	Quarantined	Offset against subsidiary's profits *after* aggregation of group results	Balance of loss reverts to subsidiary
Policy objectives to consider:			
Competitiveness	Adhered to	Compromised	Compromised
Anti-avoidance	Medium risk	Low risk	Medium risk
Simplicity	Adhered to	Adhered to	Adhered to

(Own formulation)

8.6.2 Group losses incurred during consolidation

Generally, in group tax regimes where the *company* is used as the taxable unit (loss-transfer systems), group members remain separate taxpayers and loss integration is limited to the surrendering and claimant group members.[720] Only current year losses are surrendered, and the surrendering of losses applies only to losses incurred in overlapping accounting periods. By contrast, in group tax regimes where the *group* is used as the taxable unit (consolidation systems), a single tax base is created where profits and losses of all group members are set off against one another. In the consolidation regimes where a strong single entity principle applies, problems occur when a group member exits the group or where the group ceases to be taxed as a group for group tax purposes (referred to a deconsolidation), because of the transition from a single enterprise to a separate entity. A strict application of the single enterprise principle suggests that group losses should be treated as losses incurred by the enterprise as a whole, and should not be apportioned between individual group members. In a South African context, the treatment of assessed losses during consolidation should be considered at two different points of time: during consolidation, and at exiting time or deconsolidation.

8.6.2.1 Treatment of losses during consolidation

If, in a South African group tax system, the *company* is the taxable unit (loss-transfer system), only current year losses will be surrendered, and the surrendering of losses will only apply to losses incurred in overlapping accounting periods. If the *group* is the taxable unit (consolidation system), all assessed losses accumulated during consolidation will belong to the group as a whole, instead of individual members. Depending on whether the *company* or the *group* is the taxable unit, the following options could be used:

- losses can be set off between the claimant and the surrendering company, or
- losses can be set off against profits as part of a single tax base.

In terms of the simplified method recommended by the Katz Commission, a third option can be added to these options. If a consolidated assessed loss is calculated in the group, but there is no notional profit available to transfer from any other group company to offset the loss, the consolidated assessed loss reverts to the group company. If the simplified method is used, there could never be a consolidated assessed loss in the group, as all assessed losses revert to the group company itself (Katz Commission, 1995:§10.5.34). If

720 This normally happens upon bilateral arrangement.

more than one company is responsible for the assessed loss in the current year, a decision has to be made as to which group company or companies will carry forward the assessed loss, and to what extent (Katz Commission, 1995:§10.5.33). Nevertheless, this recommendation by the Katz Commission appears to be harsh, as it applies not only upon exiting the group or deconsolidation, but also *during* consolidation. Because the treatment of losses can be considered the most important benefit of a formal group tax system, it is recommended that the consolidated loss should remain with the group during consolidation and thereafter.

8.6.2.2 Treatment of losses on exiting from the group

If, in the South African group tax system, the *company* is the taxable unit, the assessed loss remains with the company and no special rules are needed when the group ceases to exist. If the South African group tax system is designed with the *group* as the taxable unit (consolidation system), two options exist:

- the group losses could be apportioned to the separate members, or
- the group losses could remain with the parent, which is more in line with the single enterprise principle.

The Katz Commission (1995:§10.5.33) did not suggest how the consolidated loss should be apportioned to the group companies if there is more than one company responsible for the current assessed loss, but recommended that the decision should be left to the taxpayer. In this regard, the United States approach provides a potential method for apportioning the group loss to a specific subsidiary in order to be utilised in the subsidiary's separate tax return. It is submitted that the United States apportionment method could be adjusted and used in conjunction with the Katz Commission's simplified method. The following apportionment formula is suggested:

$$\text{Consolidated assessed losses} \times \frac{\text{Separate notional loss of member}}{\text{Sum of separate notional losses of all members}}$$

The Davis Committee (2018:83) warns that assessed losses may create anomalies. This is of specific relevance where subsidiaries enter or exit a group tax system (move between the single enterprise and the separate entity rules). The implementation of flawed rules can lead to avoidance, uncertainty and an unfair tax system (Davis Tax Committee, 2018:83).

8.6.2.3 South African policy considerations with regard to group losses

The design options in relation to group losses depend on whether the *group* or the *company* is the taxable unit used to calculate the tax base. No design options need to be considered where the *company* is the taxable unit; this would be, for example, where South Africa elects the loss transfer model, as the balance of assessed losses remains with the subsidiary. However, where the *group* is the taxable unit, a single tax base applies and the following design options need to be considered: either the group tax system will allow the group to have a consolidated assessed loss (no limitation) if consolidated losses exceed consolidated profits, or the set off of group losses will be limited to group profits, with any excess consolidated assessed loss reverting to a group member. This requirement, that a consolidated assessed loss reverts to the group company, was recommended by the Katz Commission as part of its simplified method. The Davis Tax Committee (2018:7) made a similar recommendation in its report. This is, however, not the preferred option for a South African context, as competitiveness and simplicity are sacrificed, and it represents a weaker application of the single entity principle than allowing the group to have a consolidated assessed loss does.

When a group member exits the group or deconsolidation occurs, two design options are available:

- the group losses can either be allocated to an exiting subsidiary, or
- they can remain with the parent or group.

The latter option suggests a stricter application of the enterprise principle, while promoting simplicity and competitiveness as policy objectives, and is the preferred option.[721] The

721 A third possibility exists, where groups are permitted to elect either to allocate group losses to an exiting subsidiary or to leave group losses with the parent. This possibility increases complexity in the group tax

summary in Table 8.7 below sets out how the different design options in respect of group losses during consolidation relate to the different policy objectives.

Table 8.7: The design options in respect of group losses during consolidation in a South African context and the related policy objectives

Treatment of group losses incurred during consolidation:	During consolidation	At exiting time
Design options:	• **Group losses are set off against profits as part of a single tax base (no limit), or** • **Group losses are set off limited to group profits – excess consolidated assessed loss reverts to company**	• **Assessed group losses are apportioned to the separate members** • **Assessed group losses remain with group / parent**
Viable option?	Group losses can be set off against profits as part of a single tax base (no limit)	Assessed group losses remain with parent
Related policy objective:		
Single enterprise principle	Strong	Strong
Competitiveness	Adhered to	Adhered to
Simplicity	Adhered to	Adhered to

(Own formulation)

8.7 TREATMENT OF ASSETS

The tax-free intragroup transfer of assets is one of the objectives that a group tax regime ideally aims to achieve. In consolidation regimes, where the *group* is the taxable unit, this aim is achieved. Only one objective is achieved in loss-transfer systems where the company is the taxable unit, namely the set-off of losses within the group. However, if the *company* is the taxable unit in the South African group tax system, the treatment of assets will also not be an issue. South Africa currently has a corporate restructuring regime that deals with the intragroup transfer of assets. Section 45 of the corporate restructuring rules provides for the tax-free intragroup transfer of assets[722]. In the United Kingdom, with its

system but enhances competitiveness, and because of South Africa's policy objectives, it would probably not be considered a viable option. This option is allowed in the Netherlands.

722 An "intragroup transaction" is defined in section 45(1) of the Income Tax Act, 58 of 1962.

loss-transfer system, separate statutes provide similar relief in the case of restructuring transactions. It is possible for South Africa to introduce a loss-transfer group tax system, while retaining its corporate restructuring regime. The Davis Tax Committee (2018:79) suggested this possibility as an initial group tax system in its report on South Africa's corporate income tax system. In this case, this structural element, the treatment of assets, will be dealt with in terms of the corporate restructuring rules, and not in terms of the group tax regime.

As a structural element, the treatment of assets clearly relates only to a group tax system where the *group* is the taxable unit, such as consolidation regimes. When designing a South African group tax system where the *group* is the taxable unit, the lawmakers will have to decide how to treat the assets of a group of companies at three different points in time: on entry of a subsidiary into a group, during consolidation, and when the subsidiary exits the group.

8.7.1 <u>Treatment of assets when entering the group</u>

Assets introduced into the group may bring with them unused tax attributes (tax costs) which could potentially result in gains or losses. The fundamental problem at entry time is how to address these issues when moving from a separate entity to a single enterprise. One way to avoid this problem is by introducing a hybrid system where the assets remain with the consolidated group members, who are treated as separate entities for some purposes, and as part of the single enterprise for other purposes. For group tax purposes, the assets owned by the subsidiary upon joining the group will still be treated as assets of the subsidiary after consolidation. No specific tax treatment is therefore needed for the assets when a subsidiary joins the group. The pooling method and the simplified method recommended by the Katz Commission are examples of hybrid tax systems.

International consolidation regimes analysed in Chapter 7 revealed three broad alternatives to the treatment of assets (other than intragroup shares) when a subsidiary enters the group:

- The first alternative is the deemed sale option where assets are deemed to have been sold to the group at their respective market values, recognising all unrealised gains or losses immediately.[723] The immediate liability for taxation has a negative effect on the attractiveness of this option. Simplicity is furthermore sacrificed, as all assets need to be valued. It is therefore suggested that this is not a viable design option to consider when designing a group tax system for South Africa.
- The rollover method, where the unrealised gains or losses are attributed to the group with no immediate tax consequences for the subsidiaries on entry into the group, provides a better alternative for the South African situation.[724] The rollover method is currently also applied in the corporate restructuring rules in South Africa. Anti-avoidance rules govern the rollover provisions in the corporate restructuring rules in the form of an 18-month deemed sale rule and de-grouping rules, amongst others. [725]Taxpayers perceive the current anti-avoidance rules as being unnecessarily harsh and extremely unfair. It is therefore suggested that these anti-avoidance rules should be amended, if these rules are to be used as part of the South African group tax system.
- The final alternative is the asset-based method, where the cost bases of assets in a subsidiary are reconstructed when entering the group and are replaced with the reset cost bases. The reset cost base amount is computed using complex tax provisions based on subjective valuations, which provide opportunities for taxpayers to manipulate the cost bases.[726] Although this method represents the strongest application of the single enterprise principle, it also carries a high risk of tax avoidance, as it provides an opportunity for taxpayers to manipulate the cost bases, which could have a negative impact on tax revenue. This method is therefore not recommended for the South African context.

723 In the Netherlands, this option is applied on intercompany receivables and interests held by the parent company in its subsidiaries.

724 This option has been adopted by the Netherlands (applies only to assets not subject to the deemed sale option). The pooling method applied by the United States also ensures that unrealised gains or losses are rolled over, although the method of deferring the unrealised gain or loss differs from the method applied in the Netherlands. A method, similar to the rollover method used by the United States, is applied in the simplified method recommended by the Katz Commission.

725 Refer to the discussion in Chapter 7, Section 7.7.

726 In terms of the Australian absorption approach, the cost bases of assets are reconstructed using complex rules.

8.7.2 Treatment during consolidation: intragroup asset transfers

If the *company* is the taxable unit (loss-transfer system) in the South African group tax system, and the current corporate restructuring regime is retained, the intragroup transfer of assets can occur in a tax neutral manner within the group only if the requirements of section 45 of the corporate restructuring rules are met. The tax-free transfer of assets would, therefore, be regulated in terms of the corporate restructuring regime and not in terms of the group tax system itself. Where the corporate restructuring rules apply, any gains on intragroup transfers could be deferred until the assets are disposed of outside of the group.

If the *group* is the taxable unit (consolidation system) in the South African group tax system, the *group tax system* itself should provide for the tax-neutral transfer of assets. In terms of the single enterprise principle, subsidiaries should be treated as divisions of the parent company, and intragroup asset transfers should be treated as transfers between divisions of a single company, without any tax implications. This can be achieved by using the rollover approach where any unrealised gain or loss is rolled over from seller to transferee without immediate tax consequences. The Netherlands rollover method provides for the rollover of the tax cost history to the transferee company, and is familiar in the South African tax environment as it is currently used to transfer assets, tax-free, in terms of the corporate restructuring rules. It is therefore a suitable option for the South African context. Another alternative to consider is the pooling method used by the United States.[727] In terms of this method, the subsidiary's taxable income is calculated separately, before consolidating group members' profits and losses to calculate the tax base of the corporate group. To calculate consolidated income, intragroup gains and losses are, however, *not cancelled* but are excluded from consolidated income and *deferred* until a subsequent event[728] triggers recognition. With the Unites States pooling method, proper records must be kept of all assets transferred within the group. The deferred gain or loss is only recognised once the asset is sold to a third party outside the consolidated group. This alternative rollover method could be considered by the South African lawmakers if they intend to employ a hybrid method like the simplified method suggested by the Katz Commission. In terms of the simplified method, asset transfers between group companies

727 This is also a hybrid method similar to the simplified method suggested by the Katz Commission.
728 For example, the disposal of the asset to a third party.

will initially be recognised when the separate entity principle is applied to calculate each group company's tax base separately. Thereafter, all profits and losses on intragroup asset transfers are cancelled in step two (Katz Commission, 1995:§10.5.41). The problem with cancelling intragroup asset transfers is the lack of a system to trace the tax history of the assets transferred between group members. It is submitted that the Katz Commission's simplified approach should be adapted to provide for the rollover method for dealing with intragroup asset transfers, rather than cancelling intragroup asset transfers. In terms of the Australian approach, all assets remain with the parent company after consolidation, and there are no tax consequences if transferred within the group during consolidation.

8.7.3 Treatment of assets at exiting time

If the South African group tax system is designed with the *company* as the taxable unit (loss-transfer systems), the assets remain with the company and no special rules are needed when a group member exits the group. If the *group* is the taxable unit (consolidation systems), the rules are complex, mainly because of the changeover from the single enterprise doctrine to the separate entity doctrine. This problem can be avoided by introducing a hybrid system where the assets remain with the consolidated group members, which are treated as separate entities. Upon exiting the group, the original cost base is simply recaptured. This method is considered as optimal in consolidation regimes (Ting, 2013b:289). Any unrealised profits and losses on intragroup asset transfers during consolidation, which previously had no tax implications for the consolidated group, should, however, be realised when a subsidiary exits the group. It is submitted that because the simplified method suggested by the Katz Commission does not provide for the tracing of intragroup asset transfers, it would be difficult to determine the gain or loss at exit. This problem can be addressed by either providing for tax cost rollover provisions like the Netherlands method, or deferring unrealised gains or losses in terms of the United States rollover method. In this regard, the pooling method of the United States is recommended, as it provides for deferring unrealised gains on intragroup asset transfers until the happening of a subsequent event. The departure from the group by the buyer or seller member is considered a subsequent event, and the deferred unrealised gains and losses will be recognised when the subsidiary exits the group. There are four design options at exiting time: the recapturing of tax bases, the rollover of tax bases,[729] the deemed sale method,[730] and the resetting of the cost bases.[731] [732]

8.7.4 South African policy considerations with regard to the treatment of assets

Design options depend on whether the *group* or the *company* is the taxable unit used to calculate the tax base. No design options need to be considered where the *company* is the taxable unit, for example where South Africa elects the loss transfer model, as the assets remain with the separate companies. Where the *group* is the taxable unit, a single tax base applies and design options need to be considered when entering the consolidated group, during consolidation, and when exiting the group.

Upon entry into the consolidated group, the rollover option appears to be the preferred option in the South African context. This option supports the competitiveness and simplicity objectives. In international consolidation regimes, the rollover option is the most common, as well as the most favoured, policy objective adopted upon joining the group and during consolidation (Ting, 2013b:291). It is also the preferred option for South Africa during consolidation and is supported by the single enterprise principle, competitiveness and simplicity.

The design option chosen where a subsidiary exits the group depends on the design option chosen during consolidation. Where the United States rollover method is followed during consolidation, the cost bases of assets should be recaptured when a subsidiary exits the group. Where the Netherlands rollover method (like the corporate restructuring

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729 The Netherlands roll-over option provides that where the transferor or the transferee exits the consolidated group, the group relationship (single enterprise) ceases to exist and the gain is actually realised by disposing of the asset to an outside party (the exiting member). The roll-over option promotes the objective of simplicity but violates the anti-avoidance objective.

730 The deemed sale option where assets are deemed to have been sold to the exiting subsidiary at their respective market values, recognising all unrealised gains or losses immediately. This option violates the realisation principle in tax by taxing unrealised profits at entry and exiting, and it is therefore not a viable design option to consider when designing a group tax system for South Africa.

731 The Australian asset-based method requires the cost bases of assets in a subsidiary to be reconstructed at exit time. There are no unrealised gains or losses to be recognised when the subsidiary exits the group. In terms of the tax cost setting rules, the process that applied at entry time is reversed and the exiting subsidiary inherits the parent company's reset cost bases of its assets. .

732 Refer to Section 7.7 of Chapter 7 for a detailed discussion of the design options.

rules) is followed during consolidation, the rollover method must be applied when a subsidiary exits the group. Both these methods are superior to the Australian method of resetting cost bases which, because of its extreme complexities and avoidance issues, is not preferred in the South African context.

The summary in Table 8.8 below sets out how the different design options available in terms of the treatment of assets are affected by conflicting tax objectives.

Table 8.8: The design options in respect of the treatment of assets in a South African context and the related policy objectives

Treatment of assets:	**Upon entry into the system**	**During consolidation**	**At exiting time**
Design options:	• **Deemed sale /** • **Rollover /** • **Transfer to parent**	• **Rollover (United States or Netherlands)** • **Remain with parent**	• **Recapture: Strong** • **Rollover: Weaker** • **Deemed sale: Strong** • **Transfer to subsidiary at reset cost bases: Strong**
Viable option?	Rollover	Rollover (United States or Netherlands)	Recapture or rollover depending on the method used during consolidation
Policy objectives to consider:			
Single enterprise principle	Weaker	Strong	Recapture: Strong Rollover: Weaker
Competitiveness	Adhered to	Adhered to	Recapture: Adhered to Rollover: Adhered to
Anti-avoidance	Adhered to	Adhered to	Recapture: Adhered to Rollover: Compromised
Efficiency	Adhered to	Adhered to	Recapture: Adhered to Rollover: Compromised
Simplicity	Adhered to	Adhered to	Recapture: Compromised Rollover: Adhered to

(Own formulation)

8.8 TREATMENT OF INTRAGROUP SHAREHOLDING

The treatment of intragroup shareholding relates broadly to the treatment of assets, except that this element concerns only shares. Due to the complex issues involving shares, particularly intragroup shareholdings, the treatment of intragroup shareholding is discussed separately. This structural element is closely connected to the multiple levels of ownership in corporate groups, which often leads to more than one layer of tax being imposed on the same company profits.[733]

Internationally, several jurisdictions have included solutions to the double tax problem as part of their group tax systems. It is evident that this structural element, like the treatment of assets, relates only to a group tax system where the *group* is the taxable unit, such as consolidation systems. This problem does not exist in group tax systems where the *company* is the taxable unit. When designing a South African group tax system, the lawmakers must first decide whether separate provisions regarding intragroup shareholding are necessary. If the decision is made to treat intragroup shareholding differently from other assets, the decision will have to be made how to treat the shareholding of a group member at three different points in time: on entry of a group member into a group, during consolidation, and when the group member exits the group.[734]

A comprehensive solution to deal with this issue of potential double taxation is the PEX regime, in terms of which double taxation is removed at the level of the shareholder (parent company) by providing tax relief for dividends and/or capital gains. In South Africa, any distribution by a company is either a "*return of capital"* (a distribution from "contributed tax capital"[735]) and therefore subject to tax on capital gains,[736] or a *"dividend"*[737] and

733 In a group context, the historical cost of assets held is recorded at two levels: At the company level (subsidiary), the company's assets are recorded at base cost ("inside basis"); while at the shareholder level (parent company), the company's shares are recorded at base cost ("outside basis"). If the assets held at the subsidiary level increase in value, the value of the shares owned by parent company also increases. Any profit on the realisation of the assets will eventually be taxed in the hands of the subsidiary and the parent company. The problem increases exponentially with the increase of the number of shareholding levels in the group (in deeper group structures). This is often referred to as the "cascading effect". For an in-depth discussion, please refer to Chapter 7, Section 7.8.

734 These rules are dealt with extensively in Chapter 7.

735 The definition of "contributed tax capital" is defined in section 1 of the Income Tax Act, 58 of 1962.

736 Paragraph 76B of the Eighth Schedule of the Income Tax Act, 58 of 1962.

subject to dividends tax. Generally, most distributions in South Africa will qualify as dividends and will therefore be subject to dividends tax. The South African dividends tax regime provides for the exemption of dividends declared by a resident company.[738] Because of this exemption, any dividend declared by a resident subsidiary to its parent company, as beneficial owner of the dividend, will be exempt.[739] Where a dividend consists of an asset *in specie* and the beneficial owner and the company that pays the dividend form part of the same group of companies, the dividend will also be exempt from dividends tax.[740] Clearly in South Africa, the parent company of a group of companies would be exempt from tax on any intragroup company distribution in the form of a local dividend. The South African tax system also includes two other participation exemptions, one in relation to foreign dividend income[741] and the other in relation to capital gains or losses on the disposal of shares in a foreign company.[742] This means that participation exemptions in respect of both dividends and the capital gains already exist in respect of any foreign company distributions. For certain foreign company distributions, double taxation may still exist where the ultimate shareholder is a natural person with a marginal tax rate lower than 45% (Davis Tax Committee, 2018:18). It is submitted that because non-resident companies are generally excluded from domestic group tax relief, it would not have a large impact on intragroup shareholdings. Additional research is, however, recommended for foreign company distributions where the ultimate shareholder is a natural person who is not taxed at the maximum marginal rate.[743]

When designing a group tax regime for South Africa, the tax authorities will have to consider whether it is necessary to provide additional relief, over and above the current participation exemptions. An advantage of the current PEX regime is that it is applicable to all groups of companies. It is furthermore applicable equally to resident and non-resident

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737 The definition of a “dividend” is defined in section 1 of the Income Tax Act, 58 of 1962.

738 The South African dividends tax regime also provides that a company that declares and pays a dividend, is relieved of the obligation to obtain a declaration and written undertaking where the beneficial owner and the company that pays the dividend form part of the same group of companies as defined in section 41. See section 64F(1)(*a*) of the Income Tax Act, 58 of 1962. .

739 Section 64G(2)(*b*) of the Income Tax Act, 58 of 1962.

740 Section 64FA(1)(*b*) of the Income Tax Act, 58 of 1962.

741 Section 10B(2)(*a*) of the Income Tax Act, 58 of 1962.

742 Paragraph 64B(1) of the Eighth Schedule of the Income Tax Act, 58 of 1962.

743 Refer to Chapter 5 for a detailed discussion of the participation exemptions.

shareholders, and provides a general and neutral solution to intragroup shareholdings.[744] To restrict the participation exemption only to companies qualifying for a group tax system would make South Africa's corporate tax system less attractive to investors. On the other hand, if specific measures are introduced to avoid double taxation in a group tax system, taxpayers could manipulate the system to claim both the current PEX regime and the exemptions provided in the group tax system. Specific anti-avoidance provisions are therefore necessary to protect any exemption from abuse.

8.8.1 <u>South African policy considerations with regard to intragroup shareholding</u>

Generally, when designing a group tax system, the policy on intragroup shareholding is the most difficult structural element to design because the double tax problem creates numerous issues in different parts of tax systems, and complex rules[745] need to be introduced to solve this problem (Ting, 2013b:291). The solution depends on whether a general PEX regime is available to domestic groups in the jurisdiction. It is submitted that no design options or related tax objectives need to be considered where a jurisdiction has a proper PEX regime. Currently, a PEX regime is in place in South Africa. It therefore seems unnecessary to introduce rules to deal with intragroup shares to avoid double taxation when designing a new group tax system for South Africa. It is suggested, though, that during the final stages of designing the South African group tax regime, the current PEX regime should be investigated to ensure that no double tax problem or avoidance issues arise due to interactions between the two regimes.

744 Although the participation exemption in respect of capital gains applies only to resident shareholders when disposing of foreign shares (Paragraph 64B(1) of the Eighth Schedule of the Income Tax Act 58 of 1962), it is submitted that non-resident shareholders will not need this exemption, as the disposal of foreign shares will in any case be excluded from the incidence of taxation in South Africa (not South African source).

745 Two group tax regimes serve as examples of these complex rules. The Australian applies the asset-based method to deal with intragroup shareholding issues. Because of the complexity of this regime (difficult "tax cost setting" rules are applied), the tax objective of simplicity is sacrificed in the process. This method also carries a high risk of avoidance, as it provides an opportunity for taxpayers to manipulate the cost bases, which could negatively impact on tax revenue. The United States does not have the benefit of a general participation exemption regime for domestic corporate groups, and to avoid the imposition of double taxation on the disposal of shares in a subsidiary that exits the pooling regime, the cost base of intragroup shares is adjusted with profits already taxed during consolidation. This policy is, as is the case with the policy of Australia, extremely complex because it has to be maintained throughout the consolidation process, it also has high compliance costs.

8.9 PRACTICAL CONSIDERATIONS

Practical considerations concern the liability for tax, which member is responsible for the submission of a tax return, and whether uniform tax years are required amongst members. The Katz Commission recommended as follows:

- Each group member should be jointly and severally liable for the income tax liabilities of the group (Katz Commission, 1995:§10.5.46).
- Only a group tax return should be lodged (Katz Commission, 1995:§10.5.45). Each group member's sub-return should be filed as part of the group return. Upon entering the group tax system, the file of a group company should be marked "consolidated", with a cross-reference to the group return (Katz Commission, 1995:§10.5.43).
- Provisional tax returns should also be lodged on a consolidated basis (Katz Commission, 1995:§10.5.47).

The Katz Commission (1995:§10.5.17; 10.5.20) did not specifically recommend uniform tax years, but they did, by implication, suggest that uniform tax years should apply to all group members. Although the Katz Commission made no recommendations concerning the company responsible for submitting the returns and paying the group's taxes, it is suggested that one company (preferably the parent company) should be held responsible.

The Davis Tax Committee (2018) did not specifically comment on any of these practical considerations.

8.9.1 South African policy considerations with regard to the practical considerations

A strong application of the single enterprise principle requires that the corporate group members should be jointly and severally liable to pay tax, have a uniform tax year, should submit a single return, and that one company, normally the parent company, should be responsible for submitting returns and paying the group's taxes on time. These requirements are similar to the recommendations made by the Katz Commission (1995).

The practical considerations depend to a large extent on the main design option applied when designing the South African group tax system. If the *company* is going to be the taxable unit in the South African group tax system, a weaker single enterprise principle will be implemented, and the design options would be adjusted accordingly. In group tax regimes where the *company* is the taxable unit, each company is severally liable for its tax obligations.[746] Each company submits its own return and the claimant company normally claims the loss on its company tax return by specifying the amount of relief claimed and the name of the surrendering company. Group members are often permitted to have different fiscal years, with losses apportioned to the overlapping periods. If the *group* is to be the taxable unit in the South African group tax system, a strong single enterprise principle will be upheld. It is also the preferred option for South Africa during consolidation, and is supported by the single enterprise principle as set out in the summary in Table 8.9 below.

Table 8.9: The design options in respect of practical considerations in a South African context and the related policy objectives

Practical considerations:	**Jointly and severally liable? Design options: Yes/No**	**Member responsible for submission of tax return? Design options: Parent / each group member separately**	**Uniform fiscal year? Design options: Yes/No**
Viable option to choose?	Yes	Parent	Yes
Policy objectives to consider:			
Single enterprise principle	Strong	Strong	Strong

(Own formulation)

746 Instead of group members being severally liable for the tax liabilities, the liability for tax can be allocated between group members in terms of an agreement, especially when a minority shareholder has a stake in a subsidiary member of the group. Alternatively, compensation payments can be made in order to satisfy the claims of minority shareholders.

8.10 CONCLUSION

In this chapter, the design options in respect of the structural elements of formal group tax systems were examined in a South African context. Firstly, the structural elements relate differently to the two main design options: having either the *company* or the *group* as the taxable unit. This is an important factor and was considered in respect of each structural element and should also be considered when designing a formal group tax system for South Africa.

It was previously argued that the design options are influenced by the policy objectives of a jurisdiction. The policy objectives that are relevant when designing a group tax system were identified in Chapter 4 of this study as comprising the single enterprise principle, competitiveness, anti-avoidance, fairness, efficiency, neutrality and simplicity, with the single enterprise principle, competitiveness, and fairness as dominant objectives, while the single enterprise principle is considered as the core objective. In this chapter, the relevant policy objectives were reconsidered, this time in the South African context. It was found that the same policy objectives regarded as relevant by countries that have introduced group tax regimes are also regarded as important for South Africa. It was also found that the policy objectives reported on by the Davis Tax Committee provide for important trade-offs that should be considered when contemplating viable design options. For instance, if simplicity is compromised, the South African tax authorities would only introduce the group tax system if the other objectives it achieves outweigh the objective of simplicity.

The structural elements with their different design options were then evaluated in relation to the policy objectives and their trade-offs in a South African context. Different design options were described for each of the seven structural elements, in a South African context. As part of the process, viable design options in respect of each of the structural elements were identified in line with the South African policy objectives to determine the policy options most suited to the South African context. The more a design option adheres to the relevant policy objectives, the more suitable the option will be in a South African group tax situation. Finally, the following design options are suggested for each structural element in a South African group tax situation:

- The rules of the pooling approach of the consolidation model appear to constitute the most appropriate way to calculate the tax base (adjusted to integrate the suggestions by the Katz Commission in terms of its simplified approach).
- The most suitable way to define the group of companies would be with reference to its *shareholding* as constituting a *relatively high* to a *high* ownership level, providing for a minimum ranging from 70% to 100%. Anti-avoidance measures should be implemented if a 100% ownership threshold is introduced to ensure that subsidiaries are not excluded when consolidation is not tax optimal from the group's point of view. It was submitted that entity forms other than companies, special concession taxpayers, and non-residents should be excluded.
- It is suggested that participation rules should provide for the voluntary application of the group tax system. Once elected, it is submitted that the group tax relief regime should be irrevocable and include all eligible entities.
- In relation to pre-entry assessed losses of a subsidiary, it is recommended that the losses should be ring-fenced upon entry into the group, and only be allowed to be set off against income of that subsidiary *after* the aggregation of group results. Upon exiting the group tax system, the balance of the pre-entry assessed loss should revert to the subsidiary. In terms of assessed group losses incurred during consolidation, it is suggested that these losses should be set off against profits as part of a single tax base (without a limit). Assessed group losses should remain within the group once the subsidiary exits the group.
- It is recommended that the rollover method be applied in respect of assets when a group member enters consolidation and during consolidation. Both the Netherlands method of rollover (similar to the method currently used in the corporate restructuring regime) and the United States method of rollover seem to be suited for the South African setting. Depending on the rollover method applied, the cost bases are either recaptured (United States method) or rolled over (Netherlands method) where a group member exits the group.
- It is suggested that it is unnecessary to introduce group tax provisions for intragroup shareholdings to avoid double taxation, as South Africa already has participation exemption rules in place.

- It is recommended that group members should be jointly and severally liable to pay tax, the parent company should be responsible for submitting tax returns, and group members should have a uniform tax year.

These recommendations, it is submitted, represent the most suitable options that are in line with the relevant policy objectives in respect of each of the seven structural elements. The analysis of the seven structural elements in this chapter can be used as a starting point to design a formal group tax system for South Africa. The next chapter of this study (Chapter 9) concludes this study by recommending a suitable group tax regime for South Africa

CHAPTER 9: CONCLUSION AND RECOMMENDATIONS

9.1 INTRODUCTION

The company, as artificial entity form, officially introduced into law in the 1700s to suit the needs of economies, is still relevant in modern economies. The characteristics of a company, in specifically the separate legal entity principle, adopted by traditional jurisprudence in the 18th century still serves the needs of modern society, particularly for companies that do not form part of a group, but operate on their own. Conducting business in the form of a company has undergone radical changes since the late 1700s, and a new business vehicle, the corporate group consisting of multiple companies operating in multi-tiered corporate structures, has emerged. This new entity form, the corporate group, is influential and powerful, and much of business today is conducted using the corporate group as an entity form. These corporate groups have a major influence in the modern economic world, operating across borders as large multinational companies. The emergence of multinational corporate groups requires a new bold approach in which the corporate group, as a whole is taxed as the enterprise, and not the constituent companies. Since the beginning of the 21st century, an increasing number of jurisdictions have implemented formal group tax regimes that recognise the corporate group as the economic unit. The present study evaluated the taxation of groups of companies in South Africa with the aim to propose an appropriate group tax regime for South Africa.

9.2 RESEARCH OBJECTIVES ACHIEVED

To propose a suitable group tax regime for South Africa, several objectives, identified in Chapter 1, had to be achieved in this study. These objectives and their outcomes are now discussed.

9.2.1 Best practice with regard to formal group tax regimes

To be equipped to recommend a suitable formal group tax regime for South Africa, it was necessary to explore international best practice by comparing formal group tax systems that are applied in comparable tax jurisdictions. Formal group tax regimes refer to group tax regimes that achieve at least one of the two ideal objectives: the tax-free intragroup transfer of assets within a group and the set-off of losses within the group. The ideal objectives should furthermore not be limited only to restructuring transactions. A comparative analysis of formal group tax systems applied in comparable tax jurisdictions revealed that South Africa's corporate restructuring regime is not a formal group tax regime. South Africa's present corporate restructuring regime, nonetheless, does contribute to achieving economic unity by allowing for tax-free transfers of intragroup assets in certain circumstances.

From the comparative analysis in Chapter 3 of formal group tax systems applying in comparable tax jurisdictions, it also became clear that there are certain common features of group taxation in the statutes of these jurisdictions. The following common features were identified and grouped together:

- the rules that enable the jurisdiction to compute the tax base of a qualifying group on a combined basis (including the proportion of the member's tax base to be included in the combined tax base);
- the definition of the group of companies (including common ownership requirements and eligibility requirements);
- the participation rules (whether participation in the group tax regime is compulsory or voluntary, whether revocable following a certain period, and whether participation relates to all qualifying members);
- the treatment of tax attributes and the balance of unused tax attributes (when entering into the group, during the group tax period, and when exiting the group); and
- other practical considerations (joint liability and filing of returns).

The above common features can be used as starting point to identify the structural elements underlying international group tax regimes. It was furthermore found that there is no single group tax model that represents best practice. In addition, numerous differences between the international group tax models exist. These differences are the outcomes of varying policy objectives and legal structures in the various jurisdictions. It is submitted that the actual group tax regime adopted in a specific jurisdiction is the result of compromises and adjustments. It would not be best practice to apply another jurisdiction's group tax model in South Africa, as that foreign jurisdiction's tax policies would also apply to the South African tax regime. Ultimately, an optimal group tax system for South Africa would be one that is developed through a process in which the structural elements underlying group tax regimes, internationally, are identified and adapted to harmonise with the South African policy objectives and the restrictions that exist in South Africa.

9.2.2 Policy objectives underpinning group tax systems

When contemplating the introduction of a formal group tax regime, it is necessary to identify essential policy objectives to be taken into consideration. In Chapter 4, the policy objectives considered by countries that have introduced formal group tax regimes were identified and evaluated in terms of the canons of a good tax system. The following policy considerations were identified as being important when considering a group tax regime: the single enterprise principle, competitiveness, anti-avoidance, fairness, efficiency, neutrality and simplicity, with the single enterprise principle, competitiveness, and fairness as dominant objectives. Of these, the single enterprise principle is considered the core of all objectives. It was found that these policy objectives are in line with the established principles of a good tax system.

9.2.3 South Africa's current group tax provisions

Before proposing a suitable regime, it was necessary to evaluate the suitability of the current tax regime in South Africa. The question had to be answered whether the current corporate restructuring rules and certain separate group relief provisions, can be considered an appropriate group tax system for South Africa. It was found that this is not the case. The suitability of the current corporate restructuring regime of South Africa had to be evaluated in terms of the policy objectives that underpin group tax regimes and in terms of the ideal objectives of a formal group tax system. Firstly, it was found that the current regime does not meet the policy objectives that are essential in a formal group tax system. These are policy objectives that also meet the recognised principles of a good tax system. The corporate restructuring regime does not promote neutrality, efficiency, anti-avoidance, or fairness, which is one of the dominant objectives. Moreover, the dominant objectives of competitiveness and the single enterprise principle are compromised, to some extent.

Secondly, it was found that only one of the objectives of a formal group tax system is presently achieved, namely the tax-free transfer of assets between companies within the same group. The current tax regime does not provide for the transfer of losses between companies in a group, which is one of the most important advantages of a formal group tax system. This indicates that the single enterprise principle is not achieved fully in the current corporate restructuring regime. Finally, it was found that the current regime in South Africa, with its corporate restructuring rules and certain separate group relief provisions, cannot be considered an appropriate group tax system for South Africa.

9.2.4 Framework of international group tax systems in terms of their tax design[747]

Next, it was important to establish a basic framework of international group tax systems, developed according to their tax design, in order to identify the main options for designing a group tax system in the South African context. It was found that the shift from a separate entity principle to a single enterprise principle in South Africa could be achieved by using one of two main design options: the first option is to extend the *tax base* (not the *taxable unit*), in other words the *taxable income* of the separate *company* will be extended. Examples of group tax regimes using this main design option are the loss-transfer model (the group tax model currently applied in the United Kingdom), the group contribution model (currently applied in Norway and Sweden), and the *Organschaft* model. It was suggested that of these three possibilities, the loss-transfer model of the United Kingdom should preferably be considered in a South African context. The United Kingdom's common law system forms an integrated part of South Africa's hybrid legal system and, like South Africa, the United Kingdom currently has a restructuring regime in place that provides for the tax-free intragroup transfer of assets.

747 Tax design is referred to by some by using the term "taxonomy".

The second design option, according to the theoretical framework of group tax regimes, is to extend the *taxable unit* (and therefore also the *tax base*), in other words, the taxable unit is the *group*, and the focus is on calculating the *group*'s taxable income. Group tax regimes designed in terms of this main design option include most consolidation models. It is suggested that the following three approaches to the consolidation model should be considered for South Africa: Australia's absorption approach, the Netherlands' attribution approach, and the United States' pooling approach. These three group tax regimes achieve both objectives of an ideal group tax system (loss offset and tax-free intragroup asset transfers).

It was furthermore found that the taxonomy of a group tax system affects the way in which the structural elements are applied, and that these two main design options should be considered when analysing the structural elements.

9.2.5 Structural elements and relevant policy objectives

Following the examination of the theoretical framework in terms of which the two main design options were identified, the structural elements underlying important group tax regimes had to be identified and described. These structural elements had to be analysed in terms of the two main design options. Thereafter, it was important to explore how the relevant policy objectives influence these structural elements.

It was found that most group tax regimes consist of the following basic structural elements: the rules used to compute the tax base of a qualifying group on a combined basis (including the proportion of the member's tax base to be included in the combined tax base); the definition of the group of companies (including common ownership requirements and eligibility requirements); the participation rules (whether participating in the group tax regime is compulsory or voluntary, whether revocable following a certain period, and whether participation relates to all qualifying members); the treatment of group losses, including pre-entry tax losses; the treatment of assets; the treatment of intragroup shareholdings; and other practical considerations (the tax liability of group members, the fiscal year end, and submission of tax returns).

From the analysis of these seven structural elements, it was found that the structural elements differ in relation to the two main design options. It was also found that some structural elements, such as pre-entry tax losses, the treatment of assets, and the treatment of intragroup shares, are disregarded where the main design option remains the *taxable unit* (the company). It was also found that different policy objectives affect the structural elements, and that the preferred option in relation to a specific structural element will depend on the trade-offs permitted in the jurisdiction. Ultimately, the tax policy considerations determine which option should be selected in respect of each structural element.

9.2.6 Adjusting the structural elements to suit the South African context

Finally, it was necessary to align the seven structural elements to the South African context by taking account of policy objectives to determine the design options that can be used in the development of a formal group tax system for South Africa. From the analysis of the recent report of the Davis Tax Committee (2016) on tax policy in South Africa, it was found that the same policy objectives, which are regarded as relevant by countries that have introduced group tax regimes, are also considered as important from a South African point of view. It was furthermore found that the policy objectives reported on by the Davis Tax Committee involve important trade-offs in respect of these policy objectives.

It was found that the seven structural elements could be used as design parameters for a formal group tax system in South Africa. It is submitted that the more a design parameter adheres to the South African policy objectives, the more suitable the design parameter and the group tax system will be, eventually, in a South African context. Finally, based on South African policy considerations, the most suitable option was suggested for each structural element in a South African group tax situation to recommend an appropriate formal group tax regime for South Africa.

9.3 PROPOSING A SUITABLE GROUP TAX SYSTEM FOR SOUTH AFRICA

It is submitted that the answer to what will be considered as an appropriate formal group tax system for South Africa does not lie in simply choosing an ‘off-the-rack’ regime, such as the loss-transfer method of the United Kingdom. The most appropriate group tax model for South Africa is one that is tailored to fit the South African context. To propose a suitable group tax regime, the different options in respect of each of the structural elements that underlie international group tax systems had to be identified and then rated in respect of the ability to satisfy South African tax policy objectives. The most appropriate regime was therefore designed by using, in respect of each structural element, the design option that best aligns with South African tax considerations. By consistently following this method of design in respect of each structural element, taking account of the limitations of the two main design options, as well as the relief provisions and the restrictions that exist in the South African tax system, a suitable group tax system can be recommended.

9.3.1 The rules used to calculate the tax base in a group tax system

The calculation of the tax base was found to be directly influenced by the two main design options, which implies that there are two possibilities for designing the South African group tax system: using the *group* as the taxable unit or using the *company* as the taxable unit.

Adding the rules of the loss transfer model to the current restructuring regime was found to be the option that corporate taxpayers in South Africa could most easily transition to, although it would not be the optimal option. This is due to all the problems created by the current corporate restructuring regime. The current restructuring regime has serious structural defects and is extremely complex. It is submitted that adding to this already flawed regime might create even more problems and further tensions.

Of the three consolidation approaches, it was found that the rules used by the pooling approach should be the preferred design option. This method can be integrated with the simplified approach recommended by the Katz Commission to establish calculation rules that are simple yet suited to the South African context. It was found that the complexity of the United States pooling regime stems from its treatment of intragroup shareholding. It was furthermore found that these complex rules, implemented to avoid double taxation in the United States group tax system, could be disregarded in a South African group tax regime because of the South African participation exemption regime that already prevents corporate double taxation. Although the rules of both the attribution approach and the absorption approach apply the single enterprise doctrine in a much stronger form, these approaches add substantial administrative complexity to corporate tax systems, and accordingly the implementation of their rules to calculate the group tax base cannot be recommended for South Africa. In the end, it was found that the rules of the pooling approach, combined with the rules of the simplified method recommended by the Katz Commission, is the option that meets South Africa’s policy objectives. It is consequently suggested that this option should be used to calculate a group’s tax base in South Africa.

It is furthermore recommended that once a member company qualifies for the group tax regime, 100% of its taxable income or loss should be combined or consolidated. This is a simple approach, which is also in line with the single enterprise principle, and therefore meets the South African policy objectives.

9.3.2 Definition of the group

It was found that the current definition of a group of companies in the Income Tax Act uses provisions to determine control similar to those used by group tax regimes internationally, namely *de jure* control using shareholding to determine common ownership shareholding. The only difference is that it does not include any anti-avoidance rule where the shareholding differs from the voting rights, which is a provision that should be considered. Regarding common ownership, it is recommended that the current definition in the Income Tax Act should be used as a starting point to implement a group tax system in South Africa. It is furthermore recommended that a relatively high to a high ownership level (70% to 100%) should be implemented in South Africa in support of the policy objectives of the single enterprise principle: neutrality, fairness, efficiency and simplicity, which are regarded as important considerations in South Africa. It is recommended that the initial percentage should be set closer to 100% to ensure that fewer groups qualify initially, bearing in mind that anti-avoidance rules should be introduced to prevent groups from excluding certain subsidiaries by merely selling a few shares. The ownership level can be reduced at a later stage.

It was found that internationally, unincorporated entities are generally not included in the group for group tax purposes. By including only entities that are similar to companies and by excluding entities that are subject to lower tax rates or exempt from tax, authorities ensure that group tax systems are not abused. The same argument applies in respect of non-resident companies: including only resident companies in the group ensures that the group tax system is not abused, as the tax treatment of resident companies is certain and clear. Where non-resident companies are included, opportunities are created for obtaining double tax relief – tax losses and certain expenses can be claimed in the home country and in the foreign country.

It is recommended that unincorporated entities, such as trusts, partnerships, and special concession taxpayers like mining companies, should not qualify for South Africa's group tax relief. Lastly, it is recommended that non-resident companies should also be excluded from South Africa's group tax relief in support of the policy objectives of the single enterprise principle, neutrality, competitiveness, efficiency, anti-avoidance and simplicity.

9.3.3 Participation rules

It was found that the single enterprise principle dictates that a corporate group should be treated as one single taxable unit. Therefore, a group tax system with fewer elective components, requiring participation of all eligible members, will promote the single enterprise principle. Competitiveness is the opposing tax objective – corporate groups prefer a tax system that provides elective components. The more electives available in the tax system, the fewer restrictions in the system, which increases the tax system's competitiveness. Where numerous electives are available, corporate groups will identify the optimal elective for tax purposes and then choose accordingly. It was recommended that South Africa should not pursue competitiveness if there are other "more important" objectives to consider. Because the current corporate restructuring regime is elective, it is recommended that any formal group tax regime introduced to replace the current regime should also be on an elective basis; provided once the election is made, all eligible entities are included. It is therefore recommended that the South African group tax system should be voluntary, irrevocable, and include all eligible entities.

9.3.4 <u>The treatment of tax losses</u>

Two types of tax losses must be considered: pre-entry tax losses that are incurred by a subsidiary before entering the group and group losses incurred after consolidation. It was found that anti-avoidance is normally the reason for the imposition of rules restricting pre-entry tax losses in international group tax systems. It poses a revenue threat to governments to allow pre-entry tax losses. The more assessed losses that are introduced into the group tax system, the more competitive the group tax system becomes. The more assessed losses permitted into the group tax system, the higher the risk that subsidiaries with assessed losses would only be included in the group to utilise their losses. If South Africa does not want to promote competitiveness because of objectives that are “more important”, all pre-entry assessed losses should be quarantined in the South African group tax. During consolidation, the offset of pre-entry assessed losses should only be allowed against the specific subsidiary’s profits, and then only *after* aggregation of the group results. Upon exiting the group, the balance of pre-entry assessed losses should revert to the subsidiary.

It was also found that this structural element (group tax losses) is directly influenced by the two main design options. No design options need to be considered where the *company* is the taxable unit, for example should South Africa adopt the loss transfer model, as the balance of assessed losses remains with the subsidiary. However, where the *group* is the taxable unit, a single tax base is applied, and different design options need to be considered. In line with South Africa’s tax objectives and the main design option (the *group* as taxable unit), it is recommended that the group tax system should allow the group to have a consolidated assessed loss, without any limitation. It is also recommended that when a group member exits the group or deconsolidation occurs, any balance of the group’s tax losses should remain with the parent or group.

9.3.5 <u>The treatment of assets</u>

It was found that the design options relating to the treatment of assets should again depend on whether the *group* or the *company* is the taxable unit used to calculate the tax base. No design options need to be considered where the *company* is used as taxable unit, for example should South Africa elect the loss transfer model, as the assets remain with the separate companies. Where the *group* is the taxable unit, a single tax base applies, and design options need to be considered when entering the consolidated group, during consolidation, and when exiting the group.

It is recommended that, upon entry into the consolidated group and thereafter, the rollover option (using either the Netherlands method or the United States method) should be applied in South Africa. The rollover option is the method that is most in line with the tax objectives in South Africa.

It was found that where a subsidiary exits the group, the optimum design option depends on the design option chosen during consolidation. Where the United States rollover method is followed during consolidation, the cost bases of assets should be recaptured when a subsidiary exits the group. Where the Netherlands rollover method (which is similar to the corporate restructuring rules) is followed during consolidation, the rollover method must be applied when a subsidiary exits the group. Both these methods are superior to the Australian method of resetting cost bases that, because of its extreme complexities and avoidance issues, is not preferred in the South African context.

9.3.6 The treatment of intragroup shareholding

It was found that the treatment of intragroup shareholding is the most difficult structural element to design when developing a group tax system. Double tax problems create numerous issues in different parts of tax systems, which lawmakers endeavour to solve when designing a group tax system by introducing rules for the treatment of intragroup shareholding. The solution depends on whether a general participation exemption regime is available to domestic groups in the jurisdiction.

It was found that no design options or related tax objectives need to be considered in respect of this structural element in South Africa, as there is currently a participation exemption regime in place in South Africa. It therefore seems unnecessary to introduce rules to deal with intragroup shares to avoid double taxation when designing a new group tax system for South Africa.

It is recommended, though, that during the final stages of designing the South African group tax regime, the current participation exemption regime should be investigated to ensure that no double tax problem or avoidance issues arise due to interactions between the two regimes.

9.3.7 <u>Practical considerations</u>

It was found that addressing practical considerations is mainly influenced by the single entity principle. In support of a strong application of the single enterprise principle, the following design is recommended for the South African context: group members should be jointly and severally liable to pay tax, the parent company should submit a single return on behalf of the group, and group companies should have a uniform tax year.

9.3.8 <u>A proposed group tax regime</u>

The most suitable design options for the seven structural elements are summarised in Table 9.1 below.

Table 9.1: Most suitable design option in respect of each structural element in the South African context

Structural element	**Design option most suited in the South African context**
The rules used to calculate the tax base	Rules used to combine or consolidate the tax base: The pooling approach of the consolidation model (the rules of the pooling approach must be adjusted to integrate the suggestions by the Katz Commission in terms of its simplified approach). The proportion of the subsidiary's tax base to be included in the combined tax base: Once a member company qualifies for the group tax regime, 100% of its taxable income or loss must be included in the combined tax base.
Definition of a group	Common ownership: *De jure* control with reference to *shareholding* (anti-avoidance rules should be introduced if the *shareholding* differs from the *voting rights*). Degree of common ownership: 70% – 100%. Eligible entities: Only companies should be included – other entities, special concession taxpayers and non-residents should be excluded.
Participation rules:	Mandatory or voluntary: Voluntary Irrevocable or revocable: Irrevocable, once elected, depending on the main design option of the group tax regime. All-in rule? Yes, no cherry-picking should be allowed.
Treatment of tax losses	Pre-entry tax losses: Upon entry of a company into the group, any pre-entry assessed loss should be ring-fenced and only set off against income of that subsidiary *after* the aggregation of group results (quarantined). Upon exiting the group tax system, the balance of the pre-entry loss should revert to the subsidiary. Assessed group losses: During consolidation, assessed group losses can be set off against profits as part of a single tax base (no limit). Assessed group losses remain within the group or parent once the subsidiary exits the group.
Treatment of assets:	Upon entry: Rollover During consolidation: Rollover (Netherlands method or United States method) At exiting time: Where the United States rollover method is applied during consolidation, cost bases are recaptured in the subsidiary's hands. Where the Netherlands rollover method is applied during consolidation, tax costs of assets are rolled over to the exiting subsidiary.
Treatment of intragroup share interests:	Unnecessary to introduce group tax rules to avoid double taxation, as South Africa already has participation exemption rules in place. It is submitted that intragroup share interests can be dealt with in terms of the "treatment of asset" rules (see previous structural element).

Practical considerations:	Group members should be jointly and severally liable to pay tax; they should submit a single return, with the parent company being responsible for submitting all returns. Group members should have a uniform tax year.

(Own formulation)

9.4 CRITICAL REFLECTIONS ON THIS STUDY

This study focused on an appropriate group tax system for *income tax* purposes. Any references to *other taxes*, for example value-added tax, were simply made in the interest of providing a holistic view. Furthermore, the study focused on groups of incorporated entities under the common control of a single parent company, and not on groups that include unincorporated entities.

Further concerns might be that the study makes use of very elementary examples to illustrate the differences between the various group tax models. This may seem unnecessary for a reader familiar with the concepts of group taxation but should be viewed in light of the fact that this study attempts to contribute on an educational and a practical level in a South African context. In addition, the concepts underpinning group tax systems are often explained and re-explained, albeit from a different viewpoint or in a different context to ensure complete understanding.

The final group tax system proposed in this study might be criticised in that no specific group tax model is recommended as being optimal in the South African context. The reason is that the most appropriate group tax model for South Africa is one that is designed by using, in respect of each structural element, the design option that best aligns with the tax objectives of government, at the time that the group tax system is introduced. The formal group tax system proposed in this study[748] relates to the most suitable design options for the seven structural elements, in line with *current* policy objectives. The detail of the formal group tax system eventually introduced may differ, depending on government's policy objectives at that later stage. It is submitted, however, that the method for determining the most suitable group tax system will remain the same.

[748] See Section 9.3 of this chapter.

9.5 CONTRIBUTIONS OF THIS STUDY

The analysis in this study draws from a wide range of material across disciplines and jurisdictions to contribute towards existing literature on group taxation in South Africa. It is furthermore trusted that this study will contribute on a tax policy level and on a practical level in the South African context.

In the first place, it is suggested that this study contributes to existing literature on South African group taxation. To date very limited research on group taxation has been performed in South Africa[749]. The present study, firstly, evaluates the current tax system applying to groups of companies in South Africa with reference to accepted canons of a good tax system and the functions of an ideal group tax system. Comparable evaluations were performed by Wilcocks & Middelman (2004:38–53), Stack, *et al*. (2015:139-160) and the Davis Tax Committee (2018) although not at the same depth. The Davis Committee (2018:2), in its review of the corporate tax structure of South Africa, referred to several of the findings from the evaluation performed in this thesis, while still in draft form, that was submitted to the Davis Committee, with consent from the University of Pretoria. The present study, secondly, provides a framework or a method that can be used to design a formal group tax system in the South African context. It is submitted that this framework presents an important contribution to existing literature on group taxation in South Africa. In their study, Wilcocks and Middelmann (2004) only focused on group taxation in general, rather than on the detailed design and the structural elements of a group tax system. The commissions of inquiry and the tax review committee, on the other hand, focused on the choice of a specific group tax model for South Africa in their reports (Margo Commission, 1987:7-20; Katz Commission, 1995:96-111; Davis Tax Committee, 2018:65-85). In this study the focus falls on the design of a group tax system and its structural elements and not on the recommendation of a specific group tax model. In other words, a framework or a method is recommended that can be used to design a formal group tax system in line with

749 Six unpublished master's degree dissertations (Kannenberg, 1999; Middelmann, 2003; Cornelissen, 2009; Omar, 2009; Skalet, 2010; and Sprout, 2010), two accredited journal articles (Wilcocks & Middelman (2004:38–53) and Stack, Stiglingh & Koekemoer (2015:139-160)), apart from the reports of two commissions of inquiry and a tax review committee (Margo Commission, 1987; Katz Commission, 1995; Davis Tax Committee, 2018).

the tax objectives of government at the time the group tax system is introduced in South Africa.

In the second place, it is anticipated that this study will contribute on a tax policy level when the South African authorities decide to introduce a group tax system and have to choose between the different options in respect of the seven structural elements. The ultimate choice will depend on the South African Government's policy objectives at the time of introducing a formal group tax system. Where there are conflicting policy objectives, the most acceptable policy objective will prevail. South Africa's policy objectives, as well as the extent to which the country proposes to apply the enterprise principle, will determine the most suitable option for South Africa's corporate tax system. It is submitted that this study can assist the government in understanding how its policy considerations influence the different design options when having to develop a formal group tax system for South Africa.

In the final place, it is submitted that this study makes a practical contribution by providing a method for the development of a formal group tax system for South Africa. Firstly, seven structural elements are suggested that could be used as parameters for designing a group tax system. Thereafter, the different design options in respect of each of the seven structural elements are analysed from a South African perspective. The design options are then evaluated in respect of their ability to adhere to South Africa's tax policy objectives. For each structural element, the design option that best aligns with South Africa's tax objectives, taking account of important trade-off considerations, is identified. The limitations of the two main design options, as well as the relief and the restrictions that currently exist in the South African tax system, are considered to identify the optimal design option in respect for each structural element. Finally, the optimal design option in respect of each of the seven structural elements is identified in order to suggest an appropriate group tax system for South Africa.

It is submitted that the above technique or a framework can assist policymakers in designing the most appropriate formal group tax system for South Africa. Finally, it is trusted that the research material in this study can be used in future studies on group taxation in South Africa.

9.6 FUTURE RESEARCH

It is recommended that future studies should focus on the detailed implementation of the structural elements as design parameters, and specifically the rules to calculate the tax base. It is further proposed that the interactions between the South African participation exemption regime and the proposed group tax regime should be investigated further. Lastly, it is suggested that future research on the tax consequences, other than income tax, should be conducted.

9.7 FINAL CONCLUSION

Despite the advent of the corporate group as a new entity form, South Africa still treats each company in the corporate group as a separate taxable unit, seemingly ignoring the international tendency to tax the corporate group as a single economic unit. There are several arguments against the implementation of a formal group tax system in South Africa: a formal group tax system would only add complexity to the South African group tax design; more research on international group tax models needs to be performed before a formal group tax regime can be introduced; a formal group tax regime can only be implemented in favourable economic circumstances; a formal group tax system can only be implemented once SARS is adequately staffed and proper systems are in place; and several other reasons. The global paradigm shift in relation to the legal and tax treatment of corporate groups, from treating group companies as separate entities to treating the corporate group as one economic unit, can no longer be ignored. The introduction of a formal group tax system is long overdue in South Africa.

In this study a framework is suggested which could be used to develop an authentic South African group tax regime, taking account of South African tax policy objectives and the unique South African circumstances. This framework can be used to ensure that an appropriate group tax regime that addresses the shortcomings of the current regime is introduced. This framework can assist in recommending an appropriate group tax regime that meets the objectives of the ideal group tax regime, as well as policy objectives, in line with established principles of a good tax system. There is a pressing need to abolish the current flawed regime, and to align South Africa’s tax system with the international norm by introducing a formal group tax regime that is tailor-made for the South African context.

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