STATUTORY MERGERS AS CONTEMPLATED IN THE COMPANIES ACT, 2008: THE APPLICABILITY OF THE CORPORATE RULES CONTAINED IN SECTION 44 OF THE INCOME TAX ACT, 1962

by

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Abstract

The purpose of this research is to determine the extent to which a statutory merger in terms of the Companies Act, 2008, may be accommodated by the provisions of an amalgamation transaction in terms of section 44 of the Income Tax Act, 1962. The research method adopted is a legal interpretative research approach.

South African company law underwent significant reform with the introduction of the Companies Act, 2008. One of the fundamental areas for reform was the need for a mechanism to appropriately accommodate a corporate merger, and thus, what is referred to as a statutory merger was introduced into South African company law. What is notable is that the statutory merger has been crafted to apply across a variety of circumstances that may arise in commerce, thus offering wide versatility. On the other hand, the tax relief afforded in terms of the corporate roll-over provisions in the Income Tax Act is designed to facilitate corporate transactions on a tax neutral basis, whilst balancing the concessions these measures introduce and the potential for tax avoidance. Consequently, the tax relief applicable to an amalgamation transaction will only apply within strictly prescribed parameters.

The research shows an ongoing effort by National Treasury to amend the provisions of the amalgamation transaction to better accommodate a statutory merger, but highlights that there are nevertheless certain conflicting purposes (policy) for each piece of legislation. For these reasons, the focus and parameters of a statutory merger and amalgamation transaction do not align perfectly. The key areas of inconsistency identified in this research are threefold, namely (i) the creation of a new company as a consequence of a statutory merger is not accommodated in an amalgamation transaction; (ii) the process of compensating the shareholders of the amalgamated company in an amalgamation transaction is not clearly contemplated in the statutory merger provisions; and (iii) mergers between a company and its shareholder currently present numerous complexities from both a company law and taxation perspective. The research concludes that the flexibility afforded under the statutory merger is largely minimised for parties who wish to simultaneously enjoy the tax relief afforded under an amalgamation transaction.

Key words: amalgamation, amalgamation transaction, business combinations, companies act, corporate rules, income tax, income tax act, merger, statutory merger.

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Chapter 1: Introduction

1.1 Context

It is trite that the tax implications of a transaction are dependent on and typically triggered by the realisation of legal rights and obligations. The Income Tax Act, No. 58 of 1962 ("the Income Tax Act") provides for various transaction mechanisms which, where the necessary requirements are met, result in a tax neutral transfer of assets and, to some extent, liabilities. These transaction mechanisms are referred to as "the corporate rules" or "corporate roll-over provisions" and are found in sections 41 to 47 of the Income Tax Act. The corporate rules essentially defer the tax events that would ordinarily be triggered on the disposal of assets (De Koker & Williams: 2019). A party that makes use of the corporate rules in the Income Tax Act will also enjoy the benefit of exemption from various other tax types, including transfer duty, securities transfer tax, and value-added tax ("VAT"). The present research will focus on the application of the "amalgamation transaction" set out in section 44 of the Income Tax Act, and the other tax types mentioned above will be briefly discussed.

Independent of the corporate rules in the Income Tax Act, the Companies Act, No. 71 of 2008 ("2008 Act" or "Companies Act") contains an amalgamation or merger procedure, referred to as "a statutory merger", intended to simplify the legal requirements and processes typically involved in a corporate merger or amalgamation, therefore encouraging business transactions in South Africa (Department of Trade and Industry: 2004). The statutory merger procedure is set out in, *inter alia*, sections 113 and 116 of the Companies Act and provides an immensely flexible and versatile mechanism for implementing an amalgamation or merger from a company law perspective (Davids, Norwitz and Yuill, 2010:337). By contrast, for the corporate rules to apply (specifically those of an "amalgamation transaction") such that a statutory merger is tax neutral, the transaction mechanisms and requirements prescribed in sections 41 and 44 of the Income Tax Act must be met.

Certain inconsistencies have been identified in the requirements of the statutory merger procedure and the amalgamation transaction, and the question arises as to whether and to what extent, a party may enjoy the benefits of both the statutory merger

procedure from a company law perspective, and an amalgamation transaction from a tax perspective. This research will therefore examine the details and nuances in respect of a statutory merger and an amalgamation transaction. The analysis of the consequences of mergers from the perspective of each of the two separate pieces of legislation, and recommendations to address conflicts between them, will contribute towards the existing literature.

1.2 Goals of the research

The goal of the research is to establish under what circumstances a statutory merger can enjoy the tax benefits afforded in section 44 of the Income Tax Act and the concomitant relief in respect of other tax types including VAT, securities transfer tax and transfer duty. The sub-goals of the research include the following:

(i) a discussion of the background, purpose and benefits of a statutory merger in terms of the Companies Act;
(ii) identifying the legal cause of the transfer of assets in the context of a statutory merger;
(iii) assessing the tax implications for the parties to a statutory merger which does not meet the requirements of the corporate roll-over provisions;
(iv) an analysis of the tax benefits of utilising the corporate rules, specifically those contained in section 44 of the Income Tax Act;
(v) the identification of conflicts that may arise between the provisions of the Companies Act and the Income Tax Act relating to mergers; and
(vi) suggesting possible amendments to legislation to address the conflicts.

1.3 Limitations of the research

The research is limited to the application of a merger between South African incorporated companies only. Furthermore, the analysis of the application of the corporate rules in the context of a statutory merger is limited to the application of section 44 of the Income Tax Act and this research does not consider the potential application of the other corporate roll-over provisions to a statutory merger.

1.4 Research methods and design

The research method to be adopted in the thesis is a legal interpretative research approach (Stack: 2011), with the purpose being to understand, interpret and explain the relevant laws. More particularly, the research methodology constitutes "doctrinal research" which is typified by "the systematic process of identifying, analysing, organising and synthesising statutes, judicial decisions and commentary" (McKerchar, 2008:18-19). This methodology therefore provides a logical exposition of the rules governing a particular legal category, in the present case looking particularly to (i) understand the policy and conceptual bases of the relevant legal principles, (ii) interpret the law based on acceptable constructs of legal interpretation and (iii) analyse the relationship and interplay of the legal provisions in company law and tax law in the context of a corporate merger. The research is conducted in the form of an extended argument, in which a question is subjected to testing and interpretation, using sound logic supported by documentary evidence.

The research methodology, which is based purely on documentary data, comprises of a critical analysis of the following documentary data:

(i) Companies Act, No. 71 of 2008;
(ii) Income Tax Act, No. 58 of 1962;
(iii) Securities Transfer Tax Act, No. 25 of 2007;
(iv) Transfer Duty Act, No. 40 of 1949;
(v) Value-Added Tax Act, No. 89 of 1991;
(vi) commentary contained in articles and accredited journals; and
(vii) South African case law.

In the case of doctrinal research, validity and reliability of the research are promoted by:

(i) adhering to the rules of the statutory interpretation, as established in terms of statute and common law;

(ii) placing greater evidential weight on legislation and case law which creates precedent, or which is of persuasive value and the writings of acknowledged experts in the field;
(iii) discussing opposing viewpoints and concluding, based on credible evidence; and
(iv) the rigour of the arguments.

The data or results will not be manipulated to support a particular viewpoint. Content will not be withheld or understated. All sources of data will be appropriately acknowledged and fully referenced. As the research does not seek to support or contest any existing theories or standpoints, no interpreter bias can arise.

As all the documentary data are publicly available, no ethical considerations arise.

1.5 Overview

In addressing the above research goals, Chapter 2 will establish the background to, purpose of and benefits of the merger procedure as provided for in section 113 of the Companies Act, No. 71 of 2008 (referred to as a "statutory merger"). In this chapter, the history behind the introduction of these provisions will be discussed, as well as the legal process and requirements for a transaction to fall within the ambit of section 113. In addition, the legal implications pertaining to the implementation of a statutory merger will be canvassed.

Chapter 3 will go on to assess those tax implications ordinarily arising in respect of a sale of shares or business assets in the context of a statutory merger that does not meet the requirements of the corporate roll-over provisions in the Income Tax Act, No. 58 of 1962. The statutory merger has given rise to some debate as to the legal cause of the transfer of property, namely whether it is in terms of the merger agreement itself (i.e. based in contract) or by the operation of law upon the implementation of the merger agreement. This is discussed at the outset of Chapter 3 in determining the tax implications attendant upon a statutory merger, as different tax outcomes may arise depending on the legal cause of the transfer of property. The examination of the detailed tax implications that may arise in the context of a statutory merger will provide

context to the tax relief afforded under the corporate roll-over provisions, discussed in Chapter 4.

The goal of Chapter 4 is therefore to analyse the tax benefits of utilising the corporate rules, specifically those provided for in section 44 of the Income Tax Act (as the scope of the research was limited to the application of section 44 of the Income Tax Act). In doing so, this chapter will cover the requirements that a transaction must comply with in order to enjoy these tax benefits, the transaction steps necessary to implement an amalgamation transaction, and the tax implications for the amalgamated company and the resultant company. This chapter will also cover the circumstances under which section 44 of the Income Tax Act will not apply, as well as the anti-avoidance provisions in the Income Tax Act introduced to prevent abuse of the corporate roll-over provisions.

In light of the analyses in Chapters 2, 3 and 4, the goal of Chapter 5 is to establish the extent to which a statutory merger may be accommodated by the tax relief afforded to an amalgamation transaction, and will focus on specific areas identified where potential conflicts may exist between the parameters of a statutory merger and an amalgamation transaction. Recommendations for the amendment to the legislation will also be proposed.

Chapter 6 will provide a recapitulation of the goals of this research, review the findings of Chapters 2, 3, 4 and 5, and provide a summary of the core concepts, findings and recommendations emanating from the research.

Chapter 2: Statutory merger in terms of the Companies Act, 2008

2.1 Introduction

The goal of this chapter is to establish the background to, purpose of and benefits of the merger procedure (referred to as a "statutory merger") as provided for in section 113 of the Companies Act, No. 71 of 2008 (referred to as the "Companies Act", or the "2008 Act"). In this chapter, the history behind the introduction of these provisions will be discussed, as well as the legal process and requirements for a transaction to fall within the ambit of section 113. In addition, the legal implications pertaining to the implementation of a statutory merger will be analysed.

2.2 Background

In 2004, the Department of Trade and Industry ("the DTI") published the policy document "South African Company Law for the 21st Century: Guidelines for Corporate Law Reform",[1] wherein it acknowledged the need for the review and reform of company law in South Africa, in order to align it with international trends and accommodate the changing environment for business, both in South Africa and globally.

At the time of the publication of the DTI's policy document, the Companies Act, No. 61 of 1973 (the "1973 Act") was 30 years old, and had not been subjected to a comprehensive review, taking into consideration the significant developments that had taken place in South Africa following the implementation of the new Constitutional dispensation in 1994. One of the fundamental areas for reform that was highlighted in the DTI's policy document was the need for a mechanism to appropriately accommodate a corporate merger. In this regard the document states (at 41) that:

> …it will be necessary to make provisions in company law for mergers in the true sense of the word, namely, the absorption of one company into another, with the assets and liabilities of the former becoming the assets and liabilities of the latter

[1] "South African Company Law for the 21st Century: Guidelines for Corporate Law Reform" was published under Government Notice 1183 in Government Gazette 26493 of 23 June 2004.

> and with the former ceasing to exist. Current company law does not provide mechanisms to combine companies, but rather requires the transfer of assets by scheme of arrangement from one company to another or third company. In order to enhance flexibility, efficiency and transparency, it is necessary that the combination of companies be facilitated through company law, so that mergers in the true sense are facilitated.

As noted by Boardman (2010:306), under the 1973 Act, there were three methods in terms of which a change of control of a company could occur, namely (a) a disposal of the whole or the greater part of the undertaking or assets of the company,[2] (b) a compromise or arrangement between a company and its creditors,[3] and (c) a takeover.[4]

As a result of the need to reform South African company law, the Companies Act was enacted with effect from 1 May 2011. In the preamble to the 2008 Act, one of its expressed aims is "to provide for equitable and efficient amalgamations, mergers and takeovers of companies". As highlighted by Davids *et al* (2010:338), it is regrettable that "this imperative did not make it into the 'Purposes' specified in s 7 of the new Act".

The Companies Act retains a revised version of the three methods of obtaining control of a company referred to above,[5] but notably introduces under Chapter 5, entitled "Fundamental transactions, takeovers and offers", a new merger procedure (referred to herein as a "statutory merger") under section 113 read with section 116. Davids *et al* (2010:340-341) state the following in this regard:

> Business combinations have generally been effected through the acquisition by one company of the shares or assets of another… The adoption of a statutory merger procedure in the new Act, which allows companies by agreement (and with the requisite approval from their shareholders) to merge their assets and liabilities into a combined entity, therefore marks a significant departure from the old regime.

[2] Section 228 of the Companies Act 1973.
[3] Section 311 of the Companies Act 1973.
[4] Section 440A to 440N of the Companies Act 1973.
[5] Sections 112 to 127 of the Companies Act 2008.

Interestingly, the 2008 Act moves away from a court-driven process (as was the case in the 1973 Act) toward a more shareholder-driven process, which is in line with the 2008 Act's expressed aim of providing for equitable and efficient amalgamations, mergers and takeovers of companies (Boardman: 2010). This is not to say that the protection of shareholders, and particularly minorities, as well as creditors of the merging company, has not been considered. The Companies Act has a plethora of protection mechanisms built into it. Some of these protection measures, as articulated by Boardman (2010:308-309), are discussed in further detail below, in considering the statutory merger procedure.

2.3 Statutory merger procedure

The statutory merger procedure under the Companies Act may be divided into three stages, as identified by Davids *et al* (2010:343), being the merger agreement, the shareholder approval process, and the implementation of the merger. The procedure is further subject to the requirements of the solvency and liquidity test being met, discussed further below.

Of particular importance to the statutory merger procedure is that a company may not implement a statutory merger unless the merger has been approved in accordance with section 115 of the 2008 Act. The protection mechanisms included in section 115 of the 2008 Act include:

(i) the solvency and liquidity test being met;
(ii) shareholder approval by way of a special resolution;
(iii) special resolution by shareholders of the holding company;
(iv) mitigating any conflict of interest with the acquiring party;
(v) opposition by minorities; and
(vi) dissenting shareholders' appraisal rights.

These key features are described in further detail below.

2.3.1 Solvency and liquidity (section 113(4))

The 2008 Act requires that the board of each merging company must consider whether, upon implementation of the merger agreement, each proposed merged company will satisfy the "solvency and liquidity test". It is only if the board reasonably believes that each proposed merged company will satisfy the solvency and liquidity test, that it may submit the agreement for consideration at a shareholders meeting of that merging company, in accordance with section 115 (the requirements of which are detailed below).

The "solvency and liquidity test" is the test set out in section 4(1) of the Companies Act, as follows:

> (1) For any purpose of this Act, a company satisfies the solvency and liquidity test at a particular time if, considering all reasonably foreseeable financial circumstances of the company at that time-
>
> (a) the assets of the company, as fairly valued, equal or exceed the liabilities of the company, as fairly valued; and
>
> (b) it appears that the company will be able to pay its debts as they become due in the ordinary course of business for a period of-
>
> (i) 12 months after the date on which the test is considered; or
>
> (ii) in the case of a distribution contemplated in paragraph (a) of the definition of 'distribution' in section 1, 12 months following that distribution.

This test, in essence, requires that at the relevant date, taking into account all reasonably foreseeable financial circumstances, the assets of the company must exceed its liabilities and that the company will be able to pay its debts in the ordinary course of business for a period of 12 months following the implementation of the merger. Davids *et al* (2010:364) state that "[t]his therefore should give the creditor some comfort that, at least in the short term, the obligations owing to it should be fulfilled."

2.3.2 Approval by way of a special resolution (section 115(2)(a))

A statutory merger must be approved by a special resolution adopted by persons entitled to exercise voting rights on such a matter, at a meeting called for that specific purpose. A quorum of shareholders entitled to exercise at least 25% of the voting rights exercisable in respect of the relevant matter is required. A “special resolution” is defined in section 1 of the 2008 Act as a resolution adopted with the support of at least 75% of the voting rights exercised on the resolution, unless the company’s Memorandum of Incorporation specifies a lower percentage, which may be no lower than 60% plus 1 vote (section 65(8), (9) and (10) of the 2008 Act).

There was initially some debate regarding whether the adjustment to these percentages in the company’s Memorandum of Incorporation, in terms of section 65, apply to a special resolution authorising a statutory merger, by virtue of the use of the words “[d]espite section 65, and any provision of a company’s Memorandum of Incorporation…” in section 115(1). However, with the amendments made by the Companies Amendment Act, No. 3 of 2011, there appears to be support for the view that the percentage of voting rights exercised in support of a special resolution approving a statutory merger may be less than 75% where the company’s Memorandum of Incorporation so dictates (Delport & Vorster, 2018:417). It is submitted that it is only the percentages as specified in sections 115(2) and (3) which cannot be altered by the Memorandum of Incorporation.

2.3.3 Special resolution by holding company (section 115(2)(b))

The statutory merger will also require the approval of the shareholders of the merging company’s parent company, also by way of a special resolution as contemplated in section 115(2)(a), if the disposal substantially constitutes a disposal of all or the greater part of the assets or undertaking of that holding company.

2.3.4 Mitigating a conflict of interest (section 115(4))

In calculating the percentage of voting rights required for determining quorum requirements or the vote in support of the special resolution, any voting rights controlled by an acquiring party, a person related to an acquiring party, or a person

acting in concert with either of them, must not be included, thus minimising the risk of a conflict of interests by the shareholders of the merging company.

2.3.5 Opposition by minorities (section 115(3))

Despite a special resolution being passed in accordance with section 115(2), a company may not proceed to implement that resolution without the approval of a court if that resolution was opposed by at least 15% of the voting rights that were exercised on that resolution and, within five business days after the vote, any person who voted against the resolution requires the company to seek court approval. In such circumstances, the company must either seek court approval or the resolution must be treated as a nullity (section 115(5)). Similarly, regardless of what proportion of shareholders in total opposed the special resolution, any person who opposed the resolution may apply to the court for leave to apply to a court to have the transaction set aside. In both instances, section 115(7) dictates that the court may set aside the resolution only if the resolution is (a) manifestly unfair to any class of holders of the company's securities, or (b) the vote was materially tainted by conflict of interest, inadequate disclosure, failure to comply with the Companies Act, the Memorandum of Incorporation or any applicable rules of the company, or other significant and material procedural irregularity.

2.3.6 Dissenting shareholders appraisal rights (section 115(8))

A shareholder in a merging company is entitled to seek relief in terms of section 164 provided they (a) have notified the company in advance of their intention to oppose the special resolution, and (b) were present at the meeting and voted against that special resolution. Section 164 entitles a shareholder to demand that the company pay the shareholder the fair value of all of the shares held by that shareholder in that company, determined as at the date on which, and time immediately before, the company adopted the resolution, provided the appropriate procedural requirements set out in section 164 are met.

Given that the focus of this discussion is on the implications of a statutory merger from a tax perspective, no further analysis is needed in respect of the provisions discussed

above, as these legal processes should not give rise to any significant tax implications. Key elements that will give rise to tax considerations, however, will arise in respect of (i) the legal cause of the disposal of the assets and liabilities, (ii) the quantum and nature of the consideration paid in respect thereof, and to whom the consideration is payable, and (iii) the incorporation, survival and/or dissolution of the parties to the statutory merger. The statutory merger introduced in the Companies Act 2008 is therefore considered in further detail below.

2.4 Requirements for a statutory merger

Section 113(1) of the 2008 Act states that "two or more profit companies, including holding and subsidiary companies, may amalgamate or merge…". Where two such companies are proposing to merge, they must enter into a written agreement (the merger agreement) setting out the terms and means of effecting the merger. The specific elements to be addressed in the merger agreement are specified in section 113(2) (see further discussion in this regard below).

In terms of the Companies Act, an "amalgamation or merger" is defined in section 1 as:

> a transaction, or series of transactions, pursuant to an agreement between two or more companies, resulting in-
>
> (a) the formation of one or more new companies, which together hold all of the assets and liabilities that were held by any of the amalgamating or merging companies immediately before the implementation of the agreement, and the dissolution of each of the amalgamating or merging companies; or
>
> (b) the survival of at least one of the amalgamating or merging companies, with or without the formation of one or more new companies, and the vesting in the surviving company or companies, together with any such new company or companies, of all of the assets and liabilities that were held by any of the amalgamating or merging companies immediately before the implementation of the agreement.

Section 1 sets out additional definitions for an “amalgamating or merging company” as “a company that is a party to an amalgamation or merger agreement”, and an “amalgamated or merged company” as:

> a company that either-
> (a) was incorporated pursuant to an amalgamation or merger agreement; or
> (b) was an amalgamating or merging company and continued in existence after the implementation of the amalgamation or merger agreement,
> and holds any part of the assets and liabilities that were held by any of the amalgamating or merging companies immediately before the implementation of the agreement.

In light of the above, an “amalgamation or merger” in accordance with the Companies Act can therefore occur in a wide variety of circumstances. As noted by Chong and Van der Linde (2014:475) “[t]hese definitions offer enormous flexibility in the manner that a merger may be structured.” Explanations and illustrative examples of merely some of forms in which a statutory merger may occur are set out in further detail below. For purposes of differentiating the elements of the statutory merger contemplated in the Companies Act from the provisions of the Income Tax Act (discussed in further detail below), references to merging or merged companies in the context of the Companies Act, are references to “amalgamating or merging company” and “amalgamated or merged company”, as detailed above.

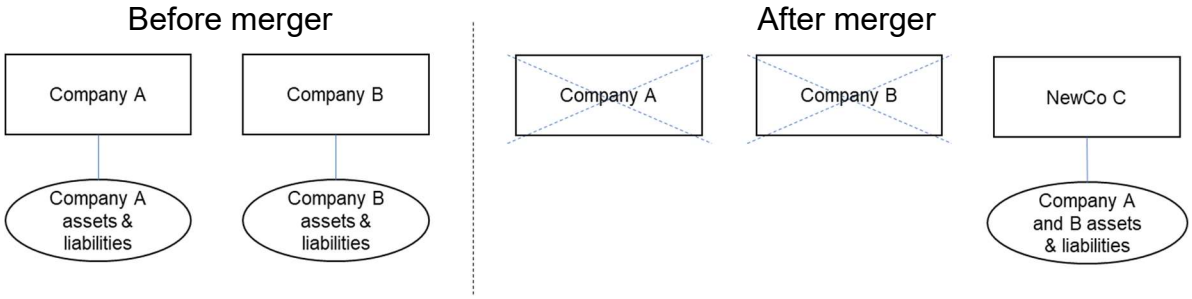
2.4.1 Subparagraph (a) of the definition of an “amalgamation or merger”

Subparagraph (a) of the definition of an “amalgamation or merger” contemplates the formation of one or more new companies (“NewCo’s”) which acquire all the assets and liabilities of the merging companies. In addition, these merging companies are terminated as a result of the merger, leaving only the NewCo or NewCo’s in existence. As the definition contemplates the disposal of *all* of the merging company’s assets and liabilities, and the subsequent dissolution of the company, a statutory merger would not be appropriate for the carve-out or separation of a portion of a company’s assets (for example, a particular business unit) into a separate company where that company survives the merger (referred to for the sake of brevity as a “corporatisation”).

In the illustrative examples used below, rectangles represent companies and ovals represent the assets and liabilities of that company. A cross struck through a company represents that the entity has been dissolved by operation of law.

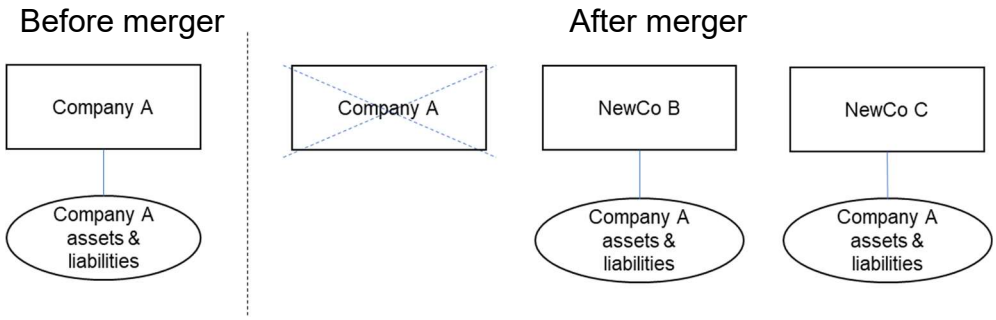
Example 1:

Company A and Company B transfer all their assets and liabilities to a newly incorporated company, NewCo C:



Example 2:

Company A transfers all its assets and liabilities to two newly incorporated companies, NewCo B and NewCo C:



2.4.2 Subparagraph (b) of the definition of an “amalgamation or merger”

Subparagraph (b) of the definition of an “amalgamation or merger” contemplates the survival of at least one of the merging companies (“the surviving company/companies”), where *all* of the assets and liabilities of the other merging companies are transferred to the surviving company or companies and, if applicable, a newly formed company or companies.

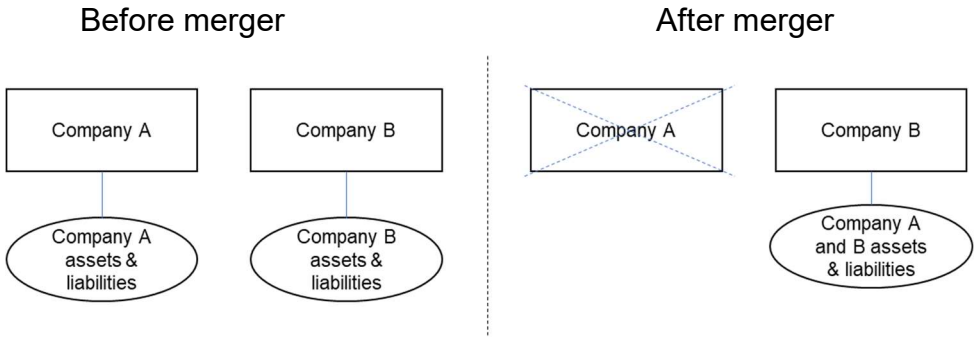
Whilst subparagraph (b) does not refer to the dissolution of the merging companies that do not survive the merger, as is the case in subparagraph (a), it is submitted that by virtue of the fact at *all* of the assets and liabilities of the other merging companies are required to be transferred to the surviving company, the merging companies would merely be shell companies following the implementation of the transfer. Furthermore, the reference to a "surviving" company infers that the other merged companies do not survive. In addition, section 116(5)(b) states that the Commission (namely the Companies and Intellectual Property Commission, abbreviated to "CIPC") must, after receiving notice of a statutory merger, deregister any of the merging companies that did not survive the merger.

It is therefore likely that the merging companies contemplated in subparagraph (b) would be dissolved by operation of law, and the merger agreement would cater for this. Chong and Van der Linde (2014) and Davids *et al* (2010) appear to adopt a similar interpretation in this regard. Furthermore, the dissolution of the merging companies would also be necessary for qualifying for tax relief under section 44 of the Income Tax Act, which is discussed in further detail in Chapter 4.

As mentioned with reference to subparagraph (a) of the definition of an "amalgamation or merger", a statutory merger would not be appropriate for a "corporatisation" where that company survives the merger. Similarly, with reference to subparagraph (b) of the definition, as *all* of the assets are required to be transferred in the context of a statutory merger, a "corporatisation" could not occur by way of a statutory merger. Such a transaction would need to be implemented by way of an ordinary sale of assets, or a Companies Act section 112 disposal of all or the greater part of the company's assets or undertaking, without the benefit of an automatic transfer of rights and obligations that takes place under a statutory merger. As this discussion is focussed on a statutory merger as contemplated in section 113 of the Companies Act, a disposal under section 112 is not considered any further.

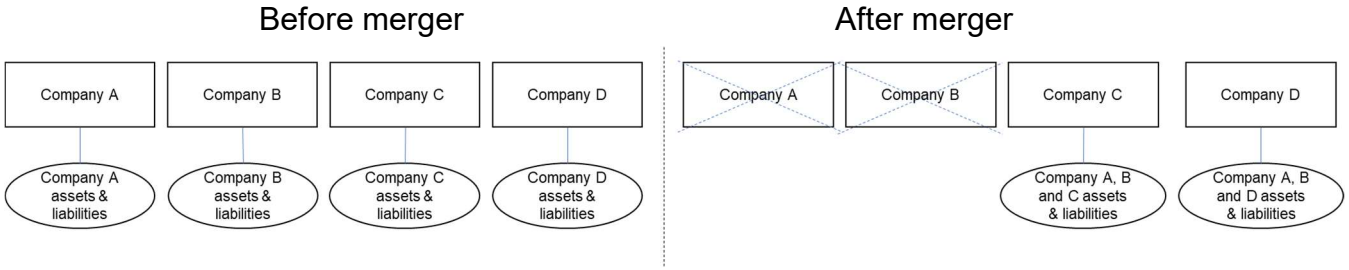
Example 3:

Company A transfers all its assets and liabilities to existing Company B:



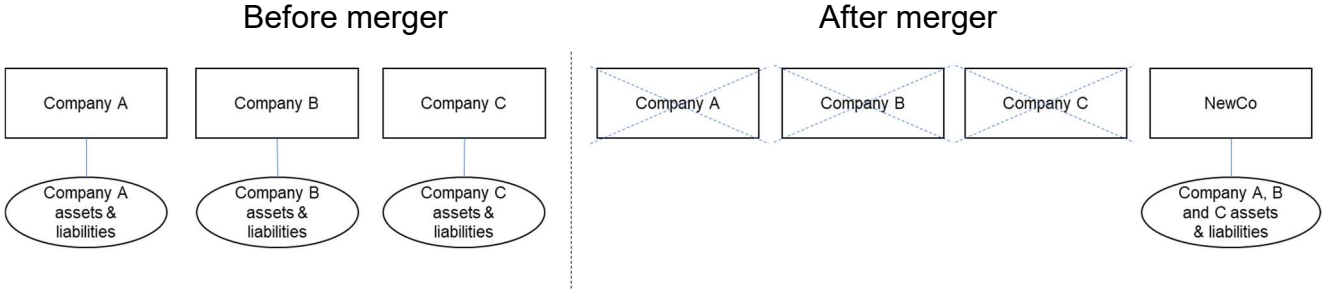
Example 4:

Companies A and B transfer all their assets and liabilities to existing Companies C and D:



Example 5:

Companies A, B and C transfer all of their assets and liabilities to a newly incorporated company, NewCo:



As is clear from the limited examples provided above, the forms in which a statutory merger could occur are endless. Section 113(2) of the Companies Act does, however, specify the elements of the statutory merger that must be considered in the merger

agreement, which also takes into consideration the merger consideration as well as the allocation of assets and liabilities:

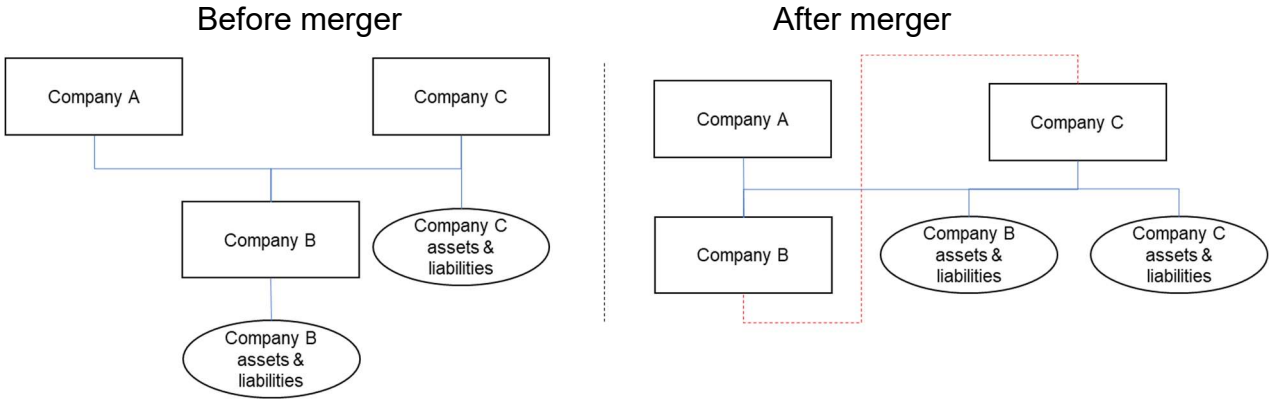
> Two or more companies proposing to amalgamate or merge must enter into a written agreement setting out the terms and means of effecting the amalgamation or merger and, in particular, setting out -
>
> (a) the proposed Memorandum of Incorporation of any new company to be formed by the amalgamation or merger;
>
> (b) the name and identity number of each proposed director of any proposed amalgamated or merged company;
>
> (c) the manner in which the securities of each amalgamating or merging company are to be converted into securities of any proposed amalgamated or merged company, or exchanged for other property;
>
> (d) if any securities of any of the amalgamating or merging companies are not to be converted into securities of any proposed amalgamated or merged company, the consideration that the holders of those securities are to receive in addition to or instead of securities of any proposed amalgamated or merged company;
>
> (e) the manner of payment of any consideration instead of the issue of fractional securities of an amalgamated or merged company or of any other juristic person the securities of which are to be received in the amalgamation or merger;
>
> (f) details of the proposed allocation of the assets and liabilities of the amalgamating or merging companies among the companies that will be formed or continue to exist when the amalgamation or merger agreement has been implemented;
>
> (g) details of any arrangement or strategy necessary to complete the amalgamation or merger, and to provide for the subsequent management and operation of the proposed amalgamated or merged company or companies; and
>
> (h) the estimated cost of the proposed amalgamation or merger.
>
> (emphasis added)

In addition to the above requirements in respect of the merger consideration and the allocation of assets and liabilities, to the extent that any shares in a merging entity are held by or on behalf of another merging entity, section 113(3) of the 2008 Act requires

that the merger agreement must provide for the cancellation of these shares upon the merger becoming effective without any repayment of capital, and they cannot be converted into shares in the merged entity. This is demonstrated by way of an illustrative example as follows.

Example 6:

Shares in Company B are held by Companies A and C. Company B merges all its assets and liabilities with Company C for consideration of Company C shares:



In the above example, the payment of consideration, in the form of the issue of shares, by Company C to Company B for the acquisition of Company B's assets and liabilities, results in Company C indirectly holding shares in itself, through its existing shareholding in Company B. Upon the termination and liquidation of Company B, Company C would receive shares in itself as a distribution from Company B. Section 113(2) also envisages a situation where the shareholder's securities in a merging company are converted into shares in the merged company, or alternatively where the shareholder receives shares in the merged company. Accordingly, as alternatives to the situation depicted in the illustration above, (i) Company C may issue additional shares to the shareholders of Company B directly, as the merger consideration for the acquisition of the Company B business, or (ii) the Company B shares may be converted into Company C shares. In the first instance, Company C would be issuing shares to itself, as an existing shareholder of Company B, and in the latter instance, its shares in Company B would convert to shares in itself.

This creates a fundamental conflict with section 35 of the Companies Act. In terms of section 35(3), a company may not issue shares to itself. In addition, shares in issue which are subsequently acquired by the issuing company are immediately cancelled in terms of section 35(5) of the Companies Act and have the same status as shares that have been authorised but not issued. It is therefore critical that, where a crossholding of shares arises as a result of the implementation of a statutory merger, the parties to the merger consider both the legal and economic impact that it may have and provide for this in the merger agreement.

The requirement regarding the cancellation of the cross holding of shares in section 113(3) of the Companies Act is significant in the context of an "amalgamation transaction" in terms of section 44 of the Income Tax Act, as is the concept of converting a shareholder's securities in a merging company to securities in a merged company. These concepts will be discussed in further detail from a tax perspective in Chapter 4.

2.5 Implementation

Section 116 of the Companies Act sets out specific provisions relating to the implementation of a statutory merger. Whilst subsections (1) to (4) cover certain administrative compliance requirements, subsections (5) to (8) contain important provisions pertaining to the legal implications on implementing a statutory merger. These include:

(i) the registration and deregistration of merging companies upon filing of the notice of a statutory merger (section 116(5)(a) and (b));
(ii) that the merger takes effect in accordance with the merger agreement (section 116(6)(a));
(iii) that the merger does not affect, *inter alia*, any existing liabilities of the merging parties and any legal proceedings or court order against the merging entities may be continued or enforced against the surviving merged entity/entities (section 116(6)(b));
(iv) that the property of each merging company "becomes the property of" the newly amalgamated, or surviving merged, company or companies,

in accordance with the provisions of the amalgamation or merger agreement (section 116(7)(a));

(v) that the newly formed merged company, or surviving merged company, is liable for all of the obligations of every merging company, in accordance with the provisions of the merger agreement (section 116(7)(b)); and

(vi) that a copy of the merger agreement, together with a copy of the filed notice of amalgamation or merger, constitutes sufficient evidence to effect transfer of the registration of any property that is registered in terms of any public regulation (such as immovable property or patents) (section 116(8)).

The implications reflected above speak to the advantages of the statutory merger in reducing the legal formalities, time and inevitable costs usually involved in effecting a transfer of property from one merging company to another.

2.6 Conclusion

One of the fundamental areas for reform that was highlighted in the DTI's policy document was the need for a mechanism to appropriately accommodate a corporate merger. The result was the introduction of, amongst others, the statutory merger provisions in the Companies Act. The goal of this chapter was therefore to establish the background to, purpose of and benefits of the statutory merger.

An "amalgamation or merger" in the context of a statutory merger, can occur between "two or more profit companies, including holding and subsidiary companies", and can broadly result in two potential outcomes, being either the formation of a new company or companies as a result of the statutory merger, or the survival of at least one of the existing companies that was party to the transaction. All the assets and liabilities of the merging companies are transferred to the surviving company or companies and, if applicable, a newly formed company or companies. In addition, these merging companies are terminated as a result of the merger, leaving only the new company or surviving company/companies in existence.

The definition of an “amalgamation or merger” is therefore incredibly flexible and, consequently, the forms in which a statutory merger could occur are endless, as has been depicted diagrammatically in this chapter. Furthermore, section 113(2) of the Companies Act sets out the elements of the statutory merger that must be considered in the merger agreement, which also accounts for the merger consideration as well as the allocation of assets and liabilities. The merger consideration in terms of a statutory merger is crafted broadly to cater for various forms and methods of compensating the shareholders of the merging company.

The Companies Act also includes provisions relating to the implementation process for a statutory merger and contains provisions pertaining to the legal ramifications of implementing a statutory merger. The advantages of the statutory merger therefore include reducing the legal formalities, time and inevitable costs usually involved in effecting a transfer of property from one merging company to another. Whilst the statutory merger offers both a flexible and practical mechanism for business combinations, it also provides for the protection of shareholders and third-party investors.

In summary, the statutory merger offers an efficient manner of implementing business combinations intended to apply across a variety of transaction structures. However, the tax implications are a crucial component in determining the costs associated with mergers and acquisitions. The following chapters will therefore first consider the typical tax implications arising on a sale of assets or shares (where no tax relief is available), the tax considerations in respect of a conversion of securities in one company to another, and thereafter the provisions of section 44 of the Income Tax Act, which provides for special tax relief in the context of an “amalgamation transaction”. These provisions fall under Part III of Chapter II of the Income Tax Act, which governs the so-called corporate roll-over relief provisions, or corporate rules. Section 44 specifically provides tax relief for South African tax resident companies seeking to merge. The tax analysis will also consider the concomitant tax relief provisions afforded under the Value-Added Tax Act, No. 89 of 1991 (“VAT Act”), Securities Transfer Tax Act, No. 25 of 2007 (“STT Act”) and Transfer Duty Act, No. 40 of 1949 (“Transfer Duty Act”).

Chapter 3: Tax considerations in respect of a sale of shares or assets

3.1 Introduction

The goal of this chapter is to identify and explain the various tax implications that may arise for both the seller and the purchaser on the implementation of a statutory merger that does not meet the requirements of the corporate roll-over provisions, which aim to provide tax neutrality. This will be achieved by first establishing the legal cause of transfer in the context of a statutory merger, and thereafter considering the typical tax implications arising in the context of (i) a sale of shares and (ii) a sale of business assets. This will provide context for the relief afforded under the corporate roll-over provisions discussed in Chapter 4. Certain circumstances unique to the statutory merger will also be examined. The exposition below will also consider the impact of transactions occurring between "connected persons" as defined in section 1 of the Income Tax Act, or for consideration less than market value.

3.2 Legal cause of transfer

As discussed in Chapter 2, the definition of an "amalgamation or merger" requires one of two outcomes, being either:

(a) the formation of one or more new companies, which together hold all the assets and liabilities that were held by any of the amalgamating or merging companies; or
(b) the survival of at least one of the amalgamating or merging companies, with or without the formation of one or more new companies, and the vesting in the surviving company or companies of all the assets and liabilities that were held by any of the amalgamating or merging companies.

In addition, section 116 of the Companies Act sets out specific provisions relating to the implementation of a statutory merger. Included in these provisions is section 116(7) which states that when a merger agreement has been implemented, the property of each merging company "becomes the property of" the surviving merged

company or companies, in accordance with the provisions of the merger agreement or any other relevant agreement.

The wording of these provisions gives rise to some uncertainty as to the legal cause of the transfer of property, namely whether it is the merger agreement itself or the operation of law upon the implementation of the merger agreement. In this regard, Delport and Vorster (2018:423) provide their interpretation of the legal nature of an automatic transfer:

> The provision in sub-s (7) that the property "becomes the property" of the amalgamated or surviving merged company implies that the transfer of property, as opposed to the consensual allocation of the property as discussed above, is *ex lege* and not consensual or otherwise based on contract.

Chong and Van der Linde (2014:484) observe that "[a] transfer by operation of law usually means that the transfer takes place automatically without the necessity of meeting the required formalities, delivery or procedures for the transfer to take place."

Gad and Strauss (2012a:Online) consider the legal implications of a transfer of assets and liabilities in the context of a statutory merger. In this regard, they consider that the underlying legal cause of the transfer of property from one company (which they refer to as "TargetCo") to another company (which they refer to as "AcquireCo") can arguably be one of two scenarios, as follows:

> **Scenario 1:** the typical contractual causes for the transfer of assets and liabilities (i.e. sale, cession, delegation etc.) in terms of the agreement between the parties. In this scenario the statutory merger provisions merely recognise, regulate and supplement the implementation of the contract between the parties and also enable parties to avoid third party consents; or
> **Scenario 2:** the automatic operation of law alone. In this scenario assets and liabilities pass ex lege and there would, for example, be no sale construction in terms whereof TargetCo disposes of assets in exchange for consideration (e.g. the assumption of liabilities) to AcquireCo.

Gad and Strauss (2012b:Online) argue that where the legal cause of the transaction is the contract, the ordinary implications arising from such an agreement would be triggered, namely that TargetCo will accrue an amount equal to the value of its liabilities which AcquireCo assumes, plus any other consideration given. However, in scenario 2 where the cause of transfer is the operation of law, they submit that:

> assets will arguably not be transferred *in return for* anything (e.g. cash, shares or the assumption of debt) and the transaction would arguably take place for *no consideration*. Various anti-avoidance provisions in the respective tax acts, which are aimed at non-arm's length transactions between connected persons, may be triggered… The acquisition of fixed or trading assets without a cost can also be problematic if the tax roll-over rules do not apply to the specific case.

Where the cause of transfer is the operation of law, and all the assets and liabilities are automatically transferred to and assumed by the surviving company, TargetCo would need to consider the income tax, Capital Gains Tax ("CGT") and other relevant tax considerations where there is not necessarily a reciprocal undertaking by AcquireCo. The tax implications for TargetCo, even where it does not receive any consideration in consequence of the statutory merger, may nevertheless be significant where amounts are deemed to be included in income for tax purposes either as recoupments or proceeds. These consequences will ultimately depend on the nature of the assets transferred, the nature and quantum of liabilities assumed by AcquireCo, any other consideration given to TargetCo, how those liabilities may be allocated to the assets acquired (if the merger agreement is silent on this) and the relationship of TargetCo and AcquireCo to one another. AcquireCo would also need to consider the extent to which it could claim expenditure for purposes of claiming allowances going forward and in the determination of the base cost of capital assets.

It is submitted, however, that whilst the Companies Act appears to envisage a merger that is implemented by operation of law, it is also explicit that the statutory merger can only be implemented pursuant to the conclusion of the merger agreement. This is not only reiterated in the definitions of "amalgamated or merged company" and "amalgamating or merging company" but also in the requirements of sections 113(2) and 116, which provisions are prescriptive. Whilst Gad and Strauss' (2012b:Online)

proposal that assets might not be transferred in return for anything is a possible outcome where a statutory merger occurs *ex lege*, it is clear from the Companies Act that the legislature intended the parties to the statutory merger to have the ability to govern the consideration payable and the allocation of assets and liabilities in the merger agreement, which must be given effect to.

It is therefore submitted that whilst the legal cause of the transfer of assets and liabilities in the context of a statutory merger may be the automatic operation of law, namely without the necessity of meeting the required formalities, delivery or procedures for the transfer to take place, the terms of the merger agreement must nevertheless be given effect to, which in itself may create reciprocal undertakings by the surviving company.

On the matter of the disposal of assets "in exchange for consideration", Chong and Van der Linde (2014:485) appear to agree with this submission where they propose that:

> There is nothing in the merger provisions which prohibits the transferee giving consideration to the transferor for the transfer of the assets. In fact, there is nothing in law which prohibits a transfer of property by operation of law from being done with consideration.

3.3 Subject matter of the sale

Sellers and purchasers typically have competing interests in a sale, which directly speaks to the nature of the asset ultimately forming the subject matter of the sale. A seller will typically seek to sell the shares in a company for the following reasons:

1. The sellers divest themselves of tax or financial risks in respect of the entity.
2. The sellers (if holding the shares as a capital investment) obtain the full proceeds from the sale subject to capital gains tax, which is included at a lower rate than proceeds of a revenue nature, whereas sale of assets from the underlying company would be subject to the recoupment of allowances previously claimed, and fully taxable at the normal rate. Any remaining profits

would be distributed to the shareholder, either as a dividend where the company's existence continues, or upon the liquidation or termination of the company. These distributions may potentially be subject to dividends tax at the rate of 20%. Thus, the seller is likely to be out of pocket in the context of a sale of business assets combined with a distribution of a dividend, in comparison with a sale of shares.

3. The seller is not liable for securities transfer tax.

The purchaser, on the other hand, will typically seek to conclude an asset deal for the following reasons:

1. The purchaser does not wish to inherit any tax or financial risks in the entity.
2. The assets will have a cost base equal to the amount incurred in acquiring the assets. Thus, the purchaser may enjoy deductions/allowances in respect of the assets against a stepped-up cost base, whereas the acquisition of the shares in the company would result in the cost base of the assets in the company being carried forward.
3. The purchaser will enjoy a full deduction of the interest incurred on the funding to acquire the assets, whereas an interest deduction on funding utilised for the purchase of shares will be limited.
4. A sale of shares would give rise to a securities transfer tax liability in the hands of the underlying company, which is recoverable from the purchaser. This tax cost would not be incurred in an asset deal.
5. VAT would be zero-rated in terms of section 11(1)(e) of the VAT Act, provided the business is being sold as a going concern. The attendant VAT costs would accordingly be deductible. Although a sale of shares would not be subject to VAT (as this constitutes an exempt "financial service" in terms of section 12 read with section 2 of the VAT Act), VAT charged on related costs incurred in the transaction, such a consultants' and advisors' fees, would probably not be deductible.

The tax implications summarised above are discussed in further detail.

3.4 Tax implications arising from a sale and purchase of shares

3.4.1 Tax consequences for the seller

3.4.1.1 Income tax

The income tax implications for a seller arising from the sale of any asset (i.e. shares or another asset) will depend on whether that asset was held as a capital asset. Whilst receipts and accruals of a capital nature are excluded from a taxpayer's gross income, with effect from 1 October 2001, section 26A of the Income Tax Act provides that there shall be included in the taxable income of a person for a year of assessment, the taxable capital gain of that person for that year of assessment, as determined in terms of the Eighth Schedule to the Income Tax Act.

A capital gain is calculated as the proceeds from the sale (calculated in accordance with paragraph 35 of the Eighth Schedule to the Income Tax Act) less the base cost of the shares in the hands of the seller (determined in accordance with paragraph 20 of the Eighth Schedule to the Income Tax Act). The net effect of the application of the capital gains tax provisions is that, to the extent that a receipt constitutes a capital gain, only a certain portion of the gain will be included in the taxpayer's taxable income, thus taxing that gain at a lower rate than it would have been taxed had the gain been included in gross income.

Where shares were held by the seller on capital account, the seller of the shares may realise a capital gain upon the disposal of the shares to the purchaser, where the proceeds from the sale exceed the base cost of the shares. In this regard, CGT would be payable by the seller. Where the seller is a company, CGT would be payable at an effective rate of 22.4%, being the corporate tax rate of 28% multiplied by the inclusion rate of 80% of the capital gain included in the company's taxable income, in terms of paragraph 10(1)(c) of the Eighth Schedule to the Income Tax Act, read with section 26A of the Income Tax Act.

Where the shares were held as trading stock or otherwise in a scheme of profit-making, the proceeds of the sale would be included in the seller's gross income. Where the seller is a company, this would result in the full proceeds being taxed at 28%.

Section 102(1) of the Tax Administration Act, No. 28 of 2011 (the "Tax Administration Act"), places the onus on the taxpayer to prove, on a balance of probabilities –

(a) that an amount, transaction, event or item is exempt or otherwise not taxable;
(b) that an amount or item is deductible or may be set-off;
(c) the rate of tax applicable to a transaction, event, item or class of taxpayer;
(d) that an amount qualifies as a reduction of tax payable;
(e) that a valuation is correct; or
(f) whether a 'decision' that is subject to objection and appeal under a tax Act, is incorrect.

Therefore, where the taxpayer contends that an amount is to be included as a capital gain (and is thus subject to a lower effective tax rate) the onus lies with the taxpayer to prove it.

As reiterated by Grosskopf J in the Cape Provincial Division in *Block v Secretary for Inland Revenue* (42 SATC 7, at 14):

> In the present case we are dealing with the profit on the sale of the appellant's shares. To show that this was a receipt of a capital nature, the appellant therefore had to show that his dominant purpose in holding the shares was to hold them more or less permanently so as to produce income. This onus had to be discharged on the ordinary basis applied in civil cases, i.e. a balance of probabilities. I emphasize this because, as I shall indicate, the majority members of the court seem in my view to have required too high a standard of proof of the appellant. (emphasis added)

As stated by Kruger and Scholtz (2003:23), "[t]he mere fact that a person receives an

amount of money from the sale of an asset does not assist in determining whether that amount is of a capital or a revenue nature. Other evidence, usually extrinsic, will have to be led by the taxpayer to prove that the proceeds of the sale are of a capital nature…".

Consequently, if a contract is structured as a sale, and the proceeds of the sale are categorised as capital in nature, the taxpayer would enjoy a lower effective tax rate on those proceeds.

3.4.1.2 Value-added tax

For VAT purposes, equity shares in a company constitute a supply of a "financial service" as defined in section 1 of the VAT Act read with section 2. In terms of section 12(a) of the VAT Act, a supply of a financial service is exempt from VAT, unless that financial service would be charged with VAT at the rate of zero per cent under section 11 of the VAT Act. Consequently, no VAT is typically levied upon the disposal of shares (i.e. it is an exempt supply).

3.4.2 Tax consequences for the purchaser

3.4.2.1 Expenditure incurred

Whilst the consideration paid by the purchaser for the shares will form part of the purchaser's base cost in those shares where the shares are acquired on capital account, the base cost of the individual assets within the entity acquired would be unaffected. On the other hand, where the shares are acquired as trading stock or otherwise in a scheme of profit-making, the expenditure incurred by the purchaser in the acquisition of the shares would constitute an allowable deduction where the requirements of section 11(a) of the Income Tax Act are met.

3.4.2.2 Purchase price allocation

The allocation of the purchase consideration is important for the purchaser from a tax planning perspective and should be clearly expressed in the legal agreements giving

effect to the sale of shares. By way of example, it is often the case where a purchaser is purchasing a business through the acquisition of the shares to also purchase the shareholder loan claims. The acquisition of a loan claim for a consideration less than the face value will have adverse tax consequences.

In terms of section 24J(1) of the Income Tax Act, an "instrument" means, *inter alia*:

> (c) any interest-bearing arrangement or debt;
> (d) any acquisition or disposal of any right to receive interest or the obligation to pay any interest, as the case may be, in terms of any other interest-bearing arrangement…
> (emphasis added)

The term "interest" is defined as including the "gross amount of any interest or similar finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement" (emphasis added).

In this regard, it would be prudent for the purchaser – when allocating a value to the shares and loan claims – to allocate the purchase price first to the loan claims (up to the face value thereof). Where a loan claim is purchased for less than its face value, the amount of the "discount" between the face value of the loan claim and the purchase consideration for it, could constitute "interest" on an instrument for section 24J purposes. Consequently, where the agreement does not specify that the purchase consideration is first attributable to the loan claims, a capital repayment of such a loan claim could be deemed to be taxable interest in the purchaser's hands. Clearly this is inefficient for tax purposes in the purchaser's hands and could simply be avoided by carefully constructing the legal agreement to reflect that the purchase price is first allocated to loan claims, and thereafter to the shares.

3.4.2.3 Change of intention/business in respect of the entity acquired

It is fundamental for parties to a transaction to consider their respective intentions in respect of the entity acquired, as this may give rise to a deemed CGT event in the hands of the entity acquired. By way of example, consider a sale of shares in a

property company. The property company held a commercial property from which it generated rental income. The shareholders of the company sell the shares in the property company to purchasers who wish to develop the commercial property into various units for sale. The intention of the company with regard to the use of the property, which is represented by the intention of its directors,[6] will therefore change following the change of shareholders. The company will change its business from being a landlord to a property developer.

In terms of paragraph 12(2)(c) read with paragraph 13(1)(g)(i) of the Eighth Schedule to the Income Tax Act, a person is deemed to dispose of a capital asset at the market value when that person commences to hold that capital asset as trading stock (i.e. where the property company changes its business in respect of the property as an investment property to a property developer). The deemed capital gain arises on the date immediately before the day that the change in intention occurs.

Consequently, where the shareholders acquire the property company with the intention that the property will be developed, that property company will become liable for CGT at the effective rate of 22,4% on the deemed capital gain, being the market value of the commercial property less the base cost of the property. Whilst this is not a direct tax payable by the purchaser of the shares, it is a significant tax cost that will impact the purchaser's acquisition as the company acquired will need to pay additional tax, and should be factored into the valuation and financing of the transaction.

3.4.2.4 Deduction of interest expense on funding

Where the consideration for the acquisition of shares is funded by way of an interest-bearing loan, an important consideration for the purchaser is whether the interest will be deductible for tax purposes. See 3.5.5 below for an examination of the relevant considerations in this regard. The implications of the deductibility of the interest expense may have a significant impact on the structure of the transaction as well as the amount of the consideration paid to the seller.

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[6] *Elandsheuwel Farming (Edms) Bpk v Sekretaris van Binnelandse Inkomste* (1978 (1) SA 101 (A), 39 SATC 163).

3.4.2.5 Tax losses

In respect of the assessed loss or capital loss of a corporate entity, an “assessed loss” means any amount by which the deductions admissible under section 11 exceeded the income in respect of which they are so admissible (section 20(2) of the Income Tax Act), and an “assessed capital loss” is essentially an amount by which the capital losses of the company exceed its capital gains (paragraph 9 of the Eighth Schedule to the Income Tax Act). An assessed loss or capital loss attaches to a corporate entity as it is determined in respect of that entity’s operations or trade. Consequently, when the shares in that entity are sold, any assessed loss or capital loss remains available in that company upon the sale of its shares, subject to the anti-avoidance provisions in section 103(2) of the Income Tax Act.

In terms of section 103(2) of the Income Tax Act, the Commissioner may disallow the set-off of an assessed loss or balance of an assessed loss against a particular company's income if he is satisfied that:

a) any agreement affecting a company or change in shareholding of a company has taken place which has directly or indirectly resulted in any income or capital gains accruing to or being received by that particular company during any year of assessment; and
b) that agreement or change of shareholding was entered into or effected by a company solely or mainly for the purpose of utilizing any assessed loss, any balance of assessed loss, any capital loss or any assessed capital loss, as the case may be, incurred by the company to avoid the liability on the part of that company for the payment of any tax, duty or levy on income, or to reduce the amount thereof.

The application of section 103(2) can therefore have a significant impact in the context of a merger if the parties to the transaction anticipated utilising an assessed loss in the merged entity which is subsequently disallowed.

In addition to the powers afforded to the Commissioner of SARS under section 103(2), section 103(5) of the Income Tax Act provides that:

> Where under any transaction, operation or scheme-
> (a) any taxpayer has ceded the right to receive any amount in exchange for the right to receive any amount of dividends; and
> (b) in consequence of that cession the liability for normal tax of the taxpayer or any other party to the transaction, operation or scheme, as determined before applying the provisions of this subsection, has been reduced or extinguished,
> the Commissioner shall determine the liability for normal tax of the taxpayer and any other party to the transaction, operation or scheme as if that cession had not been effected.

This sub-section envisages the exchange by a taxpayer of a right that gives rise to taxable income for a right that gives rise to dividend income, referred to by De Koker and Williams (2019:§19.53) as "interest-dividend swaps", which they explain as follows:

> The taxpayer must have ceded the right to receive an amount in exchange for an amount of dividends. It would appear then that the outright disposal of, for example, an interest-bearing security rather than the cession of the right to interest it essentially comprises would not be encompassed by s 103(5)(*a*).

Whilst the statutory merger provides for flexibility in the nature of the merger consideration, tax avoidance provisions may nevertheless apply to re-characterise a tax benefit arising from an "interest-dividend swap".

3.4.2.6 Securities transfer tax

In terms of section 2 of the STT Act, securities transfer tax ("STT") is payable upon the "transfer" of the shares from the seller to the purchaser at the rate of 0,25 per cent of the taxable amount of that share. "Transfer" is defined in section 1 of the STT Act to include "the transfer, sale, assignment or cession, or disposal in any other manner, of a security…" but specifically excludes, *inter alia*, "any event that does not result in a

change in beneficial ownership". In the Explanatory Memorandum on the Securities Transfer Tax Bill, 2007, National Treasury (2007:Online) states as follows regarding a change in beneficial ownership:

> The concept of transfer relates to economic ownership, as opposed to the mere registration of a security as in the case of a share registered in the name of a nominee. For that reason transfer excludes any event that does not result in a change in beneficial ownership.

In the context of a statutory merger, which may occur between or amongst holding or subsidiary companies, whether a "transfer" for STT purposes will arise or not will need to be considered on a case by case basis in determining whether there was a change in beneficial ownership of the shares. Furthermore, given that a "transfer" includes a disposal of the share "in any other manner", the legal cause of the transfer of the shares either being in terms of a contract or by operation of law, should not impact the application of the STT Act. The legal cause of transfer in respect of a statutory merger is discussed in further detail under 3.6 below.

In the context of unlisted securities, STT is levied at 0.25% on the higher of the consideration paid or the market value of the shares (section 6(1)(a) of the STT Act). Therefore, even if the consideration paid is less than the market value of the shares transferred, STT will nevertheless be calculated on the market value of the shares.

Section 6(2) of the STT Act prescribes that STT is payable by the company which issued the unlisted securities (i.e. the shares) being transferred. However, section 7(2) creates the right for the issuing company to recover the STT so paid by it to SARS from the purchaser. Consequently, the tax liability and responsibility for administrative compliance lies with the issuing company. However, it has the right to recover this amount form the purchaser. The STT Act does not dictate the mechanism by which the issuing company may seek to recover this amount. From the purchaser's perspective, where it repays the STT liability to the issuing company, the amount so repaid may be included in the purchaser's base cost of the shares it acquired, in terms of paragraph 20(1)(c)(iii) of the Eighth Schedule to the Income Tax Act.

3.5 Tax implications arising from a sale and purchase of business assets

When considering the sale of assets, these will typically fall into one or more of the following categories:

a) capital assets[7];
b) allowance assets[8];
c) trading stock[9]; and
d) contracts.

3.5.1 Capital and allowance assets

The seller of the capital assets may realise a capital gain on the disposal of the capital assets to the purchaser, where the proceeds from the sale exceed the base cost of the shares. Similarly, the seller may realise a capital loss on the disposal where the proceeds from the sale are less than the base cost. Where a capital gain is realised, CGT would be payable by the seller an effective rate of 22.4% (see above). This may be applicable to non-depreciable items such as immovable property, goodwill, contracts and other intangible assets.

Where a statutory merger is implemented for no consideration or a consideration less than the market value of the assets, the merging company may nevertheless be required to calculate a capital gain on the market value of the assets transferred to the merged company by virtue of the application of paragraph 38 of the Eighth Schedule to the Income Tax Act. This provision applies specifically where a person disposes of an asset by means of either (i) a donation, (ii) for a consideration not measurable in money, or (iii) to a person who is a connected person in relation to that person for a consideration which does not reflect an arm's length price. Although the seller is deemed to dispose of the asset at its market value, the purchaser will also be treated

[7] Namely, an "asset" as defined in paragraph 1 of the Eighth Schedule to the Income Tax Act
[8] Namely, a capital asset in respect of which a deduction or allowance is granted in terms of the Income Tax Act.
[9] "Trading stock" as defined in section 1 of the Income Tax Act.

as having acquired the asset at its market value for purposes of determining the base cost of the asset.

In the case of capital assets which constitute allowance assets, the seller may be taxed on recoupments under section 8(4)(a) of the Income Tax Act on the disposal of any allowance assets on which allowances have previously been claimed for income tax purposes, where that allowance has been recovered by the seller in part or in full. This would arise where the proceeds received for the assets upon their disposal exceed their "tax value" (acquisition price, less allowances granted).

In terms of paragraph 20(3)(a) of the Eighth Schedule to the Income Tax Act, a taxpayer's base cost in a capital asset is reduced by any amount which is or was allowable or is deemed to have been allowed as a deduction in determining the taxable income of that person. Furthermore, paragraph 35(3)(a) of the Eighth Schedule to the Income Tax Act states that:

> (3) The proceeds from the disposal, during a year of assessment, of an asset by a person, as contemplated in subparagraph (1) must be reduced by-
>
> (a) any amount of the proceeds that must be or was included in the gross income of that person or that must be or was taken into account when determining the taxable income of that person before the inclusion of any taxable capital gain…

The impact of section 8(4)(a) is that allowances that are recouped are included in the seller's income before determining its taxable capital gain. In explaining the impact of section 8(4)(a), De Koker and Williams (2019:§4.58) state that "[i]t is immaterial whether the amount recovered or recouped is part of a receipt of a capital nature or not." In summary, normal tax at the rate of 28% in the case of a seller that is a company may therefore arise on the recoupment of allowances on the sale of allowance assets. Allowance assets to which these provisions would typically apply include plant, machinery, equipment, furniture and fittings and vehicles used for purposes of trade.

In addition, section 8(4)(k) provides, *inter alia*, that for purposes of determining a recoupment under section 8(4)(a) where either (a) a company transfers an asset in

any manner or form to a shareholder, or (b) any person disposes of an asset to a connected person, that person is deemed to have disposed of that asset at its market value. Consequently, even where a statutory merger is implemented for no consideration or a consideration less than market value, the merging company will nevertheless calculate recoupments on the market value of the assets transferred to the merged company.

From the purchaser's perspective, where the sale has been concluded on an arm's length basis (i.e. for consideration equal to the market value of the asset), the purchaser's base cost in that asset will amount to the expenditure actually incurred by the purchaser in respect of the acquisition of that asset, and may also include ancillary costs actually incurred by the purchaser directly related to that acquisition such as –

(i) the remuneration of a surveyor, valuer, auctioneer, accountant, broker, agent, consultant or legal advisor, for services rendered[10];
(ii) transfer costs[11];
(iii) advertising costs to find a seller[12];
(iv) the cost of moving that asset from one location to another[13]; and
(v) the cost of installation of that asset, including the cost of foundations and supporting structures[14].

3.5.2 Trading stock

Consideration received or accrued for the sale of trading stock is inherently income in nature. Consequently, the consideration for the sale of trading stock is included in the gross income of a seller, with the cost of the trading stock usually constituting an allowable deduction under section 11(a) of the Income Tax Act. However, section 22(8) of the Income Tax Act provides for a deemed recovery or recoupment in the taxpayer's income of the value (being the cost price or the market value, as the case may be) of trading stock applied to the taxpayer's private or domestic use, donated or

[10] Paragraph 20(1)(c)(i) of the Eighth Schedule to the Income Tax Act.
[11] Paragraph 20(1)(c)(ii) of the Eighth Schedule to the Income Tax Act.
[12] Paragraph 20(1)(c)(iv) of the Eighth Schedule to the Income Tax Act.
[13] Paragraph 20(1)(c)(v) of the Eighth Schedule to the Income Tax Act.
[14] Paragraph 20(1)(c)(vi) of the Eighth Schedule to the Income Tax Act.

applied for any other purpose other than its disposal in the ordinary course of its trade, distributed *in specie* to any shareholder, or when it ceases to be held as trading stock. These deeming provisions may therefore apply to create an additional tax cost to the seller.

From the perspective of the purchaser, subject to certain exceptions, section 22(4) of the Income Tax Act deems the cost price of the trading stock in the purchaser's hands to be the current market price of such trading stock on the date on which it was acquired by such person, if the trading stock has been acquired for no consideration or for a consideration which is not measurable in terms of money.

3.5.3 Contracts

A contract has the potential to represent a source of income. In this regard, section 24 of the Income Tax Act contains special provisions that deem an accrual of the whole of an amount payable to the taxpayer under a suspensive sale agreement, on the date on which the agreement was entered into. Section 24(2) provides for an allowance against the deemed accrual but is only available in limited circumstances and at the discretion of the Commissioner. The tax implications of the application of section 24 may give rise to a significant increase in the taxpayer's taxable income in one year, while deductible expenditure in respect of that contract may significantly reduce taxable income during future years of assessment.

Section 24C of the Income Tax Act provides temporary tax relief in the form of an allowance, where a person receives an advance payment in terms of a contract, provided that such payment will be used to finance future expenditure. The amount of any allowance deducted under section 24C in a year of assessment must be added back in the following year of assessment (section 24C(3)).

It is therefore prudent to consider the implications of these allowances for both the seller and purchaser in the context of a sale of a business where the purchaser takes over the liability to perform in terms of the contract entered into by the seller. In these circumstances, the seller would be required to add back in the year of the sale any allowance deducted under section 24C, which would not be matched by a deduction

for the expenditure (which obligation may be assumed by and expenditure incurred by the purchaser). The advance amount will not be required to be used by the seller, in whole or in part, to finance future expenditure.

Similarly, the purchaser of the business who fulfils the obligations under the contract may have difficulty proving that the expenditure is incurred in the production of income, as required by section 11(a) of the Income Tax Act (as no income will be produced), where it does not receive the right to the deposit from the seller. In this regard, Olivier (2007:611) notes that "the purchaser should, to ensure a tax effective result, not assume the obligation to deliver the goods, without getting the deposit and the right to the balance of the purchase price".

3.5.4 Transfer duty and VAT

In terms of the Transfer Duty Act, subject to the exemptions provided for in section 9 of the Transfer Duty Act, transfer duty is payable by the purchaser of immovable property[15] based on the value of such property, which value is determined in accordance with the provisions of sections 5, 6, 7 and 8 of the Transfer Duty Act. The rate of transfer duty applied to properties acquired on or after 1 March 2017 ranges from 0% to 13% depending on the value of the property, as set out in section 2(1)(b) of the Transfer Duty Act:

> (b) subject to subsection (5) -
>
> (i) 0 per cent of so much of the said value or the said amount, as the case may be, as does not exceed R900 000; and
>
> (ii) 3 per cent of so much of the said value or the said amount, as the case may be, as exceeds R900 000 but does not exceed R1,25 million;
>
> (iii) 6 per cent of so much of the said value or the said amount, as the case may be, as exceeds R1,25 million but does not exceed R1,75 million;
>
> (iv) 8 per cent of so much of the said value or the said amount, as the case may be, as exceeds R1,75 million but does not exceed R2,25 million;

[15] "Property" as defined in section 1 of the Transfer Duty Act and includes in certain circumstances, shares in a property company.

(v) 11 per cent of so much of the said value or the said amount, as the case may be, as exceeds R2.25 million but does not exceed R10 million; and

(vi) 13 per cent of so much of the said value or the said amount, as the case may be, as exceeds R10 million.

One of the exemptions from transfer duty is provided for in section 9(15) of the Transfer Duty Act, in terms of which no transfer duty is payable in respect of the acquisition of any property which for purposes of the VAT Act, constitutes a taxable supply of goods to the person acquiring such property, provided that the following requirements set out in section 9(15) are met:

(a) the transferor of the property under such transaction, in a declaration in such form as the Commissioner may prescribe, certifies that value-added tax payable under the said Act has been paid to him in respect of the said supply by the transferee and has been accounted for by him in a relevant return required to be furnished by him under the said Act or will be so accounted for in such return within the time allowed under that Act for the rendering of such return, or where such supply was subject to the said tax at the rate of zero per cent, such information regarding such supply as the Commissioner may require has been furnished to him;

(b) any security required by the Commissioner for the payment of such tax has been lodged, if such tax has not yet been paid; and

(c) the Commissioner has issued a certificate to the effect that the requirements of this subsection for the granting of the exemption have been met.

Consequently, where the sale of property is subject to VAT either at the standard rate of 15 per cent (in terms of section 7(1) of the VAT Act) or zero per cent (in terms of the provisions in section 11 of the VAT Act), the transfer of the property is exempt from transfer duty.

It is therefore also relevant to consider the situation where a transfer of property may constitute a taxable supply for VAT purposes. Section 7 of the VAT Act, being the charging provision in the VAT Act, states that, subject to the exemptions, exceptions, deductions and adjustments provided for in the VAT Act, VAT shall be levied on, *inter*

alia, “the supply by any vendor of goods or services supplied by him on or after the commencement date in the course or furtherance of any enterprise carried on by him”. Consequently, in order for a supply to be vatable, the person making the supply must constitute a “vendor” for purposes of the VAT Act, and that supply must be made in the course or furtherance of any enterprise carried on by that vendor.

In terms of section 1 of the VAT Act, “goods” is defined to include “fixed property” (and any real right in such fixed property), which in turn is defined as:

> land (together with improvements affixed thereto), any unit as defined in section 1 of the Sectional Titles Act, 1986 (Act No. 95 of 1986), any share in a share block company which confers a right to or an interest in the use of immovable property, and, in relation to a property time-sharing scheme, any time-sharing interest as defined in section 1 of the Property Time-sharing Control Act, 1983 (Act No. 75 of 1983); and any real right in any such land, unit, share or time-sharing interest.

Section 23(1)(a) of the VAT Act prescribes that a person who carries on an enterprise is liable to register as a vendor if the total value of taxable supplies made by that person in the course of carrying on all enterprises exceeds R1 million in any twelve month period. Consequently, a sale of property will be subject to VAT where the seller of that property (a) is or is required to be registered as a vendor, (b) carries on an enterprise, and (c) that property is sold in the course of carrying on that enterprise.

Where VAT is payable on a transfer of property, the transfer will be exempt from transfer duty (provided the provisions of section 9(15) of the Transfer Duty Act are met). Where VAT is not payable, the purchaser will be liable to pay transfer duty (unless any other exemptions from transfer duty in the Transfer Duty Act are available).

Circumstances may arise, however, where the disposal of a property is subject to VAT at the zero rate and is also exempt from transfer duty. Section 11 of the VAT Act provides for circumstances under which a taxable supply will be subject to VAT at the zero rate. In this regard, section 11(1)(e) provides that a supply of goods will be zero rated where –

(e) the supply is to a registered vendor of an enterprise or of a part of an enterprise which is capable of separate operation, where the supplier and the recipient have agreed in writing that such enterprise or part, as the case may be, is disposed of as a going concern: Provided that-

(i) such enterprise or part, as the case may be, shall not be disposed of as a going concern unless-

(aa) such supplier and such recipient have, at the time of the conclusion of the agreement for the disposal of the enterprise or part, as the case may be, agreed in writing that such enterprise or part, as the case may be, will be an income-earning activity on the date of transfer thereof; and

(bb) the assets which are necessary for carrying on such enterprise or part, as the case may be, are disposed of by such supplier to such recipient; and

(cc) in respect of supplies on or after 1 January 2000, such supplier and such recipient have at the time of the conclusion of the agreement for the disposal of such enterprise or part, as the case may be, agreed in writing that the consideration agreed upon for that supply is inclusive of tax at the rate of zero per cent. (emphasis added)

Consequently, where a property is sold as part of an enterprise disposed of as a going concern, the transfer may qualify as a zero-rated supply for VAT purposes in terms of section 11(1)(e), and should also be exempt from transfer duty in terms of section 9(15) of the Transfer Duty Act.

3.5.5 Deduction of interest expense on funding

As mentioned in paragraph 3.3 above, a seller and a purchaser may have conflicting interests in respect of the subject matter of a transaction. It is for these reasons, as well as securing an interest deduction in respect of loan funding in some instances, that many transactions in the past were concluded using debt-deferred “intra-group transactions” (also referred to colloquially as a “debt push-down” structure, or an indirect share acquisition). In terms of a typical “debt push-down” structure, the parties would take the following steps:

1. Purchaser incorporates a new company (“NewCo”);
2. Purchaser obtains bridging finance from a bank;
3. Purchaser utilises funding to acquire shares from Seller in the target company (“TargetCo”);
4. NewCo acquires an interest-bearing loan from a bank;
5. NewCo uses funding to acquire the business assets from TargetCo, utilizing an “intra-group transaction” in terms of section 45 of the Income Tax Act, thus deferring any tax triggered on the transfer of the NewCo assets;
6. TargetCo declares and pays the sale proceeds to Purchaser as a dividend, and is subsequently liquidated;
7. NewCo repays the bridge loan using the dividend proceeds.

(National Treasury, 2012:42)

The above structure has the effect of re-characterising an “unproductive” loan (i.e. a loan on which the interest is not deductible for tax purposes) in Purchaser’s hands, into a “productive” loan (i.e. a loan on which the interest is deductible for tax purposes) in NewCo’s hands. Concomitantly, Purchaser divests itself of the risk associated with the TargetCo shares, and Seller divests itself of its shares in TargetCo. In addition, from the bank’s perspective, it is preferable to advance funding at the NewCo level, which is an operating company, rather than at Purchaser level, as the cash flows are typically more readily available in an operating company than in a holding company, where the only source of income can be dividend income.

Section 24O of the Income Tax Act was introduced once National Treasury was satisfied that such “debt push-down” structures were not a threat to the *fiscus*, but rather that it was the use of excessive debt to fund such structures that could give rise to an abuse of the Income Tax Act. In this regard, National Treasury (2012:42) published the following statement:

> Under the current paradigm, a practical dichotomy exists. Interest deductions associated with debt-financing of direct share acquisitions are not deductible while indirect debt-financing via sections 45 and 47 are allowed if the financing meets the requirements of section 23K. Therefore, these indirect share

> acquisitions have been formally accepted in the tax system under certain limited circumstances. No reason exists to deny interest-deductions associated with direct share acquisitions occurring under similar limited circumstances. To force an indirect share acquisition in all instances is to effectively add unnecessary transaction costs.

Very simply put, section 24O provides for a special allowance for the deduction of interest in respect of certain debts which it deems (i) to be incurred in the production of income and (ii) expended for the purposes of trade, where the debt is incurred to finance the acquisition of a controlling interest in an operating company.

Without section 24O of the Income Tax Act, interest expenses incurred for the acquisition of shares in the normal course are not deductible, as shares give rise to dividend income which is exempt from normal tax (and thus does not constitute "income" as defined in the Income Tax Act). Consequently, such interest expenditure does not meet the "in the production of income" requirement of section 24J and would not qualify for a deduction in terms of the section.

Notwithstanding this, parties to a transaction may meet the requirements of section 24O without having an income base against which to deduct the interest. Where this has not been carefully considered, the interest deduction could be wasted, for example in the case of a holding company generating exempt dividend income, or a company in a tax loss position.

Similarly, a situation may arise where a party to a transaction is required to purchase the shares in a company as opposed to the business assets, but the intention is to acquire the business. In these circumstances, the question arises whether interest on financing to acquire the shares may nevertheless be deductible for tax purposes in terms of section 24J of the Income Tax Act. The situation where a company has incurred interest on financing to acquire shares in a company in order to acquire its business or other income producing stream, has come before the South African courts on several occasions, and applications for advance tax rulings on the subject have been made to SARS. In this regard the crux of the matter has been the purpose of the borrowing of the funds, and whether there is a direct link between the expenditure

incurred (the interest) and the subsequent income produced. Set out below is an examination of some of the notable cases in this regard as well as the *ratio* of the court and the outcome for the taxpayers involved.

Case law

A key judicial decision is *CIR v Shapiro* (4 SATC 29), where the test of the purpose for which the money is borrow was stressed. In this case, the taxpayer borrowed money on which he paid interest in order to fund the acquisition of shares, which enabled him to become managing director of the company, in which capacity he was to receive a salary, house allowance and a percentage of profits by way of commission. The taxpayer claimed the interest as a deduction, on the basis that it was incurred in the production of his income, made up of a salary, house allowance and commission. The Commissioner denied the deduction. The court, in considering the matter, held that whilst the expenditure enabled him to qualify for the position of managing director (and therefore earn the emoluments), the expenditure did not itself actually produce any of those sources of income. The court accordingly denied the deduction on the basis that the salary, house allowance, and commission received by the taxpayer from the company were not produced by his shareholding in the company, but by the exercise of his duties in the office held by him and, consequently, the interest paid on the money borrowed to purchase the shares had not been productive of appellant's taxable income. The principle underpinning this conclusion was that the connection between the interest and the emoluments attaching to his position as managing director was considered to be insufficiently close.

However, despite the precedent set by *Shapiro,* subsequent cases have come before the courts with varying outcomes depending on the facts, with the courts attempting to distinguish these cases from the *Shapiro* case in order to arrive at an appropriate outcome. The leading case which allowed a taxpayer to deduct interest on money borrowed to fund the acquisition of shares is *CIR v Drakensberg Garden Hotel (Pty) Ltd* (1960 (2) SA 475(A), 23 SATC 251). In this case, the company leased a property from another company, which it then sub-let. It borrowed money in order to acquire the shares in the other company to obtain absolute control of the hired premises from which it derived rent and business profits, thereby ensuring security of tenure and

continuance of its income. The company acquired the shares as opposed to the property in order to avoid paying transfer duty on the land. It was held by the court that the income from which to deduct the interest expense was not the dividend income flowing from its shareholding, but other income derived from rent and business profits. The court found that the connection between the payment of interest and the production of the taxpayer's income was sufficiently close to warrant its deduction.

Interest will, however, not be deductible if an income-producing purpose in borrowing the money was merely incidental to the true purpose of deriving dividends. Consequently, the true subjective intention of the taxpayer is the key test for determining the purpose of the borrowing, supported by objective evidence validating the taxpayer's contention.

Where the borrowing for the acquisition of shares is linked to the actual or prospective receipt of dividends, the interest would not be allowed. However, as was the case in ITC 1089 (28 SATC 208), if it can be shown that the dominant purpose of the acquisition of the shares is to produce income, and that any dividends received/accrued on the shares is purely incidental to the main purpose, then the interest expense should be allowable as a deduction.

There have been varying outcomes for taxpayers who have relied on the *Drakensberg Garden* principle. Where taxpayers have been successful, they have been able to successfully fulfil the burden of proving that the dominant purpose of borrowing moneys to acquire shares has been other than the production of exempt dividend income.[16]

Binding Private Rulings

In addition to the case law and principles developed in the courts, several rulings have been issued by SARS allowing the deduction of interest incurred on a loan that has been raised to enable the business of a company to be effectively acquired through

[16]Refer to ITC 1604 (58 SATC 263), IT 1428 (50 SATC 34), *C: SARS v 121 Castle Street Cape Town CC* (2002 (1) SA 198 (C)), *CIR v Standard Bank of SA Ltd* (1985 (4) SA 485 (A)) and *C:SARS v BP South Africa (Pty) Ltd* (68 SATC 229).

the acquisition of shares in that company. Although a Binding Private Ruling ("BPR") is not binding on persons other than the applicant(s), it does provide an indication of how SARS is likely to consider this request.

In terms of the first of these rulings, a deduction of interest was allowed in BPR 057 (South African Revenue Service: 2009(a)), where the applicant's intention was to acquire the business of company A as a going concern. During its negotiations with company A, the applicant sent a letter of intention with an offer to acquire the business assets and liabilities, which the shareholders of company A rejected. The shareholders indicated they would only enter into a sale on the basis that the applicant acquires the shares. The applicant agreed to this but wanted to continue with its intention to integrate the business of company A into its current operations. To achieve this, the applicant intended to transfer all the assets and liabilities from company A following the acquisition of A and liquidate the company. SARS ruled that the interest on the loan to fund the business of A as a going concern, through the acquisition of the shares in A, will be an expense incurred in the production of income as envisaged by section 24J.

The ruling was, however, made subject to the conditions that (i) no dividends will be declared to the shareholders of the applicant as a result of or as part of the acquisition process of company A, and (ii) the business of company A would be transferred on a specified date and A would be liquidated within six months of the transfer.

In BPR 063 (South African Revenue Service: 2009(b)), similar facts were presented to SARS, where the applicant sought to acquire the shares in a target company, following which the target company would distribute all its assets to the applicant by way of a section 47 liquidation distribution. Thereafter the target company would be liquidated or deregistered. SARS ruled that the interest on the loans utilised to fund the acquisition of the shares in the target company would constitute expenditure incurred in the production of income and would be deductible under section 24J. The ruling was made on condition that, *inter alia*, the necessary steps to liquidate the target company would take place within 18 months of the section 47 liquidation distribution to the applicant.

Thus, the interest on loan funding to purchase shares may qualify for a tax deduction where there is a sufficient nexus between the acquisition of the shares and the production of “income”, which can be supported by objective evidence. In this regard, each transaction should be considered on a case by case basis and outcomes may differ from one transaction to the next.

3.5.6 Allocation of the purchase price

3.5.6.1 Capital versus revenue

When considering the capital or revenue nature of the proceeds of the sale of a business, the seller could easily be under the impression that the proceeds of the sale – usually expressed as a lump sum – are of a capital nature. This was the case until the decision by the then Appellate Division in *Commissioner for Inland Revenue v Niko* (1940 AD 416, 11 SATC 124). The outcome of the *Niko* case, in summary, is that the seller must allocate the selling price to the individual items, such as trading stock, goodwill, loan claims, etc., making up the business.

In the *Niko* case, the respondent carried on business as a scrap iron merchant and second hand dealer, a material part of his business being the acquisition of old harbour craft, such as tugs and dredgers, and of machinery of all kinds, large and small, which he usually dismantled and sold in parts, or as spares or scrap, whichever offered the greatest prospect of profit. The sales took place from time to time as occasion offered and there was thus left on his hands a heterogeneous collection of oddments, which were the remnants of his various purchases. These remnants represented the bulk of his stock.

During the tax year, the respondent sold his business to a company as a going concern, his stock-in-trade being included at a named figure, which the Special Court found to be a fair price. The Commissioner, in assessing the respondent for income tax, added the difference between this figure and the calculated cost price of the stock to the respondent's income. On behalf of the respondent it was contended that the sale of the business and assets was a slump or lock-stock-and-barrel sale and that the profit realised on the sale was a capital profit.

Centlivres JA (at 331 – 332) cited the following extract of the judgment handed down by Lord Phillimore in *Doughty v Commissioner of Taxes* (1927 AC 327) with approval:

> Where, however, a business consists, as in the present case, entirely in buying and selling, it is more difficult to distinguish between an ordinary and a realisation sale, the object in either case being to dispose of goods at a higher price than that given for them, and thus to make a profit out of the business. The fact that large blocks of stock are sold does not render the profit obtained anything different in kind from the profit obtained by a series of gradual and smaller sales. This might even be the case if the whole stock was sold out in one sale. Even in the case of a realisation sale, if there was an item which could be traced as representing the stock sold, the profit obtained by that sale, though made in conjunction with a sale of the whole concern, might conceivably be treated as taxable income.

Parties to a sale of a business should also carefully consider the allocation of part of the purchase price to goodwill. As stated by Kruger and Scholtz (2003:49), goodwill essentially "represents that portion of the purchase price of a business that is not allocable to any tangible asset". A genuine payment for goodwill would constitute a capital receipt in the hands of the seller. However, purchasers are often reluctant to make a payment of this kind upfront, without testing the performance of the business after acquisition. Consequently, payments of goodwill are often linked to the performance of the business going forward, in what is sometimes termed an "agterskot" payment.

The risk of a payment structure of this nature is that it can result in the re-characterisation of the "agterskot" as revenue in the seller's hands, thus being taxable at a higher effective tax rate. An example of this can be found in the case of *Deary v Commissioner for Inland Revenue* (1920 CPD 541, 32 SATC 92).

In this case the Appellant (Deary), who had carried on business as a general mercantile dealer for many years, entered into an agreement with three of his employees in terms of which they, in partnership, should take over his business. Deary

retained and let the premises in which the business had been conducted to the partnership and he also retained the book debts and outstandings. The stock in trade, furniture and plant were to be taken over by the partnership together with any loans made by the appellant secured by a bond to be passed in favour of the Appellant. Further, included in the assets sold to the partnership was the goodwill in the business. In terms of the agreement the partnership was required to pay over to the Appellant one fourth of the annual profits of the business as consideration for his goodwill, for so long as any sum of money was still due and owing to him under the bond.

In accordance with the provisions of the agreement there was paid to the appellant by the partnership for the year of assessment ended the 30th June 1917, the sum of £516, being one fourth of the partnership profits for that period. This amount was assessed for income tax for that year of assessment as being income subject to such tax. Against this assessment Appellant appealed to the Special Court for hearing Income Tax Appeals, contending that the amount in question was a receipt of a capital nature, and thus not income subject to tax. The Deputy Commissioner, on the other hand, contended that the amount in question had been received by the Appellant as income, as his share of the profits as a partner. Relying on the principle enunciated by English tax judge Rowlatt J in *Jones v Commissioner of Inland Revenue* (121 L.T. 611), Benjamin J for the Special Court dismissed the appeal, upholding the contention of the Deputy Commissioner, quoting Rowlatt J (at 97) as follows:

> On the other hand a man may sell his property nakedly upon the share of the profits of the business and if he does that I think that the share of the profits of the business would be undoubtedly the price paid for his property; but still that would be the share of the profits of the business and would bear the character of income in his hands, because that is the nature of it . . . I therefore think that what one has to do is to look and see what the sum payable really is.

Had Deary structured the mechanism for the payment of goodwill in a different way, for example by delinking the payment for goodwill from the profits of the business, he could have potentially avoided the adverse income tax consequences.

3.5.6.2 Assumption of liabilities

From the *Niko* case discussed above, it becomes clear that for income tax purposes, it is not the "business" that it sold, but rather the individual assets forming that business. Consequently, the purchase price paid for those assets must be allocated to the individual assets in order to determine the tax value attributable to each asset in the purchaser's hands, and also to determine the nature of the receipts or deductions available in the seller's hands.

As rightly noted by Rudnicki (2010:25), "it is not sufficient when drafting sale-of-business agreements to reflect the value of assets as a lump sum or, as occurs in many instances, to reflect the 'book value' of the business as a purchase price for the assets net of liabilities".

In *Kerbyn 178 (Pty) Ltd v Van Den Heever and Others NNO* (2000 (4) SA 804 (W) (at 816), the court gave clear guidance on the fact that a business being sold is not a holistic entity having a separate existence from its component parts, but rather a collection of real and personal property which should be dealt with separately for legal purposes. It is therefore only the assets of a business that are sold and in law, a liability cannot be sold. Liabilities may therefore be transferred by, amongst others, assumption or delegation.

Whilst a purchaser can only purchase the assets of a business, it is common for a portion of the purchase price payable by a purchaser to be settled by way of the purchaser assuming the liabilities of the seller's business. Rudnicki (2010:29) explains what the assumption of liabilities represents, in law, for the seller as follows:

> The transfer of liabilities, for the seller, in essence represents the consideration accruing to the seller in relation to the transfer of assets. In other words, ignoring the concept of book value, an accounting concept, the seller's consideration for the disposal of assets typically constitutes cash and a delegation of liabilities. An alternative contractual mechanism would be for the seller to dispose of its assets for cash, and to compensate the purchaser with a cash consideration equal to the liabilities delegated.

Consequently, by way of the purchaser assuming the seller's liabilities, the seller has received the benefit of being relieved of the obligation to settle the liabilities.

A resident's "gross income" as defined in section 1(1) of the Income Tax Act includes "the total amount, in cash or otherwise, received by or accrued to or in favour of such resident … excluding receipts or accruals of a capital nature …". Furthermore, paragraph 35(1) of the Eighth Schedule to the Income Tax Act describes "proceeds from the disposal of an asset" as "the amount received by or accrued to, or which is treated as having been received by, or accrued to or in favour of, that person in respect of that disposal…".

It is therefore important to consider what constitutes an "amount". With regard to the meaning of the word "amount", the Supreme Court of Appeal considered the meaning in *CSARS v Brummeria Renaissance (Pty) Ltd and others* (69 SATC 205), where Cloete JA stated the following (at paragraphs 11, 16 and 17):

> The word 'amount' and the phrase 'accrued to' were interpreted by Watermeyer J writing for the full court of the Cape Provincial Division in *Lategan v Commissioner for Inland Revenue* and both interpretations were approved by this court in *Commissioner for Inland Revenue v People's Stores (Walvis Bay) (Pty) Ltd*. The law was restated by this court in *Cactus Investments (Pty) Ltd v Commissioner for Inland Revenu*e. Hefer JA, who wrote both judgments in this court, summed up the law in *Cactus Investments* by saying that the definition of gross income
>
> > 'includes, as explained in *Commissioner for Inland Revenue v People's Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A), not only income actually received, but also rights of a non-capital nature which accrued during the relevant year and are capable of being valued in money'.
>
> …
>
> The law in South Africa appears from the following passage in the *People's Stores* case:
>
> > 'The first and basic proposition [in *Lategan*'s case] is that income, although expressed as an *amount* in the definition, need not be an actual amount of money but may be "every form of property earned by the taxpayer, whether

> corporeal or incorporeal, which has a money value…including debts and rights of action".
>
> …
>
> It is clear from the *People's Stores* and *Cactus Investments* cases that the word 'amount' in the definition of gross income is to be interpreted widely.

Consequently, the benefit to the seller of being relieved of the obligation to settle the liabilities would constitute an "amount" received or accrued, the value of which must be determined and brought into account for tax purposes. Whether that amount is brought to account on a capital or revenue basis will depend on the asset to which that amount is allocated.

From the seller's perspective, the question arises whether the seller has incurred deductible expenditure by forgoing a portion of the purchase price for the assumed liabilities. From the purchaser's perspective, the question arises whether the purchaser has actually incurred expenditure, or unconditionally undertaken to incur expenditure, which will impact the availability and quantum of tax deductions and allowances against the assets acquired.

Where the liabilities assumed are unconditional, the liability would typically be valued at its face value for accounting purposes. Furthermore, and more important for this discussion, an unconditional liability represents a definitive obligation of the seller to a creditor, for example an amount owed to a trade creditor, which obligation has crystallised or materialised. The distinction of an unconditional liability from a conditional liability (or a contingent liability) is critical in considering the position of both the seller and the purchaser. For the sake of brevity and given that this is not intended to be the focal point of this chapter, contingent liabilities are dealt with in general. However, the nature of such contingencies is varied and could include, for example, provisions for warranties, deposits, future expenditure, bonuses, leave pay, post-retirement medical aid, retrenchments and major maintenance.

In the case of *Ackermans Ltd and another v CSARS and another* (2011 (1) SA 1 (SCA)), the Supreme Court of Appeal was required to determine whether the appellant was entitled to a deduction under section 11(a) of the Income Tax Act for an amount

equal to the contingent liabilities, by foregoing a portion of the asset purchase price to which the appellant would otherwise have been entitled (equal to the value of the contingent liabilities). In considering the issue, Cloete JA (at page 7) found as follows:

> [10] It is clear that what occurred, as is usually the case in transactions of this nature, is that the nett asset value of the business – the assets less the liabilities – was calculated and that this valuation dictated the purchase price. In the ordinary course of purchasing the business as a going concern on this basis it would follow that the liabilities would be discharged by the purchaser…
> [11] The fact that Ackermans rid itself of liabilities by accepting a lesser purchase price than it would have received had it retained the liabilities, does not mean in fact or in law that it incurred expenditure to the extent that the purchase price was reduced by the liabilities. At the effective date, no expenditure was actually incurred by Ackermans.

The court did, however, acknowledge, in an *obiter dictum* (at page 6), that had the sale agreement been drafted to represent a reciprocal amount owing by Ackermans to the purchaser for the assumption of its liabilities, resulting in set-off, an argument may have been made for an amount of expenditure having been incurred in Ackermans' hands.

Whilst the judgment from the *Ackermans* case has received some criticism, such as comments from Kruger (2010:21) who states that the "expenditure would, however, in my view still have related to the assumption of the liability by Pepkor, and not the underlying contingent liabilities", SARS has since published Interpretation Note 94 expressing its position on contingent liabilities assumed in the acquisition of a going concern (South African Revenue Service, 2016:Online). Whilst an interpretation note does not enjoy binding force of law, it provides useful insight into the practical application of various concepts by the revenue authorities. In Interpretation Note 94, SARS (2016:12) expresses a view in alignment with the judgment handed down in the *Ackermans* case in respect of the position of the seller, as follows:

> When a purchaser assumes a free-standing contingent liability in settlement or part settlement of a purchase price owing to a seller for an asset, the seller has not incurred any expenditure in order for the purchaser to assume the free-standing contingent liability. The seller has not outlaid any assets (in cash or

> otherwise) or undertaken an unconditional legal liability to do so and has, therefore, not incurred any expenditure.

Like Cloete JA, SARS (2016:12) also acknowledges that the position could differ where the sale agreement specifically caters for the seller paying the purchaser to take over the liabilities and, separately, receiving the full purchase price in cash, and recognises that "[d]ifferent courses of action and different facts may have different tax consequences even when the economic effect is the same".

From the purchaser's perspective, the question arises as to the availability and quantum of the tax deductions and allowances that it may claim against the assets acquired, where it has incurred contingent liabilities in settlement of the purchase price. In this regard, the particular asset acquired and the relevant allowance provision in the Income Tax Act must be considered. The most common allowance provisions which may apply include section 11(a) and (e), and sections 12C and 13. The common theme of these allowances is the requirement of the "cost" or "expenditure" being "actually incurred" in order for the taxpayer to claim the deduction.

This concept has been interpreted by South African courts and is well established in South African tax law. The words "actually incurred" were considered by the court in *Port Elizabeth Electric Tramway Co Ltd v CIR* (1936 CPD 241, 8 SATC 13), where Watermeyer AJP distinguished this phrase from expenditure and losses being "necessarily incurred", which would give rise to a narrow interpretation and different consequential tax implications.

In *Edgars Stores Ltd v CIR* (1988 (3) SA 876 (A), 50 SATC 81) the court was required to express an opinion on whether expenditure was "actually incurred" where the taxpayer incurred "turnover rental" based on turnover over the lease period, which lease period differed from the tax year. Corbett JA, delivering the judgment of the majority of the Appellate Division, cited *Port Elizabeth Electric Tramway* with approval, concluding (at 90) that:

> …it is clear that only expenditure (otherwise qualifying for deduction) in respect of which the taxpayer has incurred an unconditional legal obligation during the

> year of assessment in question may be deducted in terms of s 11(a) from income returned for that year. The obligation may be unconditional *ab initio* or, though initially conditional, may become unconditional by fulfilment of the condition during the year of assessment; in either case the relative expenditure is deductible in that year. But if the obligation is initially incurred as a conditional one during a particular year of assessment and the condition is fulfilled only in the following year of assessment, it is deductible only in the latter year of assessment (the other requirements of deductibility being satisfied). (emphasis added)

It was therefore clarified by the court that for expenditure or losses to be considered "actually incurred" for purposes of the Income Tax Act, the taxpayer must have incurred an unconditional legal obligation in that year of assessment.

Subsequent to *Edgars Stores*, the Appellate Division considered the meaning of "actually incurred" in respect of contingent liabilities in *CIR v Golden Dumps (Pty) Ltd* (1993 (4) SA 110 (A), 55 SATC 198). In this case, Golden Dumps claimed a deduction under section 11(a), being the expenditure incurred in purchasing shares in other companies which Golden Dumps was contractually obliged to transfer to Mr Adrian Nash, a former employee. This contractual obligation had arisen when Golden Dumps offered employment to Nash, who accepted the offer, and in terms of the agreement, Nash was entitled to be allotted certain shares at a stipulated price. Golden Dumps dismissed Nash shortly thereafter, and Nash demanded delivery of the shares and tendered the agreed price (which was then significantly lower than the current market value of the shares, which had escalated). Golden Dumps disputed Nash's entitled to the shares; however, a court found in favour of Nash.

The issue before the Appellate Division was thus whether the expenditure incurred by Golden Dumps in purchasing the shares which it was obliged to deliver to Nash was "actually incurred" in the year of assessment when Nash instituted legal proceedings, or in the year of assessment when the dispute was resolved by the court, which ordered Golden Dumps to deliver the shares to Nash. In coming to its decision, that the expenditure incurred by Golden Dumps was "actually incurred" in the year of assessment when the dispute was resolved, Nicholas AJA stated (at 204 – 205) that:

> If the implication is that the word *actually* is mere surplusage and can be ignored, that would be contrary to the firmly established rule of statutory construction that a meaning must be given to every word… According to the *Shorter Oxford English Dictionary*, the adverb *actually* means 'in act or fact; really'. (emphasis added)

Nicholas AJA went on to state (at 206 – 207) that:

> A liability is contingent in that sense in a case where there is a claim which is disputed, at any rate genuinely disputed and not vexatiously or frivolously for the purposes of delay. In such a case the ultimate outcome of the situation will be confirmed only if the claim is admitted or if it is finally upheld by the decision of a court or arbitrator. Where at the end of the tax year in which a deduction is claimed, the outcome of the dispute is undetermined, it cannot be said that a liability has been actually incurred. The taxpayer could not properly claim the deduction in that tax year, and the receiver of revenue could not, in the light of the *onus* provision of s 82 of the Act, properly allow it. (emphasis added)

In light of this decision, a purchaser who assumes contingent liabilities in settlement or part settlement of the purchase price would not meet the requirement of expenditure being actually incurred and would not be entitled to claim the quantum of the contingent liabilities as allowances against the relevant asset. In this regard, SARS' view expressed in Interpretation Note 94 (2016:14) is as follows:

> Consequently, the purchaser has not outlaid or undertaken to unconditionally outlay cash or assets in a form other than cash at that time. In other words, the purchaser has not incurred the expenditure to the extent of the assumption of the free-standing contingent liability as at the date of sale but has merely undertaken to incur expenditure in the future should the free-standing contingent liability materialise…
>
> If and when the free-standing contingent liability materialises, and the purchaser incurs expenditure… [that expenditure] will potentially qualify for an allowance.

Whether the expenditure will qualify for an allowance upon the contingent liability materialising will depend on the nature of the asset it funded and whether the other requirements for a tax deduction would be met at that time, based on the particular facts and circumstances.

What becomes clear from the discussion is that in the context of a sale of business, both the seller and the purchaser need to carefully consider the valuation and allocation of the price payable for the business assets, the manner in which the purchase price is settled by the purchaser, and the legal structure of the arrangement, for purposes of efficient tax planning, even where the economic outcome of the structuring options may be the same.

3.6 Conclusion

From the above discussion, it is clear that there is a plethora of tax considerations for both the seller and the purchaser in a statutory merger. Sellers and purchasers typically have competing interests in a sale, which directly determines the nature of the asset ultimately forming the subject matter of the sale and the terms according to which that transaction is negotiated. Both the nature of the contract and the subject matter of the sale are crucial in determining the implications attendant on the sale. In the context of a sale of shares, elements such as a change of intention as a result in change of ownership of the company can give rise to a deemed disposal for CGT purposes, which could result in unforeseen tax costs in a transaction. For the purchaser, a critical consideration in funding the acquisition of shares will be the availability of a tax deduction for interest or similar finance charges on loan funding. The interest on loan funding to purchase shares may qualify for a tax deduction where there is a sufficiently close nexus between the acquisition of the shares and the production of “income”. In this regard, each transaction should be considered on a case by case basis and outcomes may differ from one transaction to the next.

In respect of a sale of business, each asset comprising that business requires a value to be attributed to it, as opposed to the sale of the business for a global sum. Consequently, a business sold as a going concern is not in itself a sale of a capital asset taxable as a capital gain, but rather a sale of various assets which may give rise

to capital or revenue income. Further complexities may also arise where the purchase price is settled by way of the assumption by the purchaser of liabilities, particularly conditional or contingent liabilities. As these obligations have not yet become unconditional and have thus not been “actually incurred”, the purchaser would not meet the requirement of expenditure being actually incurred for purposes of claiming allowances against the relevant asset. From the seller’s perspective, unless the legal agreement giving effect to the transaction specifically creates a reciprocal amount owing by the seller to the purchaser for the assumption of its liabilities, the seller would not be able to claim a deduction in respect of the quantum of the purchase price foregone for the assumption by the purchaser of liabilities. Purchasers should also carefully consider the terms on which they assume existing contracts of the seller, as this may affect the deductibility of expenditure incurred in delivering on those contracts.

Lastly, where the business is sold as opposed to the shares, any assessed loss will not be transferred to the buyer but may potentially shield the seller from tax that becomes payable on consideration received in respect of the sale transaction.

Having considered certain important tax considerations that would apply to a seller and purchaser in a merger on the transfer of assets otherwise than in terms of the corporate roll-over provisions, the following chapter will explore the nature and extent of the tax relief provided for in terms of a section 44 “amalgamation transaction”, and the parameters relating to the relief that may be afforded.

Chapter 4: Amalgamation transactions under the Income Tax Act

4.1 Introduction

The goal of this chapter is to analyse the tax benefits of utilising the corporate rules, specifically those provided for in section 44 of the Income Tax Act. In doing so, this chapter will cover the requirements that a transaction must comply with in order to enjoy these tax benefits, the transaction steps necessary to implement an amalgamation transaction, and the tax implications for the amalgamated company and the resultant company. This chapter will also cover the circumstances under which section 44 of the Income Tax Act will not apply, as well as the anti-avoidance provisions in the Income Tax Act aimed at preventing abuse of the corporate roll-over provisions.

4.2 Background to the introduction of the corporate rules

With the advent of the capital gains tax regime, National Treasury (2001:Online) undertook to introduce group relief measures to facilitate transactions between group companies or between founding shareholders and their company on a tax neutral basis. In this regard, National Treasury (2001:Online) stated that:

> These measures are generally based on the view that where the group or the shareholders have retained a substantial interest in the assets transferred, it is appropriate to permit the tax-free transfer of assets to the entity where they can be most efficiently used for business purposes.
>
> 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.

In addition, National Treasury (2017:44) has recognised that restructuring the business operations of a company or companies belonging to the same economic unit can help both struggling companies to improve their financial position and successful

companies to expand under a revised structure. To trigger a tax liability in these circumstances could hinder business performance in South Africa. National Treasury (2017:45) acknowledged the importance of providing corporate roll-over provisions in appropriate circumstances:

> Growth in the profitability of companies would have a positive effect on the fiscus. As such, it is Government's policy to encourage and simplify corporate restructures. However, South Africa does not have a group taxation regime which would treat a group of wholly owned or majority-owned companies as a single entity for tax purposes… Instead of having a group taxation regime, the Act contains corporate reorganisation rules that postpone the tax consequences of taxpayers that sell or transfer their assets under specific circumstances.

Consequently, the corporate roll-over provisions were promulgated in the Second Revenue Laws Amendment Act, No. 60 of 2001 with effect from 1 October 2001. The provisions relating specifically to an "amalgamation transaction" were subsequently introduced in 2002 with the promulgation of the Revenue Laws Amendment Act, No. 74 of 2002, after National Treasury (2002:Online) recognised the need for rules that would cater for an "amalgamation, conversion or merger".

4.3 Criteria for income tax relief in terms of an "amalgamation transaction"

The income tax relief afforded in terms of section 44 of the Income Tax Act only applies if the transaction meets the requirements of an "amalgamation transaction" as defined in section 44(1), as well as the additional requirements set out in the remaining sub-sections of the provision. Corresponding relief may also apply in terms of the relevant VAT, transfer duty and securities transfer tax legislation where the requirements of an "amalgamation transaction" as defined in section 44(1) are met.

Section 41 of the Income Tax Act provides a general set of rules and definitions that apply specifically to the corporate roll-over provisions in sections 42 to 47 of the Income Tax Act. Of notable importance are the definitions of "debt" and "disposal" as follows:

> "**debt**" includes any contingent liability;
> "**disposal**" means a disposal as defined in paragraph 1 of the Eighth Schedule and any deemed disposal in terms of this Part…

A "disposal" is defined in paragraph 1 of the Eighth Schedule to the Income Tax Act as "an event, act, forbearance or operation of law envisaged in paragraph 11 or an event, act, forbearance or operation of law which is in terms of this Act treated as the disposal of an asset, and 'dispose' must be construed accordingly" (emphasis added).

These definitions are of particular importance in light of the tax implications that would apply outside of the application of the corporate roll-over provisions as discussed in Chapter 3. As a "debt" includes a contingent liability, parties to an "amalgamation transaction" are not required to determine the potentially complex tax consequences of the assumption of contingent liabilities as the provisions of section 44 of the Income Tax Act make provision for the tax values attributable to the assets transferred. Furthermore, as a "disposal" for purposes of the corporate roll-over provisions refers to a disposal as defined in paragraph 1 of the Eighth Schedule, any uncertainty as to the legal cause of the transfer and thus the timing of the disposal that may have arisen outside of the corporate roll-over provisions are provided for.

Section 41(2) provides an over-arching rule applicable to the corporate roll-over provisions, to the effect that the provisions of sections 42 to 47 of the Income Tax Act will apply notwithstanding any provision to the contrary contained in the Income Tax Act. This over-arching rule does not, however, apply to certain anti-avoidance provisions in the Income Tax Act, including, *inter alia,* section 24BA, section 103, the general anti-avoidance provisions in sections 80A to 80L, and disposals that result in a "value shifting arrangement" (discussed below in paragraph 4.4).

4.3.1 Definition of "amalgamation transaction"

An "amalgamation transaction" is defined in section 44(1) of the Income Tax Act and means, *inter alia*, any transaction:

a) (i) in terms of which any company (hereinafter referred to as the "amalgamated company") which is a resident disposes of all of its assets (other than assets it elects to use to settle any debts incurred by it in the ordinary course of its trade and other than assets required to satisfy any reasonably anticipated liabilities to any sphere of government of any country and costs of administration relating to the liquidation or winding-up) to another company (hereinafter referred to as the "resultant company") which is a resident, by means of an amalgamation, conversion or merger; and

(ii) as a result of which the existence of that amalgamated company will be terminated.

In terms of subparagraphs (b) and (c) of the definition of an "amalgamation transaction", an amalgamated company may also be a "foreign company" that disposes of all of its assets to a resident resultant company, or to a resultant company which is a foreign company in certain prescribed circumstances, for example, where it forms part of the same group of companies and is a controlled foreign company in relation to any resident of that group of companies. Given that the statutory merger in terms of the Companies Act only applies between South African companies, and this discussion is focused on the congruency of the statutory merger and the amalgamation transaction, the discussion that follows will only consider the consequences of an amalgamation transaction among South African tax resident companies.

Unlike certain other provisions of the corporate roll-over rules, such as section 45 (intra-group transaction), section 46 (unbundling transaction) and section 47 (liquidation distribution), an amalgamation transaction does not require the parties to the amalgamation transaction to constitute a "group of companies" as defined in section 1, read with section 41(1), of the Income Tax Act. In addition, unlike the requirements for an asset-for-share transaction as envisaged in section 42 of the Income Tax Act, the amalgamated company, or a shareholder of the amalgamated company, is not required to hold a "qualifying interest" in the resultant company as a consequence of the amalgamation transaction.

4.3.1.1 Meaning of "amalgamation, conversion or merger"

The definition of an "amalgamation transaction" refers specifically to a disposal of assets by the amalgamated company to the resultant company by means of "an amalgamation, conversion or merger". As these words are not defined in the Income Tax Act, they are required to be given their ordinary, literal meaning. In respect of the word "amalgamation", Claassen (2019:Online) provides the following definition:

> Is not a legal, but a commercial expression… It involves the blending of two concerns into one; "substantially" the whole of the two undertakings must pass…; and it may take place by the transfer of two undertakings to a new corporation, or by the continuance of both undertakings on the terms that the shareholders of one shall become shareholders of the other. See *South African Supply and Cold Storage Co; In re Wild v South African Supply and Cold Storage Co*, [1904] 2 Ch 268; 73 LJ Ch 657; 91 LT 447. (emphasis added)

As regards a "merger", the Oxford University Press (2019:Online) defines the term as "[t]he combination or amalgamation of a commercial company, institution, etc., with another, or the consolidation of two or more companies, etc., into one". For purposes of the Competition Act, No. 89 of 1998, section 12(1)(a) states that "a merger occurs when one or more firms directly or indirectly acquire or establish direct or indirect control over the whole or part of the business of another firm".

As discussed in Chapter 2, the Companies Act also contains its own definition of an "amalgamation or merger" in section 1, being:

> a transaction, or series of transactions, pursuant to an agreement between two or more companies, resulting in-
>
> (a) the formation of one or more new companies, which together hold all of the assets and liabilities that were held by any of the amalgamating or merging companies immediately before the implementation of the agreement, and the dissolution of each of the amalgamating or merging companies; or
>
> (b) the survival of at least one of the amalgamating or merging companies, with or without the formation of one or more new companies, and the vesting in the surviving company or companies, together with any such new company

> or companies, of all of the assets and liabilities that were held by any of the amalgamating or merging companies immediately before the implementation of the agreement.

A “conversion” appears to pose a conceptually different mechanism to the combination or blending of assets, as contemplated in the meanings of “amalgamation” and “merger”. In this regard, the Oxford University Press (2019:Online) defines a “conversion” as a “[c]hange in character, nature, form, or function… Change by substitution of an equivalent in purport or value… Substitution of or exchange for something else; esp. of one kind of property for another”.

In light of the above, the words “amalgamation, conversion or merger” appear to provide a relatively wide spectrum of circumstances in which the assets of one entity may be blended or combined with another and could include the substitution of property of one kind for another. Rudnicki (2014:36) summarises his view of the meaning of these words as follows:

> The three words have the relatively broad features of bringing together two or more legal entities either into a newly incorporated legal entity or the transposition into one of the merged legal entities with the shareholders of the transferring entities acquiring shares in the merged entity.

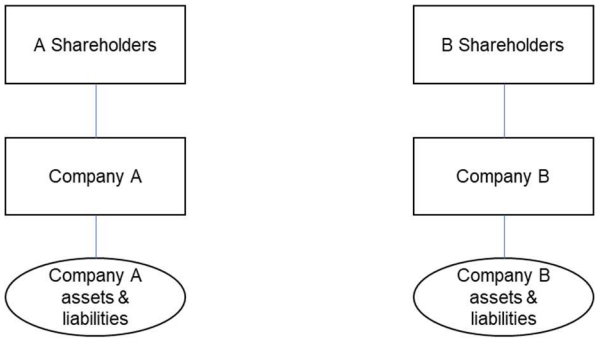
4.3.1.2 Legal steps giving effect to an “amalgamation transaction”

Set out below is a series of diagrammatic illustrations representing the mechanisms of an “amalgamation transaction” as envisaged in the Income Tax Act:

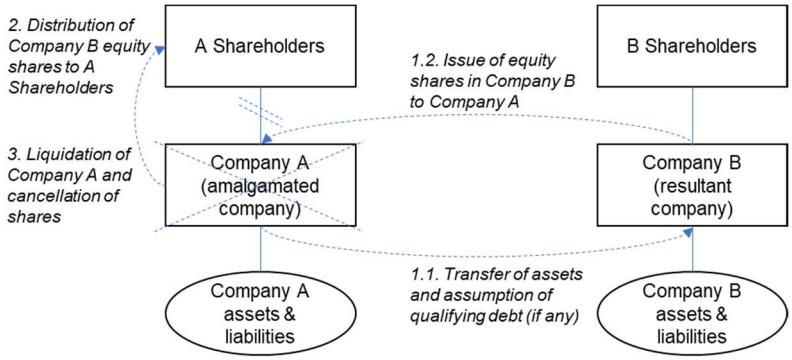
Example 7:

Company A transfers all its assets and liabilities to Company B, for consideration in equity shares in Company B. Shares in Company B are distributed to Company A's shareholders on termination of the existence of Company A:

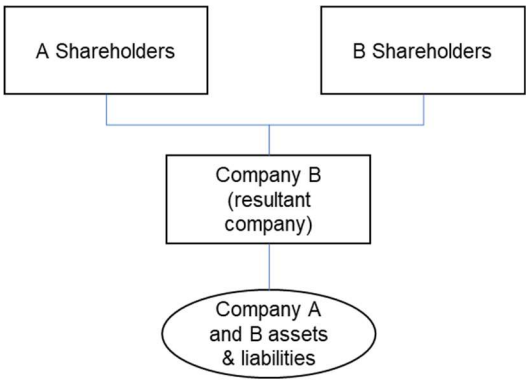
Before amalgamation transaction:



Amalgamation transaction steps:



After amalgamation transaction:



4.3.2 Disposal of assets

Whilst a transaction may meet the requirements of an "amalgamation transaction" as defined in section 44(1) of the Income Tax Act, the requirements in the remaining sub-

sections of section 44 must nevertheless be met in order for income tax relief to be afforded.

4.3.2.1 Capital assets

Where the amalgamated company disposes of a capital asset, the resultant company must acquire that asset as a capital asset (section 44(2)(a)). The market value of the capital asset disposed of must be equal to or exceed the base cost of that asset at the time of its disposal (proviso to section 44(2)(a)).

Where the above requirements are met, section 44(2)(a)(i) deems the amalgamated company to have disposed of the capital asset for an amount equal to its base cost. Accordingly, the disposal will not give rise to a capital gain in the amalgamated company's hands. In terms of section 44(2)(a)(ii), the resultant company and the amalgamated company will be treated as "one and the same person" for purposes of determining (i) the date of acquisition of the asset by the resultant company, and (ii) the base cost of the asset. Consequently, whether the resultant company acquires the assets for consideration at market value or less than market value, and subject to the application of any anti-avoidance provisions, the resultant company will record the tax value of those assets. Similarly, the amalgamated company would remove any accounting profit from the disposal of its business assets when calculating its taxable income during the year of assessment in which the amalgamation transaction occurs.

Consequently, where an amalgamated company disposes of capital assets which the resultant company intends to realise in a scheme of profit-making, such as in the example of the property developer discussed in Chapter 3 (paragraph 3.4.2.3), the provisions of section 44(2)(a) would not apply to those assets and CGT would be payable by the amalgamated company.

4.3.2.2 Trading stock

Where the amalgamated company disposes of trading stock, the resultant company must acquire it as trading stock (section 44(2)(b)). The market value of the trading stock must be equal to or exceed the tax value at the time of its disposal (proviso to

section 44(2)(b)). Where the above requirements are met, section 44(2)(b) will deem the amalgamated company to have disposed of trading stock for an amount equal to its tax value. Accordingly, the disposal of trading stock would not result in taxable income in the amalgamated company's hands. In terms of section 44(2)(b)(ii), the resultant company and the amalgamated company will be treated as "one and the same person" for purposes of determining (i) the date of acquisition of the trading stock by the resultant company, and (ii) the tax value thereof.

4.3.2.3 Allowance assets

In terms of section 44(3)(a)(i) of the Income Tax Act, where the asset disposed of constitutes an allowance asset in the hands of the amalgamated company and is equally received as an allowance asset by the resultant company (with the exception of a "REIT", as defined in section 1 of the Income Tax Act, discussed further below), no allowance granted to that amalgamated company in respect of that asset must be recovered or recouped by the amalgamated company or included in its income for the year of that transfer. Furthermore, the amalgamated company and resultant company are deemed to be one and the same person for the purposes of determining the amount of any allowance or deduction (i) to which the resultant company may be entitled in respect of the asset or (ii) that is to be recovered or recouped by or included in the income of that resultant company in respect of that asset (section 44(3)(a)(ii)).

The amendment to section 44(3)(a) of the Income Tax Act by section 52 of the Taxation Laws Amendment Act, No. 17 of 2017, in relation to REITs, was as a result of a REIT not being capable in all circumstances of receiving the asset as an "allowance asset". REITs are subject to a special tax dispensation that allows them to deduct qualifying distributions to shareholders against rental income, as the shareholders bear the tax liability. In terms of section 25BB(4) of the Income Tax Act, a REIT may not deduct an allowance in respect of immovable property in terms of sections 11(g), 13, 13*bis*, 13*ter*, 13*quat*,13*quin* or 13*sex*. Consequently, section 44(3)(a) of the Income Tax Act was amended to allow an "amalgamation transaction" to occur with a REIT by requiring that the resultant company may constitute a "REIT or a controlled company, as defined in section 25BB(1), that acquires that asset as a capital asset or an allowance asset".

In summary, where the relevant requirements of sub-sections 44(2) and (3) are met, the disposal of assets pursuant to an amalgamation transaction should be tax neutral in that no immediate income tax is triggered as a result of the disposal. In essence, any inherent gains in the assets are deferred until such time as these are realised by the resultant company, usually by way of a sale or transfer outside of the group structure to an unrelated third party.

4.3.2.4 Contracts

Section 44(3)(b) of the Income Tax Act applies where an amalgamated company disposes of a contract to a resultant company in respect of which an allowance in terms of section 24, 24C or 24P was available to the amalgamated company either (i) for the year preceding that in which that contract is transferred or (ii) for the year during which the contract is transferred, had that contract not been so transferred. Where these requirements are met, there will be no recoupment of allowances previously claimed under the sections referred to above in the amalgamated company's hands (section 44(3)(b)(i)). In addition, the amalgamated company and resultant company are deemed to be "one and the same person" for purposes of determining the amount of any allowance available or recoupment in the resultant company's hands under the relevant sections (section 44(3)(b)(ii)).

For the above to apply, the contract must have been transferred to the resultant company as part of a disposal of a business as a going concern. Where these requirements are met, the transfer of a contract in respect of which an allowance in terms of section 24, section 24C or section 24P was available, should be tax neutral and the resultant company will be deemed to inherit the tax position of the amalgamated company in relation to those contracts.

4.3.3 Nature of the consideration given in exchange for assets

Section 44(4) of the Income Tax Act is prescriptive in respect of the purchase consideration pursuant to an amalgamation transaction (referred to as "transaction consideration"). In this regard, section 44(4) provides that:

The provisions of subsections (2) and (3) will not apply to a disposal of an asset by an amalgamated company to a resultant company as part of an amalgamation transaction to the extent that such asset is so disposed of in exchange for consideration other than-

(a) an equity share or shares in that resultant company; or

(b) the assumption by that resultant company of a debt of that amalgamated company that was incurred by that amalgamated company, that-

(i) was incurred by that amalgamated company-

(aa) more than 18 months before that disposal; or

(bb) within a period of 18 months before that disposal, to the extent that the debt-

(A) constitutes the refinancing of any debt incurred as contemplated in subparagraph (aa); or

(B) is attributable to and arose in the ordinary course of a business undertaking disposed of, as a going concern to that resultant company as part of that amalgamation transaction; and

(ii) was not incurred by that amalgamated company for the purpose of procuring, enabling, facilitating or funding the acquisition by that resultant company of any asset in terms of that amalgamation transaction.

Consequently, where assets are disposed of by an amalgamated company to a resultant company in exchange for any consideration other than "equity shares"[17] in the resultant company, or the assumption by the resultant company of "qualifying debt",[18] which would include contingent liabilities, the assets attributable to that non-qualifying consideration would not be subject to the income tax relief afforded in terms of subsections 44(2) and (3) of the Income Tax Act. Similarly, new debt cannot be created in the resultant company in order to pay for assets transferred under the amalgamation transaction. If new debt is created, the assets attributable to the new debt would not qualify for income tax relief. Where circumstances permit, this may, however, not give rise to a normal tax liability (or only a nominal normal tax liability) if

[17] The term "equity share" is defined in section 1 of the Income Tax Act and must be read with the extended definition in section 41(1).

[18] References to "qualifying debt" refer to the debt described in section 44(4)(b) of the Income Tax Act.

the new debt or any other non-qualifying consideration (such as cash) is specifically attributed to assets which do not encompass an inherent gain.

Interestingly, the wording of section 44(4) of the Income Tax Act refers to the tax relief not applying to a disposal of assets in exchange for "consideration other than" equity shares or qualifying debt. As no consideration cannot be "consideration" other than equity shares or qualifying debt, it is submitted that the assets of an amalgamated company may be transferred to the resultant company for no consideration in terms of an amalgamation transaction and nevertheless qualify for the income tax relief afforded in terms of subsections 44(2) and (3). However, the provisions of section 24BA and paragraph 11(1)(g) of the Eighth Schedule to the Income Tax Act must still be considered as the corporate roll-over provisions do not apply in the place of these anti-avoidance rules.

Gad and Strauss (2012a:Online) reach a similar conclusion where they state that:

> Section 44 relief (following amendments in the 2011 TLAA [Taxation Laws Amendment Act]), only applies where assets are given in exchange for (i) no consideration, (ii) consideration in the form of equity shares, or (iii) consideration in the form of assumption of the liability for certain debts. (emphasis added)

The issue of equity shares by the resultant company to the amalgamated company will not constitute a "disposal" for capital gains tax purposes in the resultant company's hands. The issue of shares is specifically excluded as a "disposal" in terms of paragraph 11(2)(b)(i) of the Eighth Schedule to the Income Tax Act. Furthermore, the provisions of subsections 44(2) and (3) override the rules ordinarily applying in determining the deemed expenditure incurred by a company (i.e. the resultant company) which acquires assets in exchange for the issue of its shares.

Where all of the requirements discussed above are met, there should be no immediate income tax liability for the amalgamated company or the resultant company as a result of the transfer of assets and liabilities from the amalgamated company to the resultant company (refer to step 1.1 in Example 7 above).

4.3.4 Distribution of transaction consideration to shareholders

4.3.4.1 Tax relief for amalgamated company

Without the application of the corporate roll-over provisions, a distribution by a company of shares in an underlying company (or other assets) to its shareholder would either constitute a dividend *in specie* or a return of capital. Where the asset distributed constitutes a capital asset in the distributing company's hands, this would give rise to capital gain or capital loss for the distributing company determined with reference to the market value of the shares distributed (paragraph 75(1)(a) of the Eighth Schedule to the Income Tax Act). Where the assets constitute trading stock, proviso B to section 22(8) of the Income Tax Act provides for a deemed recovery or recoupment in the distributing company's income of the market value of trading stock distributed *in specie* to any shareholder.

In the context of an amalgamation transaction, where the relevant requirements are met, section 44(8) provides that an amalgamated company must disregard the disposal of shares in the resultant company (which it acquired as part of the "amalgamation transaction") to its shareholders for the purposes of determining its taxable income or assessed loss.

4.3.4.2 Tax relief for shareholders

Without the application of the corporate roll-over provisions, several tax implications may arise for a shareholder receiving a distribution from a company. In this regard, the shareholder's base cost in the shares in the distributing company would be reduced by the market value of the distributed asset (paragraph 76B(2) of the Eighth Schedule) and where the market value of the asset exceeds the base cost of the shares, that excess would be treated as a capital gain in the shareholder's hands (paragraph 76B(3) of the Eighth Schedule). The shareholder would, however, benefit from a new base cost or tax value in the distributed asset acquired equal to the market value of the asset (section 22(4) in the case of trading stock, and paragraph 75(1)(b) of the Eighth Schedule in the case of capital assets).

In the context of an amalgamation transaction, where the relevant requirements are met, section 44(6)(b) provides that the shareholder (of equity shares) in the amalgamated company who received equity shares in the resultant company by virtue of that shareholding, is deemed to have (i) disposed of the equity share in the amalgamated company for an amount equal to its base cost or tax value, and (ii) acquired the equity share in the resultant company at the same time, and for the same amount that the share in the amalgamated company was acquired. The effect of section 44(6)(b) is to provide for a tax neutral replacement in the shareholder's hands of the shares in the amalgamated company for shares in the resultant company, and in doing so defer any inherent gain in those shares until such time as the shareholder realises the value in those shares.

In addition, section 44(6)(c) deems the distribution of the shares of the resultant company to the shareholder of the amalgamated company not to be an amount transferred or applied by the amalgamated company for the benefit of its shareholders. The distribution is therefore not treated as a dividend or a return of "contributed tax capital" and thus does not give rise to income tax or dividends tax consequences for the shareholders.

Subsections 44(6)(d) and (e) provide that the tax relief afforded to the shareholder under subsections (a) to (c) will not apply to the extent that the shareholder becomes entitled to any consideration arising out of the amalgamation transaction, other than equity shares in the resultant company, in proportion to what that consideration bears to the total transaction consideration.

4.3.5 Termination of the existence of the amalgamated company

The definition of an "amalgamation transaction" clearly states that, in order for the transaction to qualify as such, the existence of the amalgamated company will be terminated. In this regard, section 44(13) of the Income Tax Act provides that the tax relief afforded under section 44 will not apply where the amalgamated company has not taken the steps contemplated in section 41(4) to liquidate, wind up or deregister within 36 months of the amalgamation transaction. Where the appropriate steps are

not taken, any tax that would have been payable as a result of the transaction may be recovered from the resultant company.

Section 41(4) of the Income Tax Act provides for certain steps to be taken, either in the case of a liquidation or winding up as contemplated in section 80 of the Companies Act, or a deregistration as contemplated in section 82 of the Companies Act. However, in terms of a statutory merger, the CIPC must, after receiving notice of a statutory merger, deregister any of the merging companies that did not survive the merger in accordance with section 116(5)(b) of the Companies Act. Gad, McCormack and Roman (2019:Online) highlight the inconsistency this poses with regard to the requirements under section 41(4) read with 44(13) of the Income Tax Act:

> It therefore appears that section 41(4) of the Income Tax Act effectively contains an unintended cross-referencing ”error”’ or oversight, as the provision refers only to sections 80 and 82 of the Companies Act in the context of steps deemed to have been taken as part of a company’s liquidation, winding up or deregistration. As stated above, a notice or request filed with the CIPC in terms of section 80(2) or 82(3)(b)(ii) of the Companies Act is not required for a company to be deregistered as a result of a statutory merger. Arguably, therefore, any transaction that gives rise to the automatic extinction of the transferor entity, may be unable to qualify for income tax relief under the reorganisation provisions.

National Treasury has recognised this potential conflict and has proposed to amend section 41(4)(b)(i) of the Income Tax Act by way of section 38(b) of the Draft Taxation Laws Amendment Bill, 2019, which includes the deregistration of a company where “(bb) a notice of amalgamation or merger has in terms of section 116 of the Companies Act been filed in respect of that company, in the prescribed form and manner with the Companies and Intellectual Property Commission”.

As a consequence of the above proposed amendment, the termination of the amalgamated company in the context of an amalgamation transaction, which is implemented by way of a statutory merger, should not fall foul of the requirements of section 44(13) on this basis.

4.4 Anti-avoidance provisions

As stated in 4.2 above, corporate relief measures are often abused to avoid tax. In order for National Treasury to balance the tax relief afforded and the potential for tax avoidance, various provisions are included in the Income Tax Act, as well as the corporate roll-over provisions themselves, to close the potential gaps for abuse.

Section 44(5) of the Income Tax Act was introduced to prevent the abuse arising out of the transfer of gain assets (i.e. where the market value exceeds the base cost) on a tax neutral basis to a company with an assessed loss, and subsequently disposing of those gain assets and utilising the loss to shield the company against the tax payable on the gains realised on disposal. For this reason, if the resultant company disposes of the asset within 18 months of acquiring it from the amalgamated company, section 44(5) imposes a rule that essentially mimics – in the resultant company's hands – the tax effect that would have arisen had the amalgamated company disposed of the relevant asset to the resultant company without the application of section 44(2) and (3). There is, however, an exception in respect of trading stock that is regularly and continuously disposed of by that resultant company (proviso to section 44(5)(b)(i)).

The impact of this anti-avoidance rule is that a portion of any capital gain or recoupment that would have arisen at the time the amalgamated company disposed of the assets to the resultant company will be subject to tax in the resultant company's hands, regardless of whether it has an assessed loss. Any gains realised in addition to what would have been realised at the time of the disposal of the asset by the amalgamated company to the resultant company will, however, be treated under the ordinary rules.

As discussed in paragraph 4.3 above, additional provisions in the Income Tax Act will apply, regardless of the provisions in sections 42 to 47 of the Income Tax Act. Amongst these are section 24BA, section 103 and disposals which result in a "value shifting arrangement".

Section 24BA of the Income Tax Act was introduced to address value mismatches involving share issues that were being used to shift value between shareholders

without triggering tax. This provision applies where a company acquires an asset from a person in exchange for the issue to that person of shares in that company, and the value of that consideration received (i.e. the shares issued) is different from what the value of the consideration would have been if the transaction was concluded between independent persons dealing at arm's length (section 24BA(2)).

To the extent that the market value of the asset immediately before the disposal exceeds the market value of the shares immediately after the issue, the excess is deemed to be a capital gain in the hands of the company, and the shareholder must reduce its base cost in the share (where held as a capital asset), or cost of the share (where held as trading stock), by the same amount (section 24BA(3)(a)). To the extent that the market value of shares immediately after the issue exceeds the market value of the asset immediately before the disposal, the excess is deemed to be a dividend *in specie* paid by the company to that person on the date of issue (section 24BA(3)(b)).

Section 24BA(4) provides an exemption to the application of section 24BA, if (i) the company that acquires the asset and the person who disposes of the asset form part of the same group of companies immediately after the company acquires the asset, (ii) the person holds all of the shares in the company immediately after the company acquires the asset, or (iii) paragraph 38 of the Eighth Schedule applies (disposals by way of donation, consideration not measurable in money, or transactions between connected persons not at an arm's length price, where the disposal is treated as if it had been at market price).

Section 103 of the Income Tax Act is an anti-avoidance provision which targets transactions, operations or schemes designed for purposes of avoiding or postponing a liability for, or reducing amounts of, taxes on income. The application of section 103 was discussed in paragraph 3.4.2.5 of Chapter 3.

Finally, the provisions relating to a "value shifting arrangement" will also apply regardless of whether the requirements for corporate roll-over relief are met. Section 41(2) specifically refers to paragraph 11(1)(g) of the Eighth Schedule to the Income Tax Act, which deals with "the decrease in value of a person's interest in a company,

trust or partnership as a result of a value shifting arrangement". A "value shifting arrangement" is defined in paragraph 1 of the Eighth Schedule as:

> an arrangement by which a person retains an interest in a company, trust or partnership, but following a change in the rights or entitlements of the interests in that company, trust or partnership (other than as a result of a disposal at market value as determined before the application of paragraph 38), the market value of the interest of that person decreases and-
>
> (a) the value of the interest of a connected person in relation to that person held directly or indirectly in that company, trust or partnership increases; or
>
> (b) a connected person in relation to that person acquires a direct or indirect interest in that company, trust or partnership.

In the context of an amalgamation transaction, where the market value of the interest of the shareholders of the resultant company decreases and either (a) the value of the direct or indirect interest of another person in that resultant company increases, and that other person is a "connected person" to the shareholder, or (b) another person simply acquires a direct or indirect interest in the resultant company and that person is a "connected person" to the shareholder, there will be a disposal for tax purposes in that shareholder's hands. The amount of the proceeds from a disposal by way of a value shifting arrangement is determined as the market value of the shareholder's interest immediately prior to the disposal less the market value of the shareholder's interest immediately after the disposal (paragraph 35(2) of the Eighth Schedule to the Income Tax Act). In addition, the shareholder's base cost will be redetermined in accordance with the formula set out in paragraph 23 of the Eighth Schedule to the Income Tax Act. This formula has the effect of reducing the shareholder's base cost in the resultant company shares by the same proportion as the market value decreased as a result of the value shifting arrangement.

4.5 Circumstances where section 44 does not apply

Section 44(14) sets out certain circumstances under which the tax relief afforded under section 44 will not apply. In this regard, section 44 will not apply:

(a) in respect of any transaction that constituted a liquidation distribution as defined in section 47(1);

(b) in respect of any transaction if the resultant company is a company contemplated in paragraph (c) or (d) of the definition of 'company';

(bA) in respect of any transaction if the resultant company is a portfolio of a collective investment scheme in securities and the amalgamated company is not a portfolio of a collective investment scheme in securities;

(bB) in respect of any transaction if the resultant company is a portfolio of a hedge fund investment scheme and the amalgamated company is not a portfolio of a hedge fund collective investment scheme;

(c) in respect of any transaction if the resultant company is a non-profit company as defined in section 1 of the Companies Act;

(d) in respect of any transaction contemplated in paragraph (a) of the definition of 'amalgamated company' if the resultant company is a company contemplated in paragraph (b) or (e)(ii) of the definition of 'company' and does not have its place of effective management in the Republic;

(e) in respect of any transaction if any amount constituting gross income of whatever nature would be exempt from tax in terms of section 10 were it to be received by or to accrue to the resultant company;

(f) in respect of any transaction if the resultant company is a public benefit organisation or recreational club approved by the Commissioner in terms of section 30 or 30A; or

(g) to a disposal of an asset by an amalgamated company to a resultant company-

(i) in terms of an amalgamation transaction contemplated in paragraph (a) of the definition of 'amalgamation transaction' where that resultant company and the person contemplated in subsection (6) form part of the same group of companies immediately before and after that disposal; or

(ii) in terms of an amalgamation transaction contemplated in paragraph (b) of the definition of 'amalgamation transaction' where that resultant company and the person contemplated in subsection (6) form part of the same group of companies (without regard to paragraph (i)(ee) of the proviso to the definition of 'group of companies' in section 41) immediately before and after that disposal,

if that amalgamated company, resultant company and person jointly so elect.

The majority of the above exceptions relate to transactions where assets would be disposed of by a company that is subject to normal income tax, to one which is exempt. Certain of the exceptions that differ from this rule are set out in sub-sections (a) and (g) of section 44(14) of the Income Tax Act.

Sub-section (a) relates to any transaction that constituted a “liquidation distribution” as defined in section 47(1) of the Income Tax Act. Consequently, an amalgamated company may not dispose of its assets to a shareholder company, which forms part of the same “group of companies”, using section 44 of the Income Tax Act. Sub-section (g), on the other hand, provides that the tax relief provided for in section 44 will not apply where the amalgamated company, resultant company and the shareholder(s) of the amalgamated company jointly so elect, provided the resultant company and the shareholder(s) of the amalgamated company form part of the same group of companies before and after the transaction. Consequently, where these parties are not part of the same group of companies, and the criteria for tax relief under section 44 are met, the parties to an amalgamation transaction may not elect out of its application.

4.6 Corresponding tax relief

Whilst income tax relief is provided for in the provisions of section 44 of the Income Tax Act, the legislature has also provided for concomitant tax relief in respect of the other tax types in the context of an amalgamation transaction. These include tax relief in respect of value-added tax (“VAT”), securities transfer tax and transfer duty.

4.6.1 Value-added tax

Section 8(25) of the VAT Act provides relief from VAT where, amongst others, the provisions of section 44 of the Income Tax Act are complied with. Ordinarily, where a VAT vendor disposes of all its business assets, it would be required to charge VAT either at the standard rate, or at the zero rate if the requirements for zero-rating the supply are met. Section 8(25) of the VAT Act, on the other hand, deems the vendors

to be “one and the same person”. Consequently, there is no supply and no VAT obligations arise.

4.6.2 Securities transfer tax

Section 8(1)(a)(ii) of the STT Act provides that any securities that are transferred in terms of an amalgamation transaction referred to in section 44 will be exempt from securities transfer tax, provided that the public officer of the relevant company has made a sworn affidavit or solemn declaration to this effect. This would apply not only to the disposal of any shares from an amalgamated company to a resultant company, but also to the distribution of shares acquired in the resultant company by the amalgamated company to its shareholders.

4.6.3 Transfer duty

Section 9(1)(l)(iB) of the Transfer Duty Act provides an exemption from transfer duty where a property has been acquired by a company in terms of a section 44 amalgamation transaction, where the public officer of the resultant company has made a sworn affidavit or solemn declaration that such acquisition of property complies with the provisions of section 44 of the Income Tax Act.

4.7 Conclusion

The corporate roll-over provisions were introduced with the advent of the capital gains tax regime, to encourage and simplify corporate restructures, resulting in growth in the profitability of companies, without triggering taxes. National Treasury also recognised, however, that such provisions were open to abuse and therefore has sought to incorporate measures in the Income Tax Act to address such abuse. These provisions are broadly referred to as anti-avoidance provisions and are included in the Income Tax Act for general application, together with specific anti-avoidance provisions within the corporate roll-over rules.

Section 44 of the Income Tax Act sets out specific criteria for a transaction to qualify as an “amalgamation transaction”, which must be met in order for the amalgamation,

conversion or merger to qualify for the income tax relief in terms of the remaining provisions of section 44. Where these criteria are met, together with the criteria in sub-sections 44(2) and (3), the disposal of assets from an amalgamated company to a resultant company should not give rise to capital gains tax or the recoupment of allowances in the amalgamated company's income, with the resultant company essentially inheriting the tax position of the amalgamated company in relation to the assets.

In order to qualify for income tax relief, the provisions of section 44 of the Income Tax Act also prescribe the nature of the consideration given for the assets that may be payable by the resultant company to the amalgamated company. This may be in the form of (i) no consideration, (ii) consideration in the form of equity shares, or (iii) consideration in the form of the assumption of qualifying debt. Any consideration that does not meet these requirements would result in the denial of the tax relief in respect of the assets funded by such consideration. The subsequent distribution of the transaction consideration to the shareholders of the amalgamated company is also provided for in section 44 and results in a tax neutral transfer to the shareholders, provided the consideration is in the prescribed form referred to above.

The legislature has also provided for concomitant tax relief in respect of the other tax types in the context of an amalgamation transaction. These include tax relief in respect of VAT, securities transfer tax and transfer duty.

Steps to terminate the amalgamated company must be taken in the prescribed manner within 36 months of the amalgamation transaction, failing which the tax relief afforded under section 44 will not apply and the tax payable may be recovered from the resultant company.

Finally, despite all the criteria for a tax neutral amalgamation transaction having been met, the anti-avoidance provisions in the legislation will nevertheless apply. These provisions largely apply in the context of using companies with assessed losses or concluding transactions for consideration not representing market value, or which give rise to a value shifting arrangement.

It is clear from the above analysis that the legislature has carefully considered and attempted to balance the need for corporate restructures with the need to protect the fiscus from tax abuse and avoidance. Thus, whilst an amalgamation transaction may be tax neutral, it should not result in any significant tax benefits for the parties to the transaction but merely defer any inherent gains in the assets until such time as these are realised by the resultant company, usually by way of a sale or transfer outside of the group structure to an unrelated third party.

Having assessed the requirements of a statutory merger from a Companies Act perspective in Chapter 2, the ordinary tax implications that may arise, where section 44 is not applied, in Chapter 3, as well as the tax relief afforded under section 44 of the Income Tax Act in the present chapter, the following chapter will analyse the extent to which parties to an amalgamation or merger may benefit simultaneously from the provisions of both the statutory merger and an amalgamation transaction.

Chapter 5: Extent to which a statutory merger may be accommodated by the provisions of an amalgamation transaction

5.1 Introduction

In this research, Chapter 2 and Chapter 4 discussed the various elements that need to be met for a transaction to qualify as a statutory merger or an amalgamation transaction, respectively. Chapter 3 detailed the intricacies of the many tax implications that may arise in respect of a statutory merger without considering the application of the tax relief provided for in the corporate roll-over provisions. The goal of this chapter is to establish the extent to which a statutory merger may be accommodated by the tax relief afforded to an amalgamation transaction and will focus on specific areas identified where potential conflicts may exist between the parameters of a statutory merger and an amalgamation transaction.

5.2 Analysis

5.2.1 Creation of a new company

As detailed in Chapter 2, an “amalgamation or merger” in the context of a statutory merger can broadly result in two potential outcomes, being either the formation of a new company as a result of the statutory merger, or the survival of at least one of the existing companies that was party to the transaction. In addition, section 116(5)(a) of the Companies Act provides for the registration by the CIPC of a new company upon the receipt or filing of a notice of a statutory merger. The legislature therefore intended to create circumstances under which parties to a statutory merger may transact with a company which is yet to be formed.

On the other hand, the definition of an “amalgamation transaction” in section 44(1) of the Income Tax Act refers to a disposal of assets to a “company”. A company is defined in section 1 of the Income Tax Act, read with section 41(1), and refers to various types of entities or associations which are already incorporated. Consequently, the definition of an “amalgamation transaction” which refers to a disposal to a “company” as defined in the Income Tax Act immediately creates a limitation for the use of an amalgamation

transaction in the context of a statutory merger, which contemplates the creation of a new company as a result of the merger. This is unfortunate, given that the Companies Act has specifically provided an efficient mechanism to register a new company by way of filing the notice of the statutory merger with the CIPC (section 116(5)(a)).

As discussed in Chapter 4, National Treasury has provided for the termination of the amalgamated company by operation of law in section 41(4) of the Income Tax Act.[19] It is recommended that amendments be made to section 44 of the Income Tax Act to extend the definition of an "amalgamation transaction" to cater for a disposal of assets between an amalgamated company (as currently envisaged) and a resultant company, where the creation of the resultant company occurs by operation of law in accordance with section 116(5)(a) of the Companies Act. Similar to the provisions of section 44(13) of the Income Tax Act, the legislature should ensure it has recourse against other parties to the amalgamation transaction, which it is submitted should extend to the shareholders of the amalgamated company and the resultant company, where compliance with the requirements for the formation of the new company are not met within prescribed timeframes. It is further submitted that the risk to the fiscus as a result of expanding the definition of an "amalgamation transaction" as described above is low, given that the assets would remain the property of the amalgamated company, if in law, they are never transferred to the resultant company due to failure to file the notice of the statutory merger with the CIPC.

Furthermore, such an expansion of the definition of an "amalgamation transaction" should not create opportunities for abuse of the corporate roll-over provisions, in light of the existing anti-avoidance provisions which apply, *inter alia*, to value shifting arrangements and the misuse of tax losses.

From a VAT perspective, section 8(25) of the VAT Act provides for relief from VAT where "any goods or services are supplied by a vendor to another vendor". Kruger (2010:25) makes the following observation in this regard:

[19] Draft Taxation Laws Amendment Bill, 2019.

> Section 8(25) also does not require the parties to be **registered** vendors, merely that they be vendors, whereas section 11(1)(e) does require the parties to be registered… Often a sale-of-business transaction involves a newly incorporated entity and the VAT registration of that entity is delayed beyond completion date of the transaction. (emphasis in the original)

A "vendor" for VAT purposes means "any person who is or is required to be registered under this Act" (emphasis added).[20] In this regard, section 23 of the VAT Act sets out certain parameters as to when a person become liable to register as a vendor. Kruger (2010:25) concluded that:

> …provided it can be said that the seller carries on an enterprise (and anything done in connection with the commencement of an enterprise is deemed to be done in the course or furtherance of that enterprise) and it will make taxable supplies exceeding R1 million in the next 12 months, it will constitute a 'vendor' and may rely on the provisions of section 8(25) of the VAT Act.

However, section 23(1) of the VAT Act was amended in 2013 (i.e. after Kruger's article was published), and the provision relied on by Kruger, namely section 23(1)(b) of the VAT Act, no longer requires that the supplier has "reasonable grounds" for believing that the total value of taxable supplies in the period of 12 months from the commencement of any month will the prescribed amount. Currently, section 23(1) of the VAT Act sets out the circumstances in which a person is required to be registered as a vendor. In this regard, any person who carries on any "enterprise" and is not a registered vendor, becomes liable to be registered, *inter alia*:

> (b) at the commencement of any month where the total value of the taxable supplies in terms of a contractual obligation in writing to be made by that person in the period of 12 months reckoned from the commencement of the said month will exceed the above-mentioned amount…

Therefore, unless the new company can show it will make taxable supplies in terms of a contractual obligation in writing, it would not be able to rely on section 23(1)(b) of the

[20] Section 1 of the VAT Act.

VAT Act to qualify as a person “required to be registered as a vendor” for purposes of section 8(25) of the VAT Act, as was the case prior to the 2013 amendment to the VAT Act.

Whilst a newly incorporated company acquiring a business as a going concern should meet the requirements for voluntary registration, and could apply for a backdated VAT liability date (which SARS allows in practice where certain requirements are met), the barrier to registration for VAT purposes nevertheless exists where the company does not yet exist, as SARS cannot register a VAT vendor without the registered details of the entity.

In summary, VAT relief under section 8(25) of the VAT Act may potentially apply in the context of an amalgamation transaction where the resultant company meets the requirements for compulsory registration in terms of section 23(1)(b) of the VAT Act. Additionally, zero-rating the supply under section 11(1)(e) of the VAT Act cannot apply in the context of a statutory merger which envisages the incorporation of a new company, as this requires the new company to be a registered vendor at the time of the supply and further requires the recipient to agree to certain terms in writing. In these circumstances, parties to a statutory merger would benefit from making use of an existing “shelf” company, which can be registered as a vendor timeously, in order to implement the transaction. Nevertheless, these tax implications significantly limit the wider use of (and inevitably the popularity of) the statutory merger, from what was intended.

It is recommended that the legislature should consider introducing a special provision for VAT relief, similar to that found in section 8(25) of the VAT Act, in the context of a transfer of a business as a going concern to a company to be registered in accordance with section 116(5)(a) of the Companies Act, provided all the relevant steps are taken to implement the transfer in accordance with the merger agreement. For example, the parties to the statutory merger would be required to (i) file the notice of the statutory merger with the CIPC within an acceptable timeframe, and (ii) apply to SARS to register as a VAT vendor within a prescribed timeframe of obtaining a company registration number from CIPC, together with the relevant supporting documentation typically required by SARS. Section 39 of the VAT Act already empowers SARS to

impose a late payment penalty of ten per cent as well as interest at the prescribed rate where VAT is not paid timeously. Section 61 of the VAT Act allows SARS to recover VAT from the recipient of a supply where, as a result of any fraudulent action or any misrepresentation by the recipient of the supply, incorrectly applied a rate of zero per cent or treated such supply as being exempt from tax. Therefore, where VAT relief is afforded to parties to a statutory merger who do not take the appropriate steps to register the new company for VAT, SARS should have recourse to impose penalties and interest retrospectively to the time of the supply and to recover any amounts owing to it from the recipient (i.e. the newly formed company).

5.2.2 Transaction consideration

The nature of the transaction consideration given in exchange for assets in an amalgamation transaction was discussed in Chapter 4 (paragraph 4.3.3). In this regard, the tax relief afforded under section 44 of the Income Tax Act only applies where the assets are transferred in exchange for (i) no consideration, (ii) consideration in the form of equity shares, or (iii) consideration in the form of the assumption of qualifying debt. On the other hand, as discussed in Chapter 2 (paragraph 2.4), section 113(2) of the Companies Act caters for a variety of the forms of consideration that may be given in the context of a statutory merger, in terms of which the merger agreement may cater for:

> (c) the manner in which the securities of each amalgamating or merging company are to be converted into securities of any proposed amalgamated or merged company, or exchanged for other property;
> (d) if any securities of any of the amalgamating or merging companies are not to be converted into securities of any proposed amalgamated or merged company, the consideration that the holders of those securities are to receive in addition to or instead of securities of any proposed amalgamated or merged company; (emphasis added)

Furthermore, section 116(7)(b) of the Companies Act prescribes that the newly formed merged company or surviving merged company, as the case may be, is liable for all of the obligations of every merging company, in accordance with the provisions of the

merger agreement. This suggests that all debts are assumed by the merged company, regardless of whether these debts constitute “qualifying debt”, as contemplated in section 44(4) of the Income Tax Act.

In addition, the tax relief afforded to the shareholders of the amalgamated company, discussed in Chapter 4 (paragraph 4.3.4), only applies where the shareholder held an “equity share” in the amalgamated company and, by virtue of that shareholding and pursuant to an amalgamation transaction, acquires an “equity share” in the resultant company. It is therefore clear that the legislature only intended for a tax neutral transfer of assets to apply, where the shareholder in the amalgamated company retains a bundle of rights that is similar in nature (and value) both before and after the amalgamation transaction, i.e. a bundle of rights which falls within the definition of an “equity share” for income tax purposes. Where consideration in any other form is given (other than the assumption of qualifying debt), such as cash or “other property”, the shareholder in the amalgamated company might not retain an interest in the resultant company and will have effectively divested itself of its business. As described previously, the corporate roll-over provisions are intended to defer any inherent gains in the assets until such time as these are realised by the resultant company. Consequently, the shareholders of the amalgamated company are not intended to benefit from a tax neutral realisation of their assets where their effective interest in those assets is not retained.

In light of the above, it is again clear that the provisions of a statutory merger are significantly more flexible than those of an amalgamation transaction, but further, that the policies underpinning the Companies Act and the Income Tax Act are, necessarily, different and cannot simply be aligned without considering what each piece of legislation seeks to achieve. Where parties wish to implement a statutory merger for consideration other than that prescribed by section 44(4) of the Income Tax Act, this will give rise to various tax considerations as described in Chapter 3.

An amalgamation transaction as contemplated in section 44 of the Income Tax Act, in essence, consists of two transactions, the first being the disposal of assets to the resultant company, and the second being the distribution of the transaction consideration to the shareholders of the amalgamated company. In contrast, the

statutory merger provisions refer to consideration payable to the holder of the shares in the merging (i.e. amalgamated) company. The provisions of the statutory merger are, however, broadly worded. Section 113(2)(c) of the Companies Act, for example, refers to the "manner in which the securities of each … merging company are to be converted into securities of any proposed … merged company" (emphasis added). It is submitted that the "manner in which" the securities in the merging company are converted into securities in the merged company can include the two-step process contemplated in an amalgamation transaction for tax purposes. However, in order to provide for alignment between the statutory merger and the amalgamation transaction, without the need to interpret the words in the Companies Act to fit the amalgamation transaction, it is recommended that section 113(2)(c) be amended to refer to the securities of each merging company being converted *either directly or indirectly* into securities of any proposed merged company.

5.2.3 Mergers between a company and its shareholder

A statutory merger may occur between "two or more profit companies, including holding and subsidiary companies" (section 113(1) of the Companies Act). In contrast, as discussed in Chapter 4 (paragraph 4.5), section 44(14) of the Income Tax Act sets out circumstances in which the provisions of section 44 will not apply. Included in this list is sub-section (a) which applies to any transaction that constitutes a liquidation distribution as defined in section 47(1) of the Income Tax Act. The tax relief afforded in respect of a "liquidation distribution", in the context of South African resident companies, applies where a company (referred to as the "liquidating company") disposes of all of its assets to its shareholders in anticipation of or in the course of its liquidation, winding up or deregistration, but only to the extent that the liquidating company and the holding company form part of the same "group of companies". Therefore, whilst a statutory merger may not meet the requirements for an "amalgamation transaction", it might meet the requirement of a "liquidation distribution", which may nevertheless give rise to a tax neutral transfer of assets, provided all the requirements of section 47 of the Income Tax Act are met.

Whilst this does not result in a simultaneous application of a statutory merger and an amalgamation transaction, it nevertheless provides a mechanism for tax relief in the

context of a statutory merger. However, if the liquidating company wishes to amalgamate all its assets with its majority shareholder in terms of a liquidation distribution, where there is also a minority shareholder, the liquidating company would need to dispose of the assets by way of a sale for consideration at value. This could pose several subsequent tax and company law issues including (i) that the transaction consideration ultimately distributed to the minority shareholder will not qualify for tax relief under section 47 of the Income Tax Act, and (ii) if the transaction consideration constitutes shares in the holding company, the holding company is limited to issuing not more than 10%, in aggregate, of the number of issued shares of any class to its subsidiary (section 48(2)(b)(i) of the Companies Act).

Where the liquidating company does not form part of the same group of companies as its shareholder, however, section 44 of the Income Tax Act may be capable of being applied in transferring assets on a tax neutral basis from a company to its shareholder (provided that shareholder is a resident company). A disposal of assets from a company to its shareholder by means of an amalgamation, conversion or merger, will be referred to as an “upstream amalgamation”.

The aspects of a statutory merger in the context of an upstream amalgamation are discussed in Chapter 2 (paragraph 2.4, Example 6). The key points for consideration in this regard were (i) the cancellation of shares without any repayment of capital where any shares in a merging entity are held by or on behalf of another merging entity, (ii) a company may not issue shares to itself (any shares in issue which are subsequently acquired by the issuing company are immediately cancelled in terms of the Companies Act, and have the same status as shares that have been authorised but not issued), and (iii) a company is limited to issuing not more than 10%, in aggregate, of the number of issued shares of any class to its subsidiary.

Consequently, in the context of an upstream amalgamation, whether the parties can rely on section 44 or section 47 of the Income Tax Act, restrictions in the Companies Act may prevent the shareholder from issuing sufficient equity shares as a transaction consideration for the assets acquired in circumstances where there is a minority shareholder in the merging company. Any other consideration paid would need to meet the requirements of section 44(4) of the Income Tax Act in order to qualify for

tax relief as an amalgamation transaction. In contrast, section 47 of the Income Tax Act does not limit the nature of transaction consideration payable to the liquidating company upon the disposal of assets as a liquidation distribution, other than in respect of the assumption of qualifying debt. Therefore, although a statutory merger may occur between holding and subsidiary companies, the practical, legal and tax implications that may arise from an upstream amalgamation may be far-reaching.

5.3 Conclusion

In this chapter, three key areas were identified as points where potential conflicts may exist between the parameters of a statutory merger and those of an amalgamation transaction. First is the creation of a new company as a consequence of a statutory merger. Currently, section 44 of the Income Tax Act does not provide for an amalgamation transaction to occur with a company yet to be incorporated. Even if the definition of an amalgamation transaction is expanded to accommodate this, the disposal of business assets would not qualify for VAT relief, either under section 8(25) or section 11(1)(e) of the VAT Act. This tax cost will significantly limit the wider use of (and inevitably the popularity of) the statutory merger.

The second area of conflict is in respect of the nature of the transaction consideration payable to a merging company in the context of a statutory merger as opposed to an amalgamation transaction. Whilst the Companies Act caters for a variety of the forms of consideration that may be given in the context of a statutory merger, section 44 of the Income Tax Act will only allow for income tax relief where the prescribed form of consideration is given. For policy reasons, section 44 of the Income Tax Act cannot be amended to accommodate the ambitious goals of the statutory merger. It is submitted that again, this has the potential to result in a more limited use of the statutory merger in practice.

Lastly, although a statutory merger may occur between holding and subsidiary companies, an upstream amalgamation presents a host of complexities from both a company law and tax law perspective, that may be difficult to overcome.

Whilst it is clear that efforts have been made by National Treasury to amend the provisions of the amalgamation transaction to better accommodate a statutory merger, there are nevertheless certain conflicting purposes (policies) for each piece of legislation. From a tax perspective, the legislature seeks to provide for the recovery of tax from a “person” as defined. As previously noted in this research, South Africa does not provide for group taxation. From a company law perspective, the legislature seeks to ensure the protection of shareholders and third-party investors in a company. From this perspective, provided the processes involved to ensure solvency and liquidity and the protection of minority shareholders and other investors in the company are met, the provisions of a statutory merger under the Companies Act should be met. Consequently, as a result of the underlying purposes of the relevant Acts, the focus and parameters of a statutory merger and amalgamation transaction do not perfectly align. As a further consequence, the flexibility afforded under the statutory merger is largely minimised for parties who wish to simultaneously enjoy tax relief afforded under an amalgamation transaction (noting, however, that this research is limited to the application of section 44 of the Income Tax Act, and has not considered the potential for the application of sections 42, 45, 46 and 47 in the context of a statutory merger).

The following chapter will recapitulate the goals of this research, review the findings of Chapters 2, 3, 4 and 5, and provide a summary of the core concepts, findings and recommendations emanating from the research.

Chapter 6: Conclusion

6.1 Introduction

The goal of this research was to establish under what circumstances a statutory merger in terms of the Companies Act can enjoy the tax benefits afforded by section 44 of the Income Tax Act and the concomitant relief in respect of other tax types, including VAT, securities transfer tax and transfer duty. The sub-goals of the research are as follows:

(i) a discussion of the background, purpose and benefits of a statutory merger in terms of the Companies Act;
(ii) identifying the legal cause of the transfer of assets in the context of a statutory merger;
(iii) assessing the tax implications for the parties to a statutory merger which does not meet the requirements of the corporate roll-over provisions;
(iv) an analysis of the tax benefits of utilising the corporate rules, specifically those in section 44 of the Income Tax Act;
(v) the identification of conflicts that may arise between the provisions of the Companies Act and the Income Tax Act relating to mergers; and
(vi) suggesting possible amendments to legislation to address the conflicts.

Each of these sub-goals has been addressed in this research in order to contextualise the findings in respect of the primary goal and provide meaning to the analysis, findings and submissions in Chapter 5. The findings in each chapter are therefore summarised in turn, below.

6.2 Findings of the research

The goal of Chapter 2 was to establish the background to, purpose of and benefits of the merger procedure as provided for in section 113 of the Companies Act (referred to as a “statutory merger”).

In 2004, the DTI published a policy document in which it acknowledged the need for the review and reform of company law in South Africa, in order to align it with international trends and accommodate the changing environment for business, both in South Africa and globally. One of the fundamental areas for reform that was highlighted in the DTI's policy document was the need for a mechanism to appropriately accommodate a corporate merger. The result was the introduction of, amongst others, the statutory merger provisions in the Companies Act.

An "amalgamation or merger" in the context of a statutory merger, can occur between "two or more profit companies, including holding and subsidiary companies", and can broadly result in two potential outcomes, being either the formation of a new company or companies as a result of the statutory merger, or the survival of at least one of the existing companies that was party to the transaction. All the assets and liabilities of the merging companies are transferred to the surviving company or companies and, if applicable, a newly formed company or companies. In addition, these merging companies are terminated as a result of the merger, leaving only the new company or surviving company/companies in existence.

The definition of an "amalgamation or merger" is therefore incredibly flexible and, consequently, the forms in which a statutory merger could occur are endless, as has been depicted diagrammatically in Chapter 2. Furthermore, section 113(2) of the Companies Act sets out the elements of the statutory merger that must be considered in the merger agreement, which also accounts for the merger consideration as well as the allocation of assets and liabilities. The merger consideration in terms of a statutory merger is crafted broadly to cater for various forms and methods of compensating the shareholders of the merging company.

The Companies Act also caters for the implementation procedures for a statutory merger and contains provisions pertaining to the legal ramifications of implementing a statutory merger. Amongst others, these include:

1. the registration and deregistration of merging companies upon filing of the notice of a statutory merger;

2. that the property of each merging company “becomes the property of” the newly amalgamated, or surviving merged, company or companies, in accordance with the provisions of the amalgamation or merger agreement;
3. that the newly formed merged company, or surviving merged company, is liable for all the obligations of every merging company, in accordance with the provisions of the merger agreement; and
4. that a copy of the merger agreement, together with a copy of the filed notice of amalgamation or merger, constitutes adequate evidence to effect transfer of the registration of any property that is registered in terms of any public regulation (such as immovable property or patents).

The advantages of the statutory merger therefore include reducing the legal formalities, time and inevitable costs usually involved in effecting a transfer of property from one merging company to another. Whilst the statutory merger offers both a flexible and practical mechanism for business combinations, it also provides for the protection of shareholders and third-party investors. Broadly, these protection mechanisms include (i) each merging company satisfying the solvency and liquidity test; (ii) the approval of the statutory merger by way of a special resolution, including a special resolution of the shareholders of the merging company’s holding company in certain circumstances; the exclusion of a shareholder’s voting rights in a merging company for purposes of the special resolution where that person is related to an acquiring party, thus mitigating conflicts of interest; and processes for the protection of minority and other dissenting shareholders that oppose the statutory merger.

In summary, the statutory merger offers an efficient manner to implement business combinations, intended to apply across a variety of transaction structures. However, the tax implications are a crucial component in determining the costs associated with mergers and acquisitions.

In light thereof, the goal of Chapter 3 was to assess those tax implications ordinarily arising in respect of a sale of shares or business assets in the context of a statutory merger that does not meet the requirements of the corporate roll-over provisions. The statutory merger has given rise to some debate as to the legal cause of the transfer of property, namely whether it is in terms of the merger agreement itself (i.e. based in

contract) or by the operation of law upon the implementation of the merger agreement. This is discussed at the outset in determining the tax implications attendant upon a statutory merger, as different tax outcomes may arise depending on the legal cause of the transfer of property.

Gad and Strauss (2012b:Online) identified that where the legal cause of the transfer is *ex lege*, then arguably there will not be a reciprocal undertaking by the acquiring company. As a consequence, various anti-avoidance tax provisions aimed at non-arm's length transactions may be triggered. In this regard, it is submitted that whilst the Companies Act appears to envisage a merger that is implemented by operation of law, it is also explicit that the statutory merger can only be implemented pursuant to the conclusion of the merger agreement. Therefore, whilst the legal cause of the transfer of assets and liabilities in the context of a statutory merger may be the automatic operation of law, namely without the necessity of meeting the required formalities, delivery or procedures for the transfer to take place, the terms of the merger agreement must nevertheless be given effect to, which in itself may create reciprocal undertakings by the acquiring company.

It was further highlighted in Chapter 3 that sellers and purchasers typically have competing interests in a sale, which influences the nature of the asset ultimately forming the subject matter of the sale, the terms according to which that transaction is negotiated and the tax implications for the purchaser in respect of funding the acquisition. Both the subject matter of the sale and the nature and value of the consideration given in exchange for assets are crucial in determining the tax implications attendant upon the sale.

Complexities identified in the context of a transaction can be summarised as follows:

Subject matter	Description
Shares and shareholder loans	*Seller* - The capital or revenue nature of the shares must be considered. The onus of proof is on the seller where it avers that the shares were capital assets, as the effective rate of tax on a capital gain is less than the normal rate of tax. *Purchaser* - A purchase price allocation first to the face value of the shareholder loan(s) should prevent loan repayments giving rise to interest income that is subject to normal tax. - A change of intention in respect of the business assets may give rise to a deemed disposal for CGT purposes. - The purchaser may not be entitled to a tax deduction in respect of interest incurred on loan funding to acquire the shares. If the purchaser generates income, it may be entitled to a limited interest deduction in terms of section 24O of the Income Tax Act, and only in certain circumstances where there is a sufficient nexus between the acquisition of shares and the production of "income" may the purchaser arguably qualify to deduct the full interest expense for tax purposes under section 24J of the Income Tax Act.
Capital and allowance assets	*Seller* - Where a statutory merger is implemented for no consideration or a consideration less than the market value of the assets, the merging company may in certain circumstances be required to calculate its capital gain on the market value of the assets transferred to the merged company. - Allowances will be recouped and subject to normal tax regardless of whether the asset is capital in nature. - The market value of the asset is deemed to be recouped where either (a) a company transfers an asset in any manner or form to a shareholder, or (b) any person disposes of an asset to a connected person.
Trading stock	*Seller* - A deemed recovery or recoupment is included in the taxpayer's income of the market value of trading stock either donated or applied for any purpose other than its disposal in the ordinary course of its trade, distributed *in specie* to any shareholder, or when it ceases to be held as

	trading stock. These deeming provisions may therefore apply to create an additional tax cost to the seller.
Future expenditure contracts	*Seller* - Where the purchaser takes over the liability to perform in terms of a contract entered into by the seller, where the seller received an advance payment in terms of that contract, the seller would be required to add back in the year of the sale any allowance deducted under section 24C, which would not be matched by a deduction for the expenditure (which obligation may be assumed by and expenditure incurred by the purchaser). *Purchaser* - The purchaser who fulfils the obligations under the contract may have difficulty proving that the expenditure is incurred in the production of income (as no income will be produced), where it does not ensure that it will receive the right to the deposit from the seller.
Allocation of the purchase price	*Seller* - Each asset comprising the business requires a value to be attributed to it, as opposed to the sale of the business for a global sum. Consequently, a business sold as a going concern is not, in itself, a sale of a capital asset taxable as a capital gain, but rather a sale of various assets, each of which may give rise to capital or revenue income.
Assumption of liabilities and contingent liabilities	*Seller* - The benefit to the seller of being relieved of the obligation to settle the liabilities would constitute an “amount” received or accrued, the value of which must be determined and brought into account for tax purposes. Whether that amount is brought to account on a capital or revenue basis will depend on the asset to which that amount is allocated. - Whether the seller has incurred deductible expenditure by forgoing a portion of the purchase price for the assumed liabilities will depend on whether the sale agreement is drafted to represent a reciprocal amount owing by the seller to the purchaser for the assumption of its liabilities, resulting in set-off. *Purchaser* - Whether the purchaser has actually incurred expenditure, or unconditionally undertaken to incur expenditure, will impact the availability

	and quantum of tax deductions and allowances against the assets acquired. - A purchaser who assumes contingent liabilities in settlement or part settlement of the purchase price would not meet the requirement of expenditure having been actually incurred and would not be entitled to claim the quantum of the contingent liabilities as allowances against the relevant asset. - Whether the expenditure will qualify for an allowance upon the contingent liability materialising will depend on the nature of the asset it funded and whether the other requirements for a tax deduction would be met at that time, based on the particular facts and circumstances.

In light of the above, despite the flexibility and efficiency offered from a company law perspective in giving effect to a statutory merger, it is clear there are far-reaching tax consequences which, if not properly considered, could overshadow any benefits arising from the use of the statutory merger. However, where a statutory merger falls within the parameters of the corporate roll-over rules, parties to the merger transaction may enjoy both the benefits from a company law perspective as well as tax relief in respect of various tax types, including income tax, VAT, securities transfer tax and transfer duty.

The goal of Chapter 4 was therefore to analyse the tax benefits of utilising the corporate rules, specifically those provided for in section 44 of the Income Tax Act (as the scope of the research was limited to the application of section 44 of the Income Tax Act). Therefore, this research has not considered the potential for the application of sections 42, 45, 46 and 47 of the Income Tax Act in the context of a statutory merger.

The corporate roll-over provisions were introduced with the advent of the capital gains tax regime, to encourage and simplify corporate restructures, resulting in growth in the profitability of companies, without triggering taxes. National Treasury also recognised, however, that such provisions were open to abuse and therefore sought to incorporate measures in the Income Tax Act to address such abuse. These provisions are broadly referred to as anti-avoidance provisions and are included in the Income Tax Act for

general application, together with specific anti-avoidance provisions within the corporate roll-over rules.

Section 44 of the Income Tax Act sets out specific criteria for a transaction to qualify as an “amalgamation transaction”, which must be met in order for the amalgamation, conversion or merger to qualify for the income tax relief in the remaining provisions of section 44. Therefore, unlike the flexibility offered in the Companies Act, an amalgamation transaction may only arise within the limited parameters provided for in the Income Tax Act.

Where these criteria are met, together with the criteria in sub-sections 44(2) and (3), the disposal of assets from an amalgamated company to a resultant company should not give rise to capital gains tax or the recoupment of allowances in the amalgamated company’s income, with the resultant company essentially inheriting the tax position of the amalgamated company in relation to the assets. This significantly reduces the complexities in determining the tax positions of the seller and the purchaser, as described in Chapter 3 and as summarised above, as the corporate rules override the ordinary tax position. Furthermore, as a “debt” includes any contingent liability for purposes of the corporate roll-over provisions, this relieves the parties from having to show to what extent allowances may be claimed going forward, as the tax value of those assets and the allowances in respect thereof are treated the same way in the purchaser’s hands as they were in the seller’s hands.

In order to qualify for income tax relief, the provisions of section 44 of the Income Tax Act also prescribe the nature of the consideration that may be payable by the resultant company to the amalgamated company. This may be in the form of (i) no consideration, (ii) consideration in the form of equity shares, or (iii) consideration in the form of the assumption of qualifying debt. Any consideration that does not meet these requirements would result in the denial of the tax relief in respect of the assets funded by such consideration. The subsequent distribution of to the shareholders of the amalgamated company is also provided for in section 44 and results in a tax neutral transfer to the shareholders, provided the consideration is in the prescribed form referred to above.

Steps to terminate the amalgamated company must be taken in the prescribed manner within 36 months of the amalgamation transaction, failing which the tax relief afforded under section 44 will not apply and the tax payable may be recovered from the resultant company. National Treasury has recognised a potential conflict between the processes involved in terminating an amalgamating company in accordance with the corporate roll-over rules and the termination by operation of law envisaged in respect of a statutory merger. Consequently, it has proposed to amend section 41(4)(b)(i) of the Income Tax Act by way of section 38(b) of the Draft Taxation Laws Amendment Bill, 2019, which includes the deregistration of a company where "(bb) a notice of amalgamation or merger has in terms of section 116 of the Companies Act been filed in respect of that company, in the prescribed form and manner with the Companies and Intellectual Property Commission". As a consequence, the termination of the amalgamated company in the context of an amalgamation transaction, which is implemented by way of a statutory merger, should not fall foul of the requirements of section 44(13) on this basis.

Despite all the criteria for a tax neutral amalgamation transaction having been met, the anti-avoidance provisions in the Income Tax Act will nevertheless apply. These provisions largely apply in the context of using companies with assessed losses without an overriding commercial rationale to do so, and transactions not concluded at arm's length or which give rise to a value shifting arrangement.

The legislature has also provided for concomitant tax relief in respect of the other tax types in the context of an amalgamation transaction. These include tax relief in respect of VAT, where both parties are "vendors", securities transfer tax and transfer duty.

The findings of Chapter 4 show that the legislature has sought to balance the need for corporate restructures with the need to protect the fiscus from tax abuse and avoidance. Thus, whilst an amalgamation transaction may be tax neutral, it should not result in any significant tax benefits for the parties to the transaction but merely defer any inherent gains in the assets until such time as these are realised by the resultant company, usually by way of a sale or transfer outside of the group structure to an unrelated third party.

In this research, Chapter 2 and Chapter 4 discussed the various elements that need to be met for a transaction to qualify as a statutory merger or an amalgamation transaction, respectively. Chapter 3 detailed the intricacies of the many tax implications that may arise in respect of a statutory merger, without considering the application of the tax relief contained in the corporate roll-over provisions. The goal of Chapter 5 was therefore to establish the extent to which a statutory merger may be accommodated by the tax relief afforded to an amalgamation transaction. In this regard, three key areas were identified as points where potential conflicts may exist between the parameters of a statutory merger and those of an amalgamation transaction, as set out below.

Conflict	**Description and recommendations**
1. Creation of a new company as a consequence of a statutory merger	*Description* - Currently, section 44 of the Income Tax Act does not provide for an amalgamation transaction to occur with a company yet to be incorporated. - Even if the definition of an amalgamation transaction is expanded to accommodate this, the disposal of business assets would not qualify for VAT relief, either under section 8(25) or section 11(1)(e) of the VAT Act. This tax cost will significantly limit the wider use of (and inevitably the popularity of) the statutory merger. *Recommendations* - (i) Extension of the definition of an “amalgamation transaction” to provide for a disposal of assets between an amalgamated company (as currently envisaged) and a resultant company, where the creation of the resultant company occurs by operation of law in accordance with section 116(5)(a) of the Companies Act. o Similar to the provisions of section 44(13) of the Income Tax Act, the legislature should ensure it has recourse against other parties to the amalgamation transaction, which, it is submitted, should extend to the shareholders of the amalgamated company and the resultant company, where compliance with the requirements for the formation of the new company are not met within prescribed timeframes.

	- (ii) Introduction of a special provision for VAT relief, similar to that found in section 8(25) of the VAT Act, in the context of a transfer of a business as a going concern to a company still to be registered in accordance with section 116(5)(a) of the Companies Act, provided all the relevant steps are taken to implement the transfer in accordance with the merger agreement. o For example, the parties to the statutory merger be required to (i) file the notice of the statutory merger with the CIPC within an acceptable timeframe, and (ii) apply to SARS to register as a VAT vendor within a prescribed timeframe of obtaining a company registration number from CIPC, together with the relevant supporting documentation typically required by SARS. o Where VAT relief is afforded to parties to a statutory merger who do not take the appropriate steps to register the new company for VAT, SARS should have recourse to impose penalties and interest retrospectively to the time of the supply and to recover any amounts owing to it from the recipient (i.e. the newly formed company).
2. Transaction consideration	*2.1 Nature of the transaction consideration* *Description* - Whilst the Companies Act caters for a variety of the forms of consideration that may be given in the context of a statutory merger, section 44 of the Income Tax Act will only allow for income tax relief where the prescribed form of consideration is given. For policy reasons, section 44 of the Income Tax Act cannot be amended to accommodate the ambitious goals of the statutory merger. - It is submitted that this has the potential to result in a more limited use of the statutory merger in practice. *Recommendations* - None: o The legislature only intended for a tax neutral transfer of assets to apply where the shareholder in the amalgamated company retains a bundle of rights that is similar in nature (and value) both before and after the amalgamation

	transaction, i.e. a bundle of rights which falls within the definition of an "equity share" for income tax purposes. o Where consideration in any other form is given, the shareholder in the amalgamated company will have effectively divested itself of its business. This is not in line with the purpose of the corporate roll-over provisions. *2.2 Distribution of transaction consideration to shareholders* *Description* - An amalgamation transaction as contemplated in section 44 of the Income Tax Act, in essence, consists of two transactions, the first being the disposal of assets to the resultant company, and the second being the distribution of the transaction consideration to the shareholders of the amalgamated company. - By contrast, the statutory merger provisions make reference to consideration payable to the holder of the shares in the merging (i.e. amalgamated) company. Although the provisions of the statutory merger are broadly worded and can be interpreted to include the two-step process contemplated in an amalgamation transaction for tax purposes, it is not clearly aligned. *Recommendations* - Section 113(2)(c) of the Companies Act to be amended to refer to the securities of each merging company being converted *either directly or indirectly* into securities of any proposed merged company.
3. Mergers between a company and its shareholder	*Description* - Restrictions in the Companies Act may prevent the shareholder from issuing sufficient equity shares as transaction consideration for the assets acquired in circumstances where there is a minority shareholder in the merging company. - Any other consideration paid would need to meet the requirements of section 44(4) of the Income Tax Act in order to qualify for tax relief as an amalgamation transaction. By contrast, section 47 of the Income Tax Act does not limit the nature of the transaction consideration payable to the liquidating company upon the disposal of assets as a liquidation distribution, other than in respect of the assumption of qualifying debt. However,

	the distribution of the consideration to the minority shareholder would not qualify for tax relief. - Therefore, although a statutory merger may occur between holding and subsidiary companies, the practical, legal and tax implications that may arise from an upstream amalgamation may be far-reaching. *Recommendations* - None.

6.3 Summary

The purpose of this research was to determine the extent to which a statutory merger in terms of the Companies Act may be accommodated by the provisions of an amalgamation transaction in terms of the Income Tax Act. The research has shown an ongoing effort by National Treasury to amend the provisions of the amalgamation transaction to better accommodate a statutory merger, but there are nevertheless certain conflicting purposes (policies) for each piece of legislation. For these reasons, the focus and parameters of a statutory merger and an amalgamation transaction do not align perfectly. As a consequence, the flexibility afforded under the statutory merger is largely minimised for parties who wish to simultaneously enjoy the tax relief afforded under an amalgamation transaction.

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