

**THE TAXATION OF BLACK ECONOMIC EMPOWERMENT TRANSACTIONS,
WITH SPECIFIC REFERENCE TO THE FINANCIAL SECTOR**

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UNATHI KAMLANA

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Abstract

There has been some concern that the pace of expectations being built up regarding the transfer of ownership of the economy into the hands of the previously disadvantaged was not allowing for the due diligence and analysis of the implications of such transactions. Tax legislation relating to the transfer of assets is also not seen to be consistently conducive to this process. The focus of this thesis is taxation and a critical analysis of how the current tax legislation affects most of the transactions which usually form the basis of black economic empowerment. It is argued that tax policy is one of the fundamental instruments available to government to encourage the process of black economic empowerment. It is therefore important to assess whether or not current tax legislation is supportive of the process of black economic empowerment and to suggest ways in which it can be amended to serve this purpose.

By means of a literature review and a case study of a Black Economic Empowerment deal in the financial sector, the thesis examines various sections of the Income Tax Act, 58 of 1962, which may have a bearing on black economic empowerment transactions and structures, including corporate restructuring rules, the taxation of trusts, inter-company loans, the use of hybrid financial instruments, the taxation of small business corporations, employee share incentive schemes, connected persons rules and value-shifting arrangements, the general deduction formula and the deductibility of interest incurred on amounts raised to acquire shares. It appears that although some aspects of the current tax legislation lend themselves to assisting black economic empowerment transactions, there are still areas where much improvement is required.

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Chapter 1: Introduction and context

1.1 Introduction

Black Economic Empowerment (referred to as BEE) has become one of the most contentious and interesting topics in South Africa. The far-reaching extent of its scope and importance of its objectives, however, makes it more challenging and significant for researchers to contribute to this field of commerce. The focus of this thesis is on taxation and a critical analysis of how the current tax legislation affects most of the transactions which are usually encountered in BEE initiatives. References are made to the relevant legislation which governs the financial sector specifically, this arguably being the industry most affected by the BEE compliance burden and its commensurate tax effects.

The main issue addressed in this thesis is the fact that, although BEE is designed to transfer ownership of economic assets into the hands of South Africa's previously disadvantaged communities, the restructuring processes that have to be followed, coupled with the business structures that are of necessity commonly used, increase the tax burden for the BEE participants.

1.2 The context of research

1.2.1 The Broad-Based Black Economic Empowerment Act, 53 of 2003

The Broad Based Black Economic Empowerment Act, 53 of 2003 (the BEE Act) was signed into law by the President of South Africa on 9 January 2004. Adapted from section 1 of the Act is the following important definition of BEE:

An integrated and coherent socioeconomic process that directly contributes to the economic transformation of South Africa and brings about both significant increases in the number of black people that manage, own and control the country's economy as well as significant decreases in income inequalities.

The Act also provides a definition of broad-based black economic empowerment (outlined in more detail in chapter two). The definition includes empowerment in terms of human resource and skills development, increases in the numbers of black people that

own and manage businesses and other productive assets, preferential procurement and encouraging investment in black owned and managed enterprises.

The provisions of the BEE Act outline the broad economic empowerment objectives of the government. From these objectives, it is apparent that there is necessarily a crucial role to be played by commercial funding structures to enable the parties to BEE transactions to attain the outlined objectives. This thesis therefore is a discussion of how, in this context, taxation should assist the process of financing these transactions. The following are the main facets of taxation legislation which are analysed in order to highlight the role of taxation in fostering BEE objectives.

1.2.2 Taxing the transfer of assets

As previously stated, the restructuring processes that have to be followed in order to transfer ownership of the country's economic assets into the hands of the previously disadvantaged communities appear to have the potential to increase the tax burden for the BEE counterparties. Kolitz et al (2004) advise that Part III of the Income Tax Act, 58 of 1962 (the Income Tax Act) provides for tax relief in the form of deferrals of taxation and rollovers of asset values between entities, for qualifying company transactions and, provided that the requirements of sections 41 to 47 of the Act are met, the adverse tax implications of these transactions can be eliminated, minimised or deferred. Kolitz et al (2004) provides a summary of the provisions of these sections and these are elaborated on in chapter three.

1.2.3 Inter-company loans

As many of the BEE schemes involve company restructuring in one form or another, the effectiveness of the provisions of the Act relating to these transactions is of crucial importance, especially the provision of inter-company debt. This thesis has also considered the possible impact of sections 8(4)(m) and 20(1)(a)(ii) of the Income Tax Act, as well as paragraphs 12(5) and 56 of the Eighth Schedule to the Act. Section 8(4)(m) provides for the deferral of taxable recouplements on the disposal of assets and only applies if the transaction giving rise to the debt was previously a deductible expense. It is also subject to the provisions of section 20(1)(a)(ii) which, in essence, provides that the balance of any assessed loss shall be reduced by the value of any benefit received from a concession granted, or compromise with the creditors whereby liabilities have been reduced, provided such liabilities arose in the ordinary course of business. In this regard,

the thesis has considered the finding of the leading South African case of Commissioner for Inland Revenue v Datakor Engineering (Pty) Ltd, [1998] 4 All SA 414 (A), 57 SATC 178, where the conversion of debt into equity, which resulted in a reduction of an assessed loss for tax purposes, was found to be a definite compromise. The details of this case and the relevance in the context of black economic empowerment transactions are analysed in chapter three.

1.2.4 Disposal or acquisition of equity shares

A relatively new section in the Income Tax Act, section 24N, defers the inclusion in gross income of amounts arising from the disposal of an asset (specifically the disposal of equity shares), which are not quantifiable in the year of assessment during which the asset is disposed of. Such amounts will only accrue or rank for deduction in the year that they become quantifiable, that is, when they become due and payable.

1.2.5 Employee share acquisitions

Also in the context of BEE, is the well-known concept of broad-based black economic empowerment. To this end, most companies now have employee share ownership schemes. Section 8B of the Income Tax Act was enacted to provide for the taxation of any amounts received by or accrued to employees from 'qualifying' equity shares acquired in terms of a broad-based employee share plan. De Beer et al (2004) argue that, where all the requirements of section 8B are met, there are essentially new tax consequences on the disposal of shares held by an employee from an employer share option scheme.

1.2.6 The taxation of small business corporations and personal service companies

In the past decade significant progress has been made by the government in order to improve the taxation effects on small business corporations. One of the pillars of such government support is the understanding that small businesses are engines of economic growth and employment creation. As such, chapter three of this thesis includes an analysis of the taxation implications of small business corporations as defined in section 12E of the Income Tax Act.

However, there is a contention that the taxation of 'personal service companies' as defined, is punitive. The argument against the taxation of personal services companies is that the effects of the taxation of these small, medium and micro enterprises, which are also usually black owned operations, as "personal services companies" as defined in paragraph one of the Fourth Schedule to the Income Tax Act, is that their entire income is subjected to employees' tax. The foregoing results in 35 percent of gross receipts paid to them being withheld for the payment of PAYE, resulting in cash flow constraints for the small businesses. Furthermore, the Act limits the deduction of expenditures incurred by these businesses only to salaries paid to employees. This could result in perpetual losses for these small operations and invariably they may end up having to shut down.

1.2.7 The use of preference share funding and hybrid financial instruments

Scholz (2005) has also argued that the fact that a significant number of BEE transactions have used preference share capital in order to enable the BEE parties to obtain the necessary funding at more affordable rates is important. Jordaan et al (2005: 239) state that "the low cost of capital has made these preference-share deals advantageous". Additionally, Zinman (2004) is of the opinion that preference shares have been available as a financing tool from the very origins of company law. This research also includes an investigation of the tax consequences of these preference share-funding structures in the context of BEE.

In analysing the relevant sections of the Act, specific attention has also been paid to section 8E of the Income Tax Act which has, as its purpose, to govern the use of preference shares and, in particular, "to counter the tax avoidance brought about by the use of so-called preference share financing schemes" (Huxham et al, 2005: 369). Section 8F of the Income Tax Act, which limits the deductibility of interest paid in respect of hybrid debt instruments, is also discussed.

1.2.8 The tax deductibility of interest incurred on amounts raised to acquire shares

BEE transactions inherently reflect a significant need for debt funding. In order to acquire the shares which are a usual subject of BEE transactions, the BEE participants are often required to raise loans usually from the formal financial sector. Section 23(f) is discussed in this thesis as it prohibits the deduction from income, of interest expenditure incurred on amounts raised to acquire shares. The argument is that this provision was aimed at

those transactions which sought to deduct interest expenditure on amounts raised merely to earn tax free dividend income. This thesis has shown that BEE transactions are not only concerned with share acquisitions in order to earn dividends, the process is more complex as it underlies broad-based economic empowerment objectives as well. This discussion, which is contained in chapter four, is preceded by an analysis of the mechanics of the general deduction formula as contained in section 11 read with section 23 of the Income Tax Act.

1.2.9 Connected persons rules and value shifting arrangements

Where an asset is disposed of to a 'connected person' as defined in section 1 of the Income Tax Act, for a consideration which does not reflect an arm's length price, the connected persons provisions contained in paragraph 38 of the Eighth Schedule to the Income Tax Act, require the Commissioner for the South African revenue services (SARS) to apply the market value of the asset as the proceeds of the transaction in question. This has the adverse effect of increasing the tax liability arising from the transaction. BEE transactions require leaner price-setting mechanisms which would allow for affordability of the assets in question, amongst other imperatives. The 'connected persons' provisions are discussed in detail in chapter five.

Furthermore, paragraph 35A of the Eighth Schedule to the Income Tax Act provides for value-shifting arrangements. These are only applicable, however, if the change in the interest in a company is as a result of a transaction which did not occur at market value. These arrangements are also briefly discussed in chapter five.

1.2.10 Industry charters

The provisions of the BEE Act also relate to aspects of the Financial Sector Charter (referred to as the FSC). Although the FSC was intended as a guideline, it forms an important benchmark against which BEE structures are measured. It is important to ascertain whether the provisions of the Income Tax Act currently cater for BEE transactions and how they could be aligned more closely to the needs of BEE and the current legislative framework in this context.

It is argued that tax authorities need to realize the importance of commercial structures of BEE transactions and to be conscious of the inevitable challenge that they pose to our country. The challenge is to legislate and amend such legal principles which appear not

to be conducive to the process of BEE in order to obtain some alignment between government policies and the tax regime concerning BEE.

Kolitz et al (2004) argue that, even if further tax incentives are not recommended, the consequence of entering into BEE structures should, at the very least, be tax neutral. Yet current tax legislation does not differentiate BEE transactions from other company reorganizations and transfers of ownership, with the result that potentially onerous tax liabilities are being imposed upon parties entering into BEE structures.

In tandem with the arguments above, Scholtz (2005: 13.1) argues that, "Tax is a significant factor in the implementation of BEE transactions. It will play a role in determining how BEE participation is to be funded...". Notwithstanding that these tax considerations are a significant factor in the facilitation of BEE transactions, it appears that there has to date been very little change introduced into the Income Tax Act specifically in order to facilitate BEE transactions.

1.3 The goals of the thesis

The following are some of the main questions to which answers were sought:

- Which aspects of the taxation legislation are conducive to the process of BEE and which aspects can be said to be restrictive?
- How does the current taxation legislative framework increase the tax and compliance burden in relation to certain BEE transactions?
- What are the tax implications of preference share funding structures?
- What are the restrictions which exist in the taxation of some small, medium and micro enterprises?
- How can current legislation and practice be enhanced and changed to be more conducive to the process of BEE, in terms of the taxation consequences?

1.4 Methods and design of the research

The research process included an in-depth analysis and interpretation of the various legislative enactments impacting on BEE structures and other relevant literature in the field, for the purpose of defining the meaning of BEE and reviewing what has been written on the topic, as this process relates to taxation. Thereafter, a case study

consisting of a BEE structured finance company has been used to examine the importance of BEE, to provide a synopsis of the BEE process and to outline problems in the existing tax legislation that discourage or could potentially discourage many taxpayers from entering into BEE structures. Possible amendments to the Income Tax Act to remove these tax barriers are highlighted, as revealed from the literature review and the case study. The scope of the thesis is limited to a detailed analysis of a case study in the finance sector and examples of particular types of transactions, which are the usual subjects of BEE transactions, with a view to ascertaining their consequential tax implications.

Furthermore, from the literature review in chapter two, the thesis defines the background of BEE in the South African context and outlines the current legislative concessions provided by the Income Tax Act, which can be utilised in the context of BEE transactions in general. Additionally, views on particular sections of the Act, which are regarded as punitive to BEE transactions, are discussed.

In chapter three, a focused analysis of the current tax legislative framework is carried out. This is done in order to highlight the specific sections of tax legislation which affect most BEE transactions. In carrying out an analysis of the tax implications of preference share funding structures in the fourth chapter, this thesis gives an outline of the changes which have been introduced to section 8E of the Act by showing how this section impacts on preference share funding by banks of BEE transactions, these being referred to as "strategic transactions" specifically in the context of BEE funding. The analysis is done to highlight the impact of this section on preference share funding structures and therefore certain BEE transactions, before and after the legislative changes. Additionally also in chapter, the provisions of a new section, section 8F are examined. This is followed by an illustration by way of one case study in chapter five of a BEE transaction in the financial sector. The study covers specific provisions of the Act which could potentially adversely affect a BEE deal in the financial sector. Chapter six provides the conclusions flowing from the research and contains a summary of the findings and recommendations.

In complying with ethical requirements, appropriate action has been taken to protect the anonymity of the finance company, which has agreed to be the subject of the case study. All other documents which have been used in the research are in the public domain.

1.5 Conclusion

The overarching theme of the discussion presented above is the fact that tax authorities need to appreciate the importance of the commercial structures underlying BEE transactions and to be conscious of the inevitable challenge of the need to amend such legal and tax procedural principles that appear not to be conducive to the process of BEE. Furthermore, as Mazwai (2003) rightly states, it is unfortunate that most empowerment transactions merely focus on the news-making headlines of the transaction, leaving the real business case, costs and actual implementation as an afterthought. This does not build up the necessary skills base amongst business of understanding, before the deal is concluded, what the likely taxation dispensation would be for specific BEE transactions.

Chapter 2: Literature Review

2.1 Introduction

As BEE is a relatively new concept, most of what has been written on the topic has been in the popular press and very little research has been done of the impact of taxation on BEE transactions and structures. This chapter comprises a limited review of the relevant literature. The intention is to analyse and interpret the literature in the field of black economic empowerment (referred to as BEE) and taxation. This chapter also gives a background to BEE in the South African context. This discussion is important, as it constitutes the foundation upon which the taxation effects on BEE transactions are discussed in the chapters that follow.

2.2 The Black Economic Empowerment landscape

The disenfranchisement of the majority of the South African population during the apartheid era left a legacy of poverty, a huge discrepancy between the wealthy and the impoverished and a scarcity of people from the disadvantaged groups, particularly black people, in positions of leadership. Kolitz et al (2004: 1).

Kolitz et al (2004) further argue that apart from being denied opportunities and access to education, this sector of the population was often also denied access to ownership and investment in land and businesses.

It is estimated by Kolitz et al (2004) that since the African National Congress (ANC) government came to power in 1994, the correction of this inequality has been a priority and there have been various initiatives to economically empower the historically disadvantaged community, but these have not always produced the desired results. Indeed, the correction of this inequality was recognized by the ANC even before it came to power.

Economic transformation through black economic empowerment is an important underpinning of South Africa's continued development. Kolitz et al (2004) state that there is also a strong argument that in order to accelerate investment, government should introduce financial and tax incentives in support of empowerment transactions as it is argued that preferential tax provisions will encourage largely white-owned companies to take the steps necessary to integrate previously disadvantaged individuals into the

economy. So far, the government has given very little indication that it will introduce such incentives and is generally known to be opposed to using widespread tax incentives to achieve economic objectives.

Kolitz et al (2004) argue that even if tax incentives are not recommended, the consequence of entering into BEE structures should, at the very least, be tax-neutral. Yet current tax legislation does not differentiate BEE transactions from other company reorganizations and transfers of ownership, with the result that onerous tax liabilities may possibly be imposed upon parties entering into BEE structures.

To make matters worse, tax concessions available in terms of the Act, which provide rollover relief from capital gains tax and income tax for company reorganisations and transfers of ownership, often do not apply to BEE structures because one or more of the requirements of those sections cannot be met. Consequently, the parties entering into a BEE structure may end up paying more tax than would be the case in an ordinary commercial transaction.

2.3 The definition of BEE

There is often a tendency in South Africa to define BEE narrowly and to equate it with the development of a black capitalist class. The narrow definition focuses on the entry and transaction activities of black people in business, especially what is commonly referred to as BEE investment holding companies (BEE Commission Report 2000: 11).

The above definition of BEE depicts a limited view of only the experiences and challenges faced in the establishment of big BEE companies, which are usually led by the stalwarts of the historical struggle for liberation dispensation, and significantly ignores the experiences of small and medium businesses and the development of skills.

The broader definition, which is the approach the BEE Commission anchored its research in, argues: "The fundamental crisis in our economy is that black people remain excluded from financial and economic resources. BEE must incorporate comprehensive strategies, which are aimed at increasing access to productive assets whilst simultaneously ensuring the productivity of those assets" BEE Commission (2000:12).The definition of BEE is therefore a broad all-encompassing one and this broad definition is accepted for the purposes of this research.

In addition, Scholtz (2005) believes that the most cruel consequence of the legacies of apartheid is a deficit of skills amongst black people, attributable to an inferior black education system. He (Scholtz: 2005) further substantiates this fact by stating that as late as 1988, educational expenditure per white child was R22 769 per child, while educational expenditure per black child was R595. Inferior black education itself served to limit black participation in the economy. Therefore, the response of the government currently is to set out to establish equality through a multi-faceted BEE strategy. This strategy is supported by legislation, which includes the specific legislation outlined below.

2.4 The legal framework for black economic empowerment

The following is a limited discussion of a few of the recent legislative enactments which support black economic empowerment. The analysis is intended to give a broad overview of the legislative foundation which has been laid to assist black economic empowerment initiatives, particularly in the last ten years. The discussion is limited and is not meant to provide a thorough legal analysis of the legislation. It is only a broad overview of what the specific legislation entails pertaining to black economic empowerment.

2.4.1 The Broad-based Black Economic Empowerment Act, 53 of 2003

The Broad-based Black Economic Empowerment Act (referred to as the BEE Act) was signed into law by the President of South Africa on 9 January 2004. In section 1, the BEE Act defines BEE as:

An integrated and coherent socioeconomic process that directly contributes to the economic transformation of South Africa and brings about both significant increases in the number of black people that manage, own and control the country's economy as well as significant decreases in income inequalities.

In addition, the BEE Act defines broad-based black economic empowerment as and outlines broad BEE objectives as the following¹:

¹ Section 1 of the BEE Act

The economic empowerment of all black people including women, workers, youth, people with disabilities and people living in rural areas through diverse but integrated socioeconomic strategies that include, but are not limited to-

- (a) Increasing the number of black people that manage, own and control enterprises and productive assets;
- (b) Facilitating ownership and management of enterprises and productive assets by communities, workers, cooperatives and other collective enterprises;
- (c) Human resource and skills development;
- (d) Achieving equitable representation in all occupational categories and levels in the workforce;
- (e) Preferential procurement; and
- (f) Investment in enterprises that are owned or managed by black people.

The definition of broad-based black economic empowerment above, gives an expanded meaning to BEE. It extends its horizon to more than just a purchase of shares in an organization and the consequential dividends earned. This definition speaks of economic empowerment, implying a more sustainable and substantive way of redressing the predominant economic imbalances and inequality, which were brought about by the legacy of apartheid. This definition is also all encompassing, as it includes women, workers, youth, people with disabilities and people living in rural areas.

Further, according to Scholtz (2005), the BEE Act does not itself directly prescribe the criteria governing preferential procurement and empowerment. The writer of this thesis agrees that what its framework does, instead, is to provide a legislative basis for the promulgation of such criteria under the guidance of the different advisory councils, some of which were appointed in terms of industry specific charters.

The BEE Act makes provision for an Advisory Council and section 5 of the BEE Act outlines the following duties for the Advisory Council:

- (a) advise government on black economic empowerment;
- (b) review progress in achieving black economic empowerment;
- (c) advise on draft codes of practice, which the Minister intends publishing for comment in terms of Section 9(5) of the Act;
- (d) advise on the development and adaptation of a strategy for the pursuit of

- broad-based black empowerment to be issued by the Minister;
- (e) advise on transformation charters;
- (f) facilitate the creation of public-private partnerships, which advance BEE objectives.

Of the functions of the Council, the most vital is its role in advising on draft codes of practice and transformation charters. It is the codes of practice and transformation charters, which are to embody the specific criteria for preferential procurement. Sections 9 and 10 of the BEE Act determine the ambit and status of the codes of good practice.

Section 9 of the Act enables the Minister, by notice in the Government Gazette, to issue codes of good practice that may cover:

- (a) the further interpretation and definition of broad-based black economic empowerment;
- (b) criteria for preferential procurement;
- (c) indicators to measure broad-based black empowerment;
- (d) the weighting to be attached to broad-based black economic empowerment indicators;
- (e) guidelines for stakeholders in relevant sectors of the economy to draw up transformation charters for their sector; and
- (f) any other matter necessary to achieve the objectives of the Act.

This section determines what may be covered in codes of good practice; while Section 10 determines their status and obliges every organ of state and public entity to take into account, and, as far as is reasonable, to apply any relevant code of good practice issued under the Act in:

- (a) determining the qualification criteria for the issue of licences, concessions or other authorisations in terms of any law;
- (b) developing and implementing a preferential procurement policy;
- (c) determining qualification criteria for the sale of state-owned enterprises; and
- (d) developing criteria for entering into public-private partnerships.

The Minister has recently issued and continues to update the draft codes of good practice (or 'statements'). To date, these centre on the introduction of a sophisticated

'balanced scorecard' approach to the determination of degrees of empowerment. The essence of that approach is to award a score to enterprises competing for government contracts, which measures not only the degree to which the enterprise is itself empowered, but also the extent to which the enterprise, in its own commercial relations, favours other empowered enterprises.

2.4.2 The Employment Equity Act, 55 of 1998

An in-depth analysis of the provisions of the Employment Equity Act (referred to as the EEA) is beyond the scope of this thesis. However it is important to highlight that the EEA provides for the formulation of affirmative action and other black economic empowerment policies which are implemented as necessary interventions to redress the systematic exclusion of most black South Africans from participating to their full potential in their economy.

It is argued that the marginalisation of black people led to significant structural distortions in the economy. The EEA also prescribes compliance for all employers with more than fifty employees and also uses turnover thresholds which apply to different industry sectors.

2.4.3 Skills Development Act, 97 of 1998

According to Scholz (2005), the Skills Development Act sets out to provide a framework for workplace strategies to improve the national skills base. It established the so-called Sector Education and Training Authorities (SETA's), principally to oversee a system of workplace learnerships.

Another important legislative instrument in this context is the Skills Development Levies Act, 9 of 1999. This legislation obliges employers to contribute one percent of their annual payroll towards the National Skills Fund. These funds are expended on training and development projects and are also refundable to employers to finance their own employee training activities.

2.4.4 Preferential Procurement Policy Framework Act, 5 of 2000

The Preferential Procurement Policy Framework Act provides a framework within which preferential procurement policies for particularly government purchasing agencies would be formulated and implemented. It also provides for a preference point system to be followed in awarding contracts. However, it is argued that this legislation was to a significant extent overridden by the introduction of the BEE Act, which produced the much needed explicit criteria, in the implementation of preferential procurement policies by government.

2.5 The Financial Sector Charter

One of the most important government and industry initiatives contributing to the furtherance of BEE has been the Financial Sector Charter (FSC). This charter has set out clear guidelines for achieving BEE targets. Government and industry representatives signed the FSC in August 2003.

The FSC sets out a balanced scorecard against which BEE progress by companies within the industry can be measured. The balanced scorecard applies certain weightings to the each category of empowerment transactions as outlined in the financial sector charter as depicted below; the total points on the charter add up to 100². Although not an exact duplicate of the generic scorecard as produced by the Department of Trade and Industry, the FSC does represent the essential elements of the generic balanced scorecard. The FSC also contains three core elements which are direct empowerment, human resource development and indirect empowerment. For completeness, all the areas of measurable compliance have been outlined below. The expanded and defined areas of BEE compliance included below are the focus of this thesis. BEE compliance is measured in the following areas (FSC and Balanced Scorecard: 2003):

Human resource development

- Human resource development [20 points]

The undertaking by each financial institution to promote a non-racial, non-sexist environment and to enhance cultural diversity and gender sensitivity within the sector; invest in human resource development across the full spectrum of skills,

² The Financial Sector Charter and the Balanced Scorecard (2003).

with special emphasis on increasing the participation of black people in skilled, strategic and operational leadership in the sector; invest in and equip current and future leadership incumbents in the sector with the appropriate knowledge and capacity to enable them to play a central role in driving the transformation programme.

Indirect empowerment

- Procurement and enterprise development [15 points]
- Corporate social investment [3 points]
- Access to financial services [18 points]

Direct empowerment

- Empowerment financing [22 points]

The provision of finance for or investment in targeted investments and BEE transactions. Targeted investment means the debt financing or other form of credit extension or equity investments in South African projects in areas where gaps or backlogs in economic development and job creation have not been adequately addressed by financial institutions. The charter also defines BEE transactions as all transactions for the acquisition by black people of direct ownership in an existing or new entity in the financial or any other sector of the economy.

- Ownership and control in the sector [22 points]

The ownership of an equity interest, together with control over all of the voting rights attaching to that equity interest.

As depicted above, each sub element has a weighting attached to it. As advised by Scholtz (2005), the weightings attached also indicate the maximum level of points available for the specific BEE element.

According to the Department of Trade and Industry (DTI website: 2005), a twenty-one member Charter Council, which is comprised of representatives from organized labour, industry and the government, regulates the charter. The Council is mandated to review ownership provisions in order to identify shortcomings and to make decisions on what further steps should be taken. These reviews are only due in 2009 and 2015; however

the Charter Council does give policy direction to the sector on a continuous basis. From a political perspective, the charter is not a definitive answer to the perceived transformation and other deficiencies in the sector. However, it does give a structured and clear framework within which the sector can work and measure its own progress.

The focus of this thesis is based on three elements of the FSC balanced scorecard, being ownership and control, human resource development and empowerment financing. Chapter three and four contain the analysis of provisions which lend themselves to the furtherance of share purchase transactions and corporate restructuring rules. These provisions support the ownership and control objectives of the charter. The discussion in these chapters also covers the provisions which have been introduced to the Income Tax Act to support the purchase of shares by employees in terms of broad-based employee share schemes, and as such would contribute to the attainment of some of the goals envisaged under the human resource development sub-element of the FSC. In addition, chapter four is dedicated to the discussion of the use of preference share funding structures which could enable the financial sector to attain the empowerment financing objectives set out by the financial sector industry charter. These three elements are important as they count for 64 points out of the FSC balanced scorecard weightings.

There is a need to understand this background to BEE, as it constitutes an important foundation in order to analyse how tax and other financial instruments could facilitate the necessary process of transition in South Africa. BEE has been and continues to be an important tool used to transform South Africa's corporate and economic landscape into one more representative and inclusive of South Africa's population. It is in this context, that this otherwise political foundation is laid before the technical aspects of the Income Tax Act, which affect BEE transactions, are analysed.

2.6 Tax and BEE

Scholtz (2005: 13.1) argues that, "Tax is a significant factor in the implementation of BEE transactions. It will play a role in determining how BEE participation is to be funded...". Notwithstanding that these tax exposures may be a significant obstacle to the implementation of arrangements intended to accommodate BEE participants, to date very little change has been introduced into the Income Tax Act, which might be said to have been specifically introduced in order to facilitate BEE transactions.

The discussion which follows below includes an analysis of the taxation impact of the following provisions of the Income Tax Act:

- Corporate restructuring rules
 - Sections 41-47
- Employee share acquisitions
 - Sections 8B, 10(1)(nC) and 11(IA)
- Debt transactions and inter-company loans
 - Section 8(4)(m), section 20(1)(a)(ii) as well as paragraphs 12(5) and 56 of the Eighth Schedule.
- Deferral of the accrual and incurral of share acquisition amounts
 - Section 24N
- Taxation of trust income
 - Section 25B and the discussion on share acquisition trusts
- Taxation of small business corporations and personal service companies
 - Section 12E
 - Paragraph 1 of the Fourth Schedule to the Income Tax Act
- Preference shares and hybrid financial instruments as a means of funding
 - Sections 8E and 8F
- The general deduction formula and tax deductibility of interest expenditure
 - Sections 11(a), 23(g) and 23(f).

2.6.1 Corporate restructuring rules

Kolitz et al (2004) state that Part III of the Income Tax Act provides for tax relief in the form of deferrals and rollovers for qualifying company transactions and, provided the requirements of sections 41 to 47 are met, the negative tax implications of these transactions can be eliminated, minimised or deferred. The relief that these sections provide, could also be utilized for those BEE transactions, which meet the criteria contained in the said provisions.

2.6.2 Employee share acquisition

De Beer et al (2004) correctly note that one of the important focuses of the drive for BEE in South Africa, is the inclusion of previously disadvantaged employees in employee share ownership schemes, and this is also one of the facets of the FSC.

Looking at other countries for an example, it can be noted that in 2002 already, Zambia had promulgated specific tax legislation to encourage employers to issue share options to employees. In addition, according to De Beer et al (2004), the tax benefits to Zambian companies include the following:

- The costs incurred by the company to set up and administer the scheme are tax deductible.
- The income of the scheme is tax exempt.
- The employer is exempt from Property Transfer Tax on shares transferred to the scheme.

In addition, there are also benefits to the employees themselves, in that employees are exempt from tax on benefits arising from an approved scheme. One of the differences in tax legislation between South African and Zambia is that in Zambia, the growth in the value of the share options (between the market value at date of grant and at exercise date) is tax exempt at the date the shares are released to the employee. However, should the shares be sold, the employee will be taxed on the gain made, being the difference between the proceeds received and what was paid for the shares. De Beer et al (2004) point out that in South Africa tax is levied when the share options are exercised and capital gains tax (CGT) is paid on subsequent profits realized when the shares are sold. However, in Business Day (March 8, 2005) it was reported that new amendments to the Income Tax Act were being proposed and these would herald the first tentative move of the South African Revenue Service (SARS) to encourage the transfer of equity to previously disadvantaged individuals.

De Beer et al (2004) further advises that where all the requirements of section 8B of the Income Tax Act are met, the following are essentially the new tax consequences on the disposal of shares held by an employee from an employer share option scheme:

- The discount on the shares (upon release of the shares to the employee) will not be included in the income of the employee.
- If the employee sells the shares within five years, the profit made on the sale will be included in the employee's taxable income in the ordinary way.
- However, if the employee sells after the five-year period, the employee will be taxed on the capital gain, effectively reducing the applicable rate of tax.
- The employer will, within some restrictions, be able to claim a tax deduction under new section 11(IA). The deduction is an amount equal to the market value of shares, but limited to R3000 per participating employee in the year of issue of the shares,

with the excess being carried forward for deduction in ensuing years at a rate not more than R3000 per participating employee per year (up to a total of R9000 per employee).

In tandem with the provisions of section 8B discussed above, sections 11(IA) and 10(1)(nC) are discussed in more detail in chapter three.

2.6.3 Debt transactions and inter-company loans

It is important to note the possible impact of sections 8(4)(m) and 20(1)(a)(ii), as well as paragraphs 12(5) and 56 of the Eighth Schedule to the Income Tax Act, on debt transactions and inter-company loans. Section 8(4)(m), which was introduced into the Act in 1997, states the following:

- where as a result of the cancellation, termination or variation of an agreement or due to the prescription, waiver or release of a claim for payment;
- any person was relieved or partially relieved from the obligation to make payment of any expenditure actually incurred;
- and such expenditure or any allowance was not paid and was allowed as a deduction from such person's income;
- such person shall be deemed to have recovered or recouped an amount equal to the amount of the obligation from which such person was relieved or partially relieved.

This section only applies if the transaction giving rise to the debt was previously a deductible expense. It is also subject to the provisions of section 20(1)(a)(ii), which in essence provides that the balance of any assessed loss shall be reduced by the value of any benefit received from a concession granted, or compromise with the creditors whereby liabilities have been reduced, provided such liabilities arose in the ordinary course of business. When the compromise benefit relates to a transaction of a capital nature, the provisions of paragraphs 12(5) and 56 of the Eighth Schedule to the Act apply to include the taxable gain in taxable income. These sections are discussed in more detail in chapter three.

2.6.4 Deferral of accrual and incurral of equity share acquisition amounts

The provisions of a new section, section 24N of the Income Tax Act, defer both the inclusion in gross income and the deduction from income (in the case of expenditure), of amounts forming the subject of a disposal of an asset (section 24N provides specifically for the disposal of equity shares), which are not quantifiable in the year of assessment during which the asset is disposed. Such amounts will only accrue or rank for deduction in the year that they become quantifiable.

Scholtz (2005) concedes that there is general consensus amongst some tax authors, that section 24N was introduced into the Income Tax Act to aid BEE transactions, this is in view of the fact that this provision effectively promotes the sale of shares 'on terms' by providing that instalments receivable in later years will only be caught as proceeds when the instalments become due and payable.

2.6.5 Trusts and BEE structures

Different types of trusts are also a common feature of BEE funding structures. This is mostly found where the interests of groups of people, such as employees and/or previously disadvantaged communities are to be represented. Furthermore there are also other legitimate business and strategic reasons for using trusts and these include family and estate planning, joint ventures, joint holdings of business assets, fiduciary arrangements, life-long care for physically and mentally handicapped, and so on.

It is interesting to note that where the general public has an interest through the medium of a business trust structure, as is often the case within BEE structures, there is the potential conflict with the provisions of section 37 of the Unit Trust Control Act 54 of 1981 (This Act was replaced by the Collective Investment Schemes Control Act, 2002), which provides that:

No person shall do any act or enter into any agreement or transaction for the purpose of establishing, carrying on or managing any scheme, other than a Unit Trust Scheme...in terms of this Act, in pursuance of which members of the public are or will be invited or permitted for valuable consideration to acquire an interest or undivided share in an asset or one or more groups of

assets and to participate proportionately in the income or profits derived therefrom.

Moreover, van Wyk (2003) justifiably submits that it is a well-known fact that SARS dislikes trusts and perceives them in general to be vehicles used for tax avoidance. A number anti-avoidance rules clearly have been devised to make the use of trusts less attractive, including taxing trusts (other than special trusts) at the marginal rate of 40 percent compared with companies which are taxed at the rate of 29 percent and individuals taxed at the graduated tax rate structure of between 18 to 40 percent. In the context of BEE however, an aggressive tax regime for trusts seems very prejudicial and perhaps also unconstitutional.

Trusts are often used as business vehicles³, to a certain extent because the major advantages vested in both the company and close corporation alternate business structures, for example, limited liability, can be enjoyed by using a trust less onerously in terms of expense and administrative hurdles. Moreover, trusts are not required by law to be audited (Estate Planning, Service Issue: Nov 2002). It has however been argued that in certain instances, and for the reason that the limited liability feature is obtained without the necessary protection for creditors, the maintenance of capital required by company law and the solvency and liquidity required by close corporation law, trust beneficiaries can therefore be exposed to prejudice caused by the lack of clear rules as contained in the trust deed for their protection. However, in assessing this potential hazard, Wunsh (1986: 561 at 563) said "I should point out that although business trusts provide scope for the avoidance and reduction of duties and taxes, despite the dangers adverted to by the Law Commission and the Standing Advisory Committee on Company Law, there is no evidence of prejudice to or losses by the public as the result of the use of trusts for business purposes."

The main argument concerning this rather contentious structure is that although a trust is a taxable entity in terms of the Income Tax Act the income that accrues to or is received by the trust, will not always be taxed in the hands of the trust. This income might be taxed in the hands of the beneficiaries or the founder of the trust or a disponent. The most effective cause of the taxation of trust income in the hands of the founder of the trust or

³ The fact that tax losses in a trust can no longer be passed through to the trust beneficiaries may make trading trusts less attractive.

disponer is the operation of the provisions of section 7, which are aimed at preventing income splitting.

The most common use of trusts in the BEE context will occur in situations where the anti-avoidance provisions of section 7 will not be applicable, further assuming that the business trusts usually formed are residents of the Republic. This situation will therefore be governed by section 25B of the Act. This will be dealt with in some detail in chapter three.

2.6.6 Taxation of small business corporations and personal service companies

Section 12E of the Income Tax Act outlines the definition of the small business corporations which qualify for tax relief provided by the taxing acts to date. This is analysed as many of these small business corporations are black owned and managed and as such contribute to BEE.

Further, the taxation of personal services companies has the effect that the taxation of these small, medium and micro enterprises, which are also often black owned operations, as "personal services companies" as defined, is that their entire income is subjected to employees tax. This results in 35 percent of gross receipts paid to them being withheld for the payment of PAYE, resulting in cash flow constraints for the small businesses.

In addition, there is a limit on the level of deductions allowed for the determination of taxable income. Effectively only salaries paid to employees are allowed as a deduction. According to section 23(k) of the Income Tax Act, a personal services company may not deduct any expenses incurred, other than the amounts paid or payable to any employee of such company, for the purposes of determining the company's taxable income. The disallowing of the remainder of expenses (possibly a substantial percentage of total expenditure) incurred in the production of income for the type of trade in question, results in cash flow strains and an unequal tax burden on these small businesses. Further, it can be argued that these tax costs have made and could potentially make more of these operations technically insolvent and put them in a loss-making position for prolonged periods of time.

2.6.7 Preference shares and hybrid financial instruments as a means of funding

As argued by Scholz (2005), a significant number of BEE transactions have featured the use of preference share capital in order to enable the BEE parties to obtain the necessary funding at more affordable rates. Jordaan et al (2005: 239) state that "the low cost of capital has made these preference-share deals advantageous". Zinman (2004) is of the opinion that preference shares have been available as a financing tool from the very origins of company law.

The writer of this thesis concedes that the cost of financing the multi-billion obligations arising from most of the big BEE deals, coupled with the unfavourable tax treatment of interest expenditure on monies borrowed to purchase shares, have also encouraged the use of preference share funding. Chapter five of this thesis has been dedicated to a detailed investigation of section 8E of the Income Tax Act which regulates the use of preference share funding and the consequential tax costs that may be applicable to BEE. The provisions of this section were introduced into the Act as an anti-avoidance measure to counter the prevalent use preference share funding schemes to disguise debt obligations as equity.

Section 8F has also been introduced into the Income Tax Act, its purpose being to limit the deduction from gross income of certain interest payments which were incurred under equity transactions disguised as debt. The main discussion in chapter five, however, is focused on the tax implications of section 8E, both prior to and after the 26 October 2004 amendments and how these could affect preference share funding structures and, ultimately, BEE funding.

2.6.8 The general deduction formula and the deductibility of interest expenditure incurred on amounts raised to acquire shares

Scholtz (2005) advises that one of the major impediments to increased share acquisition by black people is the refusal of the South African tax system to allow the deduction from income of interest expenditure incurred on loans raised in order to acquire shares. The provisions of section 11(a), 23(g) and 23(f) which constitute the general deduction formula and as such govern the tax deductibility of interest expenditure, are analysed in

detail in chapter three, in order to highlight how the current format of the general deduction formula impedes the attainment of some of the objectives of black economic empowerment.

2.7 Conclusion

It is apparent from the discussion above, that there is some legislative foundation which has been established, particularly in the past ten years, to aid the implementation of BEE policies, especially in the financial sector. This has been illustrated by an analysis of some of the legislative enactments which have been introduced in the last ten years to support economic transformation. Additionally, there are a few provisions in the Income Tax Act which can be useful tools in promoting cost- efficiency in terms of the taxation of BEE transactions. There are, however, some sections of the Act which can be punitive in relation to the structuring of BEE transactions and their financing.

Kolitz et al (2005) and Scholz (2005) agree that there is some relief which is available from the application of sections 41-47 of the Act which provide rollover and deferral of both income and/or capital gains tax for qualifying company formation transactions. The combination of sections 8B, 10(1)(nC), and 11(IA) appear to provide a significant legislative contribution towards the promotion of share acquisitions by employees; this is supportive of the attainment of the goals of broad-based economic empowerment.

Jordaan et al (2004) and Zinman (2004) concede that the use of preference share funding and the consequential taxation implications have been prevalent in large BEE transactions to date. Section 8E of the Income Tax Act, however, serves to limit the willingness of financiers to subscribe for preference shares, as some of the dividend income earned could be deemed to be interest income and therefore taxable, if the requirements of the section are satisfied. The following chapter investigates in more depth both the provisions of the Act which aid BEE and those which are punitive to these transactions.

Chapter 3: A discussion of certain taxation provisions and their impact on black economic empowerment

3.1 Introduction

The previous chapters outlined certain facets of tax legislation regarding the transfer of assets that may not be particularly conducive to the process of structuring and financing BEE transactions. The opening discussion in this chapter is on the taxation of the transfer of assets within a group. This includes a brief discussion of the effects of the corporate restructuring rules of the Income Tax Act, contained in sections 41-47. In addition, an analysis of the taxation effects of inter-company loans is carried out. The analysis is done with a specific focus on sections 8(4)(m), 20(1)(a)(ii) as well as paragraphs 12(5) and 56 of the Eighth Schedule, taking into account some aspects of the capital gains tax (CGT) legislation.

There is also a discussion on the taxation of share acquisition schemes, based on the new sections 8B, 10(1)(nC) and 11(IA) of the Income Tax Act.

The chapter further includes an outline of the legislation governing the taxation of trust income and how this may affect BEE transactions.

The chapter also briefly analyses the provisions of section 24N of the Act, a relatively new section, the effect of which is the deferral of tax on the sale and acquisition of equity shares, subject to some requirements contained in section 24N(2) of the Act. The discussion is centered on the usefulness of this section to BEE transactions.

Lastly, a discussion of paragraph 1 of the Fourth Schedule to the Act is carried out, this is done in order to highlight a few taxation hurdles brought about by the taxation of personal service companies and how these could affect black-owned small, medium and micro enterprises. This discussion is preceded by a general analysis of the taxation of small business corporations as defined in section 12E of the Act. This is done in order to highlight the fact that although there are still significant areas of concern, a lot of work has been done by the government on targeted tax policy reforms which support small business corporations and black economic empowerment by implication.

3.2 Taxing the transfer of assets

For the purposes of this thesis, the assets discussed are broadly defined to include property of whatever nature, whether movable or immovable, corporeal or incorporeal and a right or interest of whatever nature to or in such property. This definition is designed to be wide enough to cover any type of assets including fixed assets, intangibles or rights of use of any other asset or property.

Tax legislation is currently designed to prevent excessive tax benefits being claimed by the movement of assets within a group. Hence, if assets are moved within the group, these assets are deemed to have been disposed of at their market values. The said transference can result in both income tax and capital gains tax under the Income Tax Act. At this point it is also important to note that "There is no separate capital gains tax (CGT) in South Africa. A person's taxable capital gain for a year of assessment is included in his taxable income and subject to normal tax...this means that taxable capital gains are subject to normal tax rather than a separate CGT" (Silke, 2002:546).

Scholtz (2005) defines the corporate restructuring rules as essentially rollover relief rules, which govern the transfer of assets to, or between companies. When groups of companies are restructured for good commercial or corporate-political reasons, as it inherently is in the case of BEE structures, some rationalization rules have been incorporated into the current legislation. As outlined in chapter two, these rules are contained in sections 41-47 of the Act. The focus of the discussion in this chapter, however, is limited to sections 42, 43, 44 and 45 of the Act as it is considered that these sections are arguably the most relevant to the types of BEE transactions envisaged in this thesis. Adapted from the analysis by Koliz et al (2004), the provisions of sections 41 to 47 are summarised below:

- **Section 41** sets out the definitions of terms used in sections 42 to 47 and defines the scope of these sections.
- **Section 42** provides for the deferral of income tax and capital gains tax (CGT) arising from company formation transactions in respect of which a person disposes of an asset to a company in exchange for shares in that company.
- **Section 43** provides for the deferral of income tax and CGT arising from share-for-share transactions in respect of which a person disposes of an equity share in one company (the target company) to another company (the acquiring company) in exchange for shares in the acquiring company.

- **Section 44** provides for tax concessions which defer the taxation of certain recoupments arising from amalgamation transactions in terms of which a company disposes of all of its assets to another company and, following the disposal, existence of the first company is terminated.
- **Section 45** provides for the deferral of income tax and CGT arising from intra-group transactions in terms of which an asset is disposed of by one company to another and both companies form part of the same group of companies.
- **Section 46** provides for the deferral of income tax and CGT arising from unbundling transactions in terms of which a company disposes of equity shares to its shareholders.
- **Section 47** provides for the deferral of income tax and CGT arising upon the liquidation, winding-up or deregistration of a company.

Section 42 of the Income Tax Act, which governs “company formations”, applies where assets are transferred to a company against an issue of shares. The primary requirement is that the transferor company must acquire more than 25 percent of the equity interest in the transferee company. For the purposes of this thesis and in the context of BEE, a transferee company may be set up and assets transferred to it before selling a stake in that company to a BEE participant. The BEE participant might also form a company itself and transfer some assets in return for an issue of shares. These parties may then invoke section 42 to ensure that the assets are transferred free of the adverse tax and CGT consequences. Importantly, as provided in Huxham et al (2004: 258) “...the section only applies to the extent that the parties agree that a transaction must be dealt with as a company formation transaction”.

Another aspect of the corporate restructuring rules which might be relevant in black economic empowerment transactions is section 43, which governs share-for-share transactions. Huxham et al (2004: 262) define these as

“...transactions in terms of which any person (other than a trust which is not a special trust) disposes of any equity share (the target share) in a company (the target company) to a South African resident company (the acquiring company) in exchange for any equity share in that acquiring company (and the market value of the equity share disposed of is more than its base cost, if a capital asset, or more than its tax value, if it is trading stock). If the requirements of this section are fulfilled and the election is not made or cannot be made (as an election can only be made in the case of both parties being part of the same group of companies), the provisions of this section apply automatically”.

Generally, where the provisions of this section apply, Huxham et al (2004: 263) state that "...the transferor is deemed to have sold the shares (if they are not trading stock) at his base cost and he is deemed to have acquired the shares in the acquiring company at the same base cost". This is contained in section 43(2). However, if shares are held in the target company as trading stock, the transferor is deemed to have disposed of them at their tax value in terms of section 22(1) and he is deemed to have acquired the shares in the acquiring company at the same value (Huxham et al :2004). Most BEE transactions feature the use of share-for-share transactions, for example, a large multinational group might want to purchase a stake in a small BEE distribution company. In view of the benefits for both companies in owning each other's shares, they may elect to have a share-for-share transaction. Provided that the conditions of section 43 are met, there are significant CGT savings on these transactions, and this is most welcome for BEE transactions at large.

Section 44 of the corporate restructuring rules governs company amalgamations as contemplated in section 44(1). Huxham et al (2004) assert that according to this section, in amalgamation transactions the 'amalgamated company' disposes of all of its assets to the 'resultant company' and as a result of the amalgamation, the amalgamated company ceases to exist. This section is not subject to an election in order to apply, unless the parties to the amalgamation are group companies. Section 44(13) stipulates that the amalgamated company must take steps to liquidate or deregister within six months from the date of the amalgamation transaction. In a BEE scenario, where the companies often do not possess any meaningful assets except for the shares in issue, should a BEE company decide to dispose its own shares in return for shares in the resultant company, Huxham et al (2004) state that according to section 44(6), if as a result of the share exchange a profit is made over and above the base cost or tax value, then the share acquisition and disposal are for the same amount. This may be base cost or tax value, depending on what the parties choose in the particular situation. This transference would therefore be effectively tax free. However, it is important to note that where the resultant company subsequently disposes of some of the assets acquired under an amalgamation transaction within 18 months from the date of the amalgamation transaction, a portion of the tax savings might be lost, triggering significant capital gains tax in some instances. This is provided by section 44(5) which acts as an anti-avoidance provision of the section.

One of the general requirements relating to the corporate rules of the Act, is that the holding company must, after the restructuring (which may involve the transfer of assets),

“...remain a 75 percent shareholder of the company to which the assets have been transferred” Silke (2002: 351). As an example,

A large listed group enters into an agreement with BEE partners to enable them to acquire a significant equity stake in a large and profitable division of the group. To achieve this, a new company is formed in which the group and the partners hold equity stakes, and the relevant assets (including goodwill) are transferred to the new company. If the market values of the assets are much higher than the values for tax purposes, either or both income tax and CGT will be payable if the group does not continue to hold at least 75 percent of the new company (Mazansky: 2003).

Put another way, assets may only be transferred within the group where the companies' equity share capital is held within the group to the extent of at least 75 percent. The real effect of this rule is that unless companies have budgeted for all these underlying tax costs or up-front tax liabilities, the maximum the group can offer to BEE partners is a 25 percent shareholding. If assets are initially transferred within the group, should there be an understanding between the BEE partners and their group of companies that they will increase their shareholding to a percentage greater than 25 percent at an agreed point in time after the initial acquisition of the 25 percent stake, because of section 45(2) of the Act, such transfer is deemed to have occurred at base cost, and is hence effectively tax-free. Section 45 contains the provisions which relate to intra-group transactions. Huxham et al (2004: 269) define these transactions as “...transactions in terms of which any asset is disposed of by one company (the transferor company) to another company which is a resident (the transferee company) and both companies form part of the same group of companies on the date of the transaction”. Taxpayer companies may elect the application of the provisions of this section on an asset-by-asset basis.

As previously stated, in terms of an intra-group transaction, if the group's shareholding is later diluted to less than 75 percent, any further transference or disposal is deemed to have occurred at market values of the assets in question on the date of the initial (25 percent) transaction. If a holding company, for example, sells a further 10 percent to the BEE partners in the example above, there is an immediate tax liability arising from the difference between the base cost or tax value and the market value of the assets being disposed of.

However, according to Mashigo (2005) of the National Treasury, in the 2005 Budget, amendments were announced for the current corporate restructuring rules, which provide more relief for company formations and restructurings, and which in turn facilitate black economic empowerment deals. These amendments refine critical policy areas, especially the impact of capital gains tax on company formations and restructurings. The 75 percent shareholder threshold has now been relaxed to a 70 percent direct or indirect holding, making the tax relief provisions more accessible. The new definition of "group of companies" will allow up to 30 percent to be transferred to an empowerment consortium, and this accommodates all black economic empowerment charters.

In addition, under the current tax legislation as discussed above, companies disposing of assets in exchange for shares (such as in an empowerment transaction) have to take 25 percent in equity in the new company to qualify for tax-free company formation relief. The BEE partner is also liable for capital gains tax on any shareholding of less than 25 percent. These current rules impede empowerment transactions because transactions may involve more than one company in the transaction, yet with a stake of less than 25 percent they will not be able to claim the relief. This hinders company formations when multiple parties seek to form a company. The 25 percent threshold has now been reduced, thus allowing companies to dispose of less than 25 percent of their shares in a restructuring and still claim the tax relief.

These amendments allow for wider application of the relief provisions. Although the amendments facilitate company restructuring in general, specifically, they facilitate empowerment deals such as intra-group transactions, where assets are disposed of by one company to another entity and more than a 25 (now 30) percent share of such entity is transferred to the empowerment consortium. However, it is important to note that complying with the requirements of the corporate restructuring rules is not an easy matter. The sophistication of these rules, may to a significant extent dilute the inherent benefits that some of these rules may provide for BEE transactions. As such, there is a need to consider simplified legislation in order to support company reorganisations which include the attainment of black economic empowerment objectives. This would also augur well for increased tax compliance.

3.3 Share incentive schemes

The recently introduced section 8B, introduced by the Taxation Laws Amendment Act 2004, addresses the adverse tax consequences which normally arose with the issue of shares to employees at a discount. Issuing shares to employees at a reduced cost or for no consideration tended to trigger "fringe benefit" tax, which many employees could not afford because of the adverse cash flow consequences of having to pay the tax. According to paragraph 2(a) of the Seventh Schedule to the Act, as discussed in Huxham et al (2004), there is a taxable benefit which arises when an asset has been acquired by an employee from his/her employer for less than the determined value (as provided in paragraph (5) of the Seventh Schedule). The taxable benefit is the difference between what the employee has actually paid and the determined value. In the context of the acquisition of shares, apart from the provisions of section 8A which govern share options predominantly acquired by directors, the value in question for the purposes of this discussion would be the market value of the shares at the time when the employee acquired the shares. This difference would have triggered fringe benefit tax even in the case of employee share schemes for BEE, prior to the introduction of section 8B.

Section 8B provides that, in prescribed circumstances, the discount on the issue price shall not give rise to a taxable benefit in the hands of the employee and the issuing company may under certain circumstances claim a deduction in respect to the issue of shares. This section also provides for the taxation of any amounts received or accrued to employees from the disposal of 'qualifying' equity shares acquired in terms of a broad-based employee share plan. Mitchell et al (2005) advise that section 8B effectively allows for the tax free treatment of 'qualifying equity share(s)' acquired by employees, even though the shares may have been acquired at a discount or without cost. Adapted from the discussion by Scholtz (2005), the preconditions for the application of section 8B are as follows:

The employee share plan must be a broad based employee share plan. In terms of section 8B, this only means that the plan must be open for participation to at least 90 percent of all permanent employees who have worked for the company in question on a full-time basis for at least one year and are not shareholders of the company in terms of any other employee share scheme. Secondly, the consideration attached to the issue of the shares must not exceed the minimum requirement set by the Companies Act, 61 of 1973. Thirdly, the employees who are shareholders in terms of the scheme must be entitled to all dividends and full

voting rights with respect to their shares. Where the requirements of this section are satisfied, then the discount on the shares will not be included in the taxable income of the employee.

In this context, in terms of section 10(1)(nC), any amount received by or accrued to a taxpayer who is a natural person, in the form of a qualifying equity share contemplated in section 8B is exempted from taxation. These provisions were introduced by the Revenue Laws Amendment Act, 2004 (26 October 2004) and apply to any qualifying equity share received or accrued on or after that date. In addition, in the past the company issuing the shares at a discount would not qualify for tax deduction for the issue, as the discount does not represent a cost "actually incurred" by the company. This has now been rectified by the provisions of section 11(A), which allows a deduction for an employer who introduces a 'broad-based employee share plan' as contemplated in section 8B(1) for its employees. It allows as a tax deduction an amount as paraphrased in the paragraph below:

An amount equal to the market value of any qualifying equity share granted to an employee as contemplated in section 8B, as determined on the date of grant as defined in section 8B, which applies in lieu of any other deduction which may otherwise be allowed to that taxpayer or any other person in respect of the granting of that share: Provided that the deduction under this paragraph may not during any year of assessment in aggregate exceed R3 000 in respect of all qualifying equity shares granted to a single employee and so much as exceeds R3 000 may be carried forward to the immediately succeeding year of assessment.

Although it is considered that there are still restrictions, especially in terms of section 8B, which still pose a challenge to the furtherance of BEE objectives in the sphere of broad-based employee share acquisitions, these sections combined provide a fair contribution from the tax legislation to promote the acquisition of shares by employees and as such contribute to the attainment of some of the objectives of the BEE Act. One such restriction is the fact that, in terms of section 8B(1), employees who dispose of the shares within five years of their having been granted, will be taxed on the amount accruing from the disposal.

3.4 Debt transactions and inter-company loans

In addition to the fact that BEE companies may be saddled with up-front tax costs and other indirect tax liabilities, they are more often than not also burdened with very high debt service obligations. Some of these may be inter-group but most liabilities would stem from external parties, for example the formal financial sector. The discussion below represents an adaptation specifically incorporated to discuss inter-company borrowings.

It is customary for holding companies, or cross-company subsidiaries, to lend funds to each other on an ad hoc basis. This is mostly true for BEE structures, where normally a new company would be formed to accommodate empowerment partners or a particular empowerment deal. The new company may require some form of funding from the holding company or other fellow subsidiaries until it becomes profitable in its own right and engages in a repayment agreement. Because of varying circumstances or other business imperatives, the form of funding may change from debt to equity or the holding company may decide to write off the debt of the subsidiary without even considering the resulting tax consequences of its actions.

Consideration needs to be given to the possible impact of sections 8(4)(m), 20(1)(a)(ii) as well as paragraphs 12(5) and 56 of the Eighth Schedule to the Income Tax Act on the fore-mentioned policy decisions.

Section 8(4)(m), which was introduced into the Act in 1997, states that⁴:

- where as a result of the cancellation, termination or variation of an agreement or due to the prescription, waiver or release of a claim for payment;
- any person was relieved or partially relieved from the obligation to make payment of any expenditure actually incurred;
- and such expenditure or any allowance was not paid and was allowed as a deduction from such person's income;
- such person shall be deemed to have recovered or recouped an amount equal to the amount of the obligation from which such person was relieved or partially relieved.

⁴ Section 8(4)(m) of the Income Tax Act, 1962

This section⁵ only applies if the transaction giving rise to the debt was previously a tax deductible expense. It is also subject to the provisions of section 20(1)(a)(ii) which, in essence, provide that the balance of any assessed loss shall be reduced by the value of any benefit received from a concession granted, or compromise with the creditors whereby liabilities have been reduced, provided such liabilities arose in the ordinary course of business.

As mentioned in chapter one, in the case of Commissioner for Inland Revenue v Datakor Engineering (Pty) Ltd, [1998] 4 All SA 414 (A), 57 SATC 178, the conversion of debt into equity, which resulted in a reduction of an assessed loss for tax purposes, was found to be a definite compromise. Notwithstanding controversy on the effect of this judgement, it remains important legal precedent in debt conversion transactions. Moreover, it will mostly govern such transactions and/or conversions and inter-company debt write-offs for BEE structures as well.

In addition, in company formation transactions⁶, taxpayers may want to transfer property, subject to previously existing debt, at no cost or at a discount, thereby creating debt relief for the transferor. This form of debt relief, strictly speaking, should trigger part-disposal treatment under section 8(4)(m) (discussed above). In practical terms, this part-treatment would undo the main intent of making company formations tax-free.⁷

Additionally, Huxham et al (2004: 199) stipulate that according to section 20(1)(a)(ii) of the Act:

The balance of assessed loss shall be reduced by the amount or value of any benefit received by or accruing to a person resulting from a concession granted by or a compromise made with his creditors whereby his liabilities to them have been reduced or extinguished, provided such liabilities arose in the ordinary course of trade.

Huxham et al (2004: 200) provide an explanation of the above statement by way of the following example:

Z.L. Ltd has a balance of assessed loss as at 31 December 2003 of R50 000. For the year ended 31 December 2004 the company has gross income of R500 000 and deductible expenses of R480 000. During the 2004 year the company

⁵ See Note 5

⁶ See discussion of sections 42 and 44 on pages 30-31

⁷ Amendment of section 38 of the Income Tax Act, 1962

enters into a compromise with its creditors in terms of which it derives a benefit of R40 000. The tax effect for the 2004 year is as follows:

Gross income	R500 000
Expenses	(R480 000)
Assessed loss brought forward (from 2003)	<u>(R 50 000)</u>
Balance of assessed loss	<u>(R 30 000)</u>

The R30 000 is the balance which must be reduced by the compromise of R40 000. The balance of the assessed loss carried forward is nil. The R10 000 of the compromise benefit not absorbed by the assessed loss is not carried forward.

However, since section 8(4)(m) is subject to section 20, Huxham et al (2004) argue that section 8(4)m cannot apply if section 20 applies. The rationale is that the benefit provided by section 20 would be diminished by the recoupment triggered by section 8(4)(m) which would reduce the balance of the assessed loss at the end of the year.

With the introduction of Capital Gains Tax (CGT) on 1 October 2001, paragraph 12(5) was introduced into the Eighth Schedule to the Income Tax Act, which has the effect that any write-off of a loan, which is not subject to section 8(4)(m) will have CGT consequences for the debtor or borrower. When a holding company writes off the debt of a subsidiary, any excess not caught under the provisions of section 20(1)(a)(ii), may be subject to CGT. This will apply if the transactions giving rise to the debt were not included in the holding company's income (and were therefore of a capital nature). The subsidiary company will be taxed on the capital gain made when the loan is written off. Assuming that the subsidiary company is a BEE company, it would then be burdened with the CGT liability that the debt relief passively introduces, although in essence it would still be better off. The holding company may only claim the corresponding capital loss if the subsidiary company includes the loan write-off in its taxable income (paragraph 56), provided also that the holding company itself has a capital gain against which such capital loss may be utilised.

3.5 Amounts incurred or accrued from the disposal of equity shares

Another section which is relevant in the context of BEE is the new section 24N. This section was introduced into the Income Tax Act by the Taxation Laws Amendment Act

2004 and was effective from 1 January 2005. What this section effects is the deferment of the taxation, particularly CGT, on the full purchase price of shares, to a later time period when the amount accrued is actually due and payable. However, this section is only applicable if the requirements of section 24N(2) are met. McFadden (2005) advises that the requirements of section 24N(2) can be summarised as follows:

- more than 25 percent of the purchase price becomes due and payable after the end of the current year of assessment in question;
- the amount of the purchase price payable is based on the future profits of the company;
- the seller and the purchaser are not connected persons in relation to each other as defined;
- the purchaser is obligated to return the shares to the seller if the purchaser defaults on the payment for any of the shares in question;
- the amount must not be payable to the seller on the back of a financial instrument that is tradable in the open market; and
- the value of the shares, which have been disposed of as part of the transaction, must exceed 25 percent of the total value of the shares in issue in the company.

If and when the above-mentioned requirements are met, any amount which is not due to the seller of the shares in the current year of assessment, is deemed to have accrued to the seller only in the year of assessment in which it becomes due and payable. Essentially, the section allows a taxpayer to sell a meaningful shareholding in a company without being subject to immediate taxation if substantial payment proceeds are deferred until a later year. It therefore promotes seller self-financing.

Although it is considered that some of the provisions of this section may be limiting, the section does provide a way around the general provisions contained in paragraph 35 of Schedule 8, which have the effect of including in gross income amounts which accrue to taxpayers in terms of asset disposal transactions and therefore subjects such amounts to CGT by including the amounts in the taxable income on the year that the asset was disposed of, if the payment which accrues to the taxpayer in a later year(s) is not conditional. The problem associated with this section is the provision that the seller and purchaser may not be connected persons, after the disposal of the shares. Section 24N in turn, may have a positive bearing on certain BEE transactions, as it allows the

disposal of shares to BEE parties with payment of the amount owing in respect of the shares arranged in instalments, without the upfront tax costs on such a disposal.

3.6 Taxation of trust income

Also relevant to the analysis of the tax consequences of BEE transactions, is a discussion of the tax dispensation relating to South African trusts. Section 25B of the Act provides that any income received by or accrued to or in favour of a trustee of a trust, whether testamentary or *inter vivos*, shall, subject to the provisions of section 7, be deemed to be income accrued to the beneficiary, if the income has been derived for the immediate or future benefit of an ascertained beneficiary who enjoys a vested right to such income. Where these conditions are not met the income is deemed to be the income of the trust.

Furthermore, section 25B (3)⁸ stipulates that, in determining any allowance or deduction attributable to the taxable income of any trust beneficiary, to the extent that trust income has accrued to or is received by such beneficiary, the said deduction or allowance will be deemed to be a deduction or allowance which originally could be made in the determination of the taxable income of such a beneficiary according the Income Tax Act.

Interesting to note is the fact that in South Africa, most beneficiaries from designated groups and previously disadvantaged communities will not legally arrange for their heirs to be entitled to their share of trust income should that income be distributed after the occurrence of an event like death. This is caused partially by the lack of access to information, and partially the existing low levels of literacy. The result therefore is that the beneficiary would cease to have a vested right to such income and the income would then be deemed to be trust income, taxable in the hands of the trust.

Trusts are taxed at the flat rate of 40 percent which would invariably be a rate higher than the tax rates applicable to the majority of the beneficiaries the trust would be representing from designated groups or previously disadvantaged communities.

In 2001 SARS enacted amendments to section 25B of the Income Tax Act the effect of which was that trust income may be still be distributed amongst beneficiaries, but that expenditure may not be distributed in the same way. The application of this section was to a greater extent dependent on the wording of the trust deed.

⁸ It is important to note that section 25(2), which deals with deductions applicable to income derived from deceased estates, refers to the deduction of "expenditure", whereas section 25B(3) refers only to "allowances or deductions".

According to Van Wyk (2003), the trusts affected by this amendment had as beneficiaries persons dependent on income receivable from such a trust and resulted in such beneficiaries paying more tax than was previously the case. This led to various submissions being made to SARS in this regard and eventually the amendments were withdrawn during the latter part of 2001. The original purpose for SARS effecting the amendments to section 25B was probably to avoid a perceived abuse of trusts in the income tax environment. In fairness to SARS, trusts are often used in structured finance and special projects where tax planning plays a major role in the transaction.

In addition, it is probably for this reason that SARS introduced the revised 2001/2002 version of income tax returns, which stipulate, in the corporate tax returns, that taxpayers must disclose in as far as they were involved, participated or advised (or both) in any structured finance deal during the year of assessment applicable for their tax returns.

The nature of trust income in the hands of a beneficiary also warrants discussion. This principle has also been dealt with significantly in case law.⁹ When a trust beneficiary is taxed on trust income, the income retains its nature¹⁰. The trust only acts as a conduit and therefore, if the income receivable by the beneficiary is dividend income or interest income as the case may be, it retains its nature in the hands of the beneficiary.

The taxation of the transfer of assets has already been dealt with in the preceding section. It is, however, relevant to this section to mention that the advantages of the restructuring rules¹¹ are not applicable to trust structures. If, for example, the BEE partners who hold shares in an operating subsidiary of a listed holding company want to exchange their shares for shares in the listed holding company, such transfer may result in CGT. A concession may be granted with the effect that such CGT will be only payable on the ultimate sale of the listed shares by the BEE partners. This corporate restructuring concession is, however, not granted when the shareholder (BEE partner) is a trust.

This, once again, reflects the attitude that SARS has adopted in looking at the formation and subsequent taxation of trust structures. Also important to note, relating to this

⁹ *Armstrong v CIR* 1938 AD 343; *SIR v Rosen* 1971 (1) SA 172 (A)

¹⁰ *Wunsh* in SALJ 1986 at 561: *Business Trusts in South Africa*.

¹¹ See discussion of sections 41-47 in chapter three.

structure, is that there is no knowledge base developed on the subject of business trusts, particularly as they relate to BEE.

In addition, and relevant to the use of business trusts in the South African BEE context, is the formation of trusts with undetermined beneficiaries and/or beneficiaries who are only indicated as a class or group. Many trusts will be formed on this basis to represent a group of employees from designated groups, communities, or undetermined beneficiaries at the time of the formation, as part of a broader BEE transaction. This concept was dealt with in the case of Pretorius v Commissioner for Inland Revenue, 1984(2), SA 619(T), where Judge Le Roux delivered the judgment and concerning this issue said: "I can find no objection in principle with the trusts at the last mentioned provision and beneficiaries designated by a class description are often found in trust law..."¹². This principle is also said to have arisen in the case of Unit Trusts, as regulated by the Unit Trust Control Act of 1947, with an inherent feature that at inception, beneficiaries are often unknown. The income of this type of trusts therefore would be subject to the marginal tax rate of 40 percent and as such adversely affect the income available for beneficiaries when they are determined.

Share-purchase trusts are also a common phenomenon encountered in BEE structures, especially in the employer-employee funding structures. A leading case on share-purchase trusts is the case of CIR v Pick 'n Pay Employee Share Purchase Trust, 54 SATC 271, 1992 (A). This is discussed here in view of the relevance of the principles that it established, and its fairly recent nature. The contention in this case was in relation to the profits generated by the employee share purchase trust on disposal of certain shares.

The trust in question was formed by a group of companies pursuant to provisions of section 38(2)(b) of the Companies Act 61, of 1973, to administer a share purchase scheme for the benefit of employees of the group. The trust contended that that proceeds arising upon disposal by it of shares in question constituted amounts of a capital nature excluded from gross income as defined in section 1 of the Income Tax Act. The trust further contended that it was created and maintained to enable employees to purchase shares in their employer company and that it did not acquire shares with the intention of reselling them at a profit in a scheme of profit making.

¹² (Also see Honore' SA Law of Trusts 2nd edition at 393)

Regarding the continuous dealing in shares by the trust, in giving the judgment, Judge Smalberger stated as follows:

Irrespective of the number of transactions, whether the receipts that flowed from the carrying on of a business were revenue, still depended upon whether the business was conducted with a profit making purpose, i.e. as part of a profit-making venture or scheme. To hold otherwise would be a departure from the earlier authorities. While a profit motive is not essential for the carrying on of a business, its presence or absence is an important factor in determining whether a business is being conducted. Whether the trust was carrying on a business by trading in shares must be determined applying ordinary common sense and business standards. The court holds that on a common sense approach the trust was not carrying on a business by trading in shares for profit.

Further that it was not the intention (purpose) of either the company in founding the Trust or the trustees in conducting the affairs of the trust to carry on business by trading in shares for profit in a profit making scheme. Accordingly the unsold shares held by the trust from time to time did not constitute floating capital. Where no trade is conducted there cannot be floating capital.

The sole purpose of acquiring, holding and selling the shares was to place them in the hands of eligible employees...accordingly any receipts accruing to the Trust from the sale of shares were not intended or worked for but purely fortuitous in the sense of being an incidental by-product. They were therefore non-revenue being accruals of a capital nature falling outside the definition of 'gross income' in section 1 of the Act and therefore not subject to tax.

The most important principles that form the basis of the finding in this case, are the emphasis on intention, the original purpose and the continuous or recurring actions that support this original intention. The importance of the matter is not only the intention at the inception, or as set out in the founding statement in this case, but it is apparent from the case above that for the court to justifiably hold that there was no trading per se, and that the shares were not trading stock and most importantly, that the profits made were "purely fortuitous", the taxpayer must prove that the original non-profit motive was

supported by the recurring actions of the taxpayer in “conducting the affairs” of the trust. This is important for trusts that are formed to hold shares for BEE employee share schemes, for example, to be cognizant of the importance of outlining the original intention of holding such shares and being able to prove that the subsequent transactions engaged in were not divergent from the original purposes of forming the trust.

In as much as the Commissioner does not particularly like these trust structures, their tax efficiency and usefulness in representing the interests of the masses, people from different classes and even beneficiaries unidentifiable at inception is problematical. The effect of section 25B and the supporting case law in respect of the taxation of income in beneficiaries’ hands, which is especially relevant to discretionary trusts and the conduit principles discussed here, are the main reason this discussion is included in this chapter as these can prove to be useful and vital in the advancing of BEE funding structures. As previously asserted, trusts can be used to accommodate the interests of groups of people, employees and so on and, as such, they may have an important role to play in BEE funding structures and transactions.

3.7 The tax implications of small business corporations (“SBCs”)

3.7.1 Definition

Section 12E of the Act defines a small business corporation as:

- a close corporation or private company (not an employment company as defined);
- the entire shareholding of which is at all times during the year of assessment held by shareholders or members that are natural persons;
- the gross income for the year of assessment does not exceed R6 million ;
- none of the shareholders or members at any time during the year of assessment of the company or close corporation holds any shares or has any interest in the equity of any other company as defined in section 1, other than a company contemplated in paragraph (a) of the definition of “listed company”;
- not more than 20 percent of the total of all receipts and accruals (other than those of a capital nature) and all the capital gains of the company or close

corporation consists collectively of investment income and income from the rendering of a personal service; . . .

It is estimated that SBCs contribute to some degree of wealth creation for the entrepreneurs through the ownership of capital assets and to an extent, some form of economic empowerment in terms of independent employment of capital assets and importantly, skills transference. To this end, the development and continued support of small, medium and micro enterprises is a significant contributor to the achievement of the broader economic objectives. Thus, there is a role to be played by both government and the private sector in ensuring that the support given in this regard is adequately rewarded and/or provided with meaningful incentives.

To an extent, the creation and continued support of SBCs contributes to the attainment of the ideals enshrined in the BEE Act and is therefore to be seen as an instrument of broad based black economic empowerment. A growing number of small business owners are black South Africans.

3.7.2 Macroeconomic implications

It is argued that SBCs have resulted in improvements in terms of productivity. This is said to be a function of the owners being motivated by purchasing their own capital assets and operating these for their own account. Furthermore on a medium to long-term basis, the returns on capital investment are enhanced as small business owners acquire the necessary skills base, become familiar with the industry risks and acquire increased capital assets.

In addition, other economic benefits derived from the establishment of sustainable SBCs include enabling employment creation, economic independence and exposure to more business opportunities drawing from both commercial incorporation and improved levels of expertise. These operations should be supported and enhanced for further sustainable growth opportunities.

3.7.3 The general tax treatment of small business corporations

In his annual budget speech in 2005, the Minister of Finance announced comprehensive tax measures aimed at the support of small, medium and micro enterprises. One such measure was the incorporation of certain personal service companies into the category

of small businesses which are eligible for the relief granted by the Act, provided that these businesses maintained at least four employees for core operations.

Additionally, according to the National Treasury's Budget Review (2005: 86), the threshold turnover limit of small businesses eligible for relief was increased from R5 million to R6 million effect from 1 April 2005. Moreover, the qualifying small businesses referred to, were from 1 April 2005 subject to the following graduated tax rate structure:

R0 – R35 000 of taxable income	-	0 percent
R35 001 – R250 000	-	10 percent
R250 001+	-	29 percent

Qualifying small businesses are also eligible for a depreciation write-off at a 50:30:20 percent rate over three years for all depreciable assets, this does not include manufacturing assets which are depreciated at 100%. However, all SBCs pay STC on dividend distributions, regardless of their taxable income.

According to the National Treasury, the tax concessions granted to SBCs in 2005, came at a cost of R1,4 billion to the fiscus. This reflects to a great extent the positive focus that the government has towards encouraging small businesses in South Africa. However, the discussion that follows outlines one of the important areas where significant improvements in the tax implications of SBCs are still lacking. As previously asserted, although the tax relief provided by the taxation treatment of small business corporations is not targeted at only back owned small businesses, these tax concessions also contribute to the attainment of black economic objectives as a significant number of these small businesses are owned by black people.

3.7.4 The tax treatment of personal service companies

In his first maxim of taxation, Adam Smith (1776) as quoted in Black et al (2005: 122) stated:

The subjects of every state ought to contribute towards the support of the government... in proportion to their respective abilities...in proportion to the revenue which they respectively enjoy under the protection of the state.

The above quote states to an important principle of taxation, that of tax equity which is an important characteristic of a "good" tax system. An analysis of a microcosm of the South African economy, personal service companies, indicates that the current tax regime governing the taxation of these schemes is punitive and in breach of the maxim of equity in tax. The intention of this analysis therefore is to outline the effect of these punitive tax provisions on small businesses, on broad-based economic empowerment and on general macro-economic activity and establishing the actual tax implications on these companies.

Currently, there is a significant number of small, medium and micro enterprises (referred to as SMMEs) which are taxed as "personal service companies" as defined in paragraph 1 of the Fourth Schedule to the Income Tax Act. The definition as contained in the Act is as follows:

"Personal service company" means any company (other than a company which is a labour broker), where any service rendered on behalf of such company to a client of such company is rendered personally by any person who is a connected person in relation to such company, and--

- a) such person would be regarded as an employee of such client if such service was rendered by such person directly to such client, other than on behalf of such company; or
- b) such person or such company is subject to the control or supervision of such client as to the manner in which, or hours during which, the duties are performed or are to be performed in rendering such service; or
- c) the amounts paid or payable in respect of such service consist of, or include, earnings of any description which are payable at regular daily, weekly, monthly or other intervals; or
- d) where more than 80 per cent of the income of such company during the year of assessment, from services rendered, consists of or is likely to consist of amounts received directly or indirectly from any one client of such company, or any associated institution as defined in the Seventh Schedule to this Act, in relation to such client,

except where such company throughout the year of assessment, employs more than three full-time employees who are on a full-time basis engaged in the business of such company of rendering any such service, other than any employee

who is a shareholder or member of the company or is a connected person in relation to such person.

It is generally accepted that there is an expected and acceptable tax liability to be borne by all taxpayers, or at least this should be the case. The taxation of some SMMEs, however, is such that the effect of the taxation of these operations as “personal services companies” as defined, is that the entire income generated is subjected to employees’ tax. This results in 35 percent of gross receipts paid to such operations being withheld by the clients for the payment of PAYE, resulting in cash flow constraints for the small businesses.

In addition, there is a limit on the level of deductions allowed for the determination of taxable income. Effectively only salaries paid to employees are allowed as a deduction. According to section 23(k) of the Income Tax Act, a personal services company is not allowed to deduct any other expenses incurred other than the amounts paid or payable to any employee of such company for the purposes of determining the company’s taxable income. The disallowing of the remainder of other bona fide business expenses incurred in the production of income for the type of trade in question, results in cash flow constraints and an unequal tax burden on these small businesses. Further, it is argued that these tax costs have made and could potentially make some of these operations technically insolvent and put them in a loss-making position for prolonged periods of time. It is arguable therefore that there is a strong case that the expenditure incurred in the production of income should be allowed as deductions under the normal general deduction formula as contained in section 11(a) read with section 23 of the Act, or allowed as a specific deduction.

However, it must be borne in mind that the definition of a “personal service company” does not apply if the company employs more than three full-time employees throughout the year of assessment, provided that these full-time employees are not connected persons in relation to the owner of the operation and the number of full time employees requirement excludes the owner/shareholder of the business. In this regard, although BEE is an important policy objective of the government, it is also important to highlight that one of the most significant policy objectives of the government is employment creation. Most small, medium and micro enterprises targeted for incentive and tax policy stimulus and support mechanisms are based on the assertion that SMMEs are engines of economic growth and employment creation. It is accurately attested to by Black et al

(2005) that tax relief measures should be intended and aimed at the promotion of job creation and improvement in cash flow for small businesses.

3.8 Conclusion

This chapter has highlighted both the tax provisions which can be seen as aiding BEE transactions and those which inhibit the process. The chapter specifically looked broadly into the following, in no particular order: taxation of the transfer of assets by companies, the taxation of trust income and how this would involve BEE transactions, the taxation of broad-based share incentive schemes, the tax implications of inter-company loans and the taxation of SBCs.

Importantly, a discussion of the corporate restructuring rules was carried out which highlighted the potential usefulness of the provisions of these sections to the cause of BEE. However, it was indicated that complying with these provisions is not an easy matter. As such, their usefulness may sometimes be jeopardised by an inability of parties to BEE transactions to understand the provisions. Additionally, a discussion of the taxation implications of small business corporations was included. In this regard it was found that although significant improvements have been made by government to improve the way small businesses are taxed, there are still areas of concern. For the purposes of this thesis, the taxation challenges facing 'personal service companies' were highlighted. The nature of the tax obstacles discussed throughout the chapter further illustrate the need to re-legislate and amend those sections of tax legislation and tax practice in order not to only achieve economic growth by means of a less punitive tax regime but to also attain alignment between government policies and the current legislative regime.

The following chapter provides a further illustration of the need to amend tax legislation to be more conducive to BEE realities. The discussion that follows is on the taxation treatment of preference share schemes, with a particular focus on section 8E and section 8F of the Act. The analysis is done in view of the prominence of preference share funding schemes, hybrid debt and equity instruments in the current BEE environment.

Chapter 4: The tax treatment of preference shares, hybrid financial instruments, the general deduction formula and the tax deductibility of interest

4.1 Introduction

Chapter 3 dealt with a number of provisions of the Income Tax Act which are relevant in terms of BEE policies. This chapter discusses the provisions of section 8E of the Act. The analysis covers the importance of the use of preference share funding for both the financiers and the client and the rationale thereof. Although the discussion is not entirely based on BEE transactions, inferences are drawn as to the usefulness of these funding structures to BEE objectives of the government. Further, the amendments of section 8E which took effect on the 26 October 2004 are discussed in order to highlight what the new taxation effects are on the preference share funders, in particular the financial sector which also plays a significant role in funding BEE transactions.

Additionally, the provisions of a new section, section 8F are also discussed. The purpose of this section is to counter tax avoidance measures by ensuring that equity is not disguised as debt. The section is analysed as it has potential tax hurdles for the raising of debt by BEE companies as well, if hybrid debt instruments as defined are used. The chapter concludes with a discussion of the deductibility for tax purposes of interest expenditure incurred on monies raised to acquire shares. The discussion is particularly relevant to the prevalent use of debt funding by BEE participants in order to acquire shares. An analysis is made of how the deductibility of this interest expenditure could potentially hamper wide BEE equity participation.

4.2 The rationale for the use preference share funding

In Huxham et al (2004: 347), there is an accurate discussion of the rationale which underpins the general use of preference share funding. The description is as follows:

The way the scheme worked was that, instead of borrowing money and paying interest on the loan, a company would issue preference shares to the "lender" (that is the bank) and pay dividends on the shares. The investor (lender) would receive the dividend free of normal tax, whereas had it received interest, the interest would have been liable for tax. As the dividend was tax free, the lender was prepared to accept a rate of dividend, which was lower than the rate of interest charged on a loan. The "borrower" would therefore have obtained a



cheaper form of finance. Usually the borrower had an assessed loss and so did not mind paying a dividend on preference shares (not tax-deductible) as opposed to interest on a loan (usually tax deductible).

The foregoing can be further illustrated by way of an example adapted from Zinman (2004). Assume that a bank was prepared to offer a conventional loan to a customer at a rate of ten percent. Taking into account the tax-exempt nature of dividend income, the rate that the bank would require to take up preference shares in that same company would equate to the after-tax rate it would earn on the above conventional loan, that is:

$$10.00 \text{ percent} / (1 + \text{the relevant company tax rate})$$

Assuming that the relevant tax rate is 29.00 percent = 7.5 percent

As quoted in Huxham et al (2005), Corbett JA (1985: 191) stated in Commissioner for Inland Revenue v Standard Bank of South Africa Limited, 47 SATC 179, at 191 [also referenced at 1985 (4) SA 485 (A)]:

From the Bank's point of view, the non-taxability of the dividend holds no particular advantage since the coupon rate is correspondingly lower than the interest rate on a medium-term loan (which interest is taxable) would be. Moreover the security afforded by a preference share issue is inferior to that pertaining to a loan in that in the latter case the Bank has the status of a creditor and in the former is merely a shareholder.

However the reason banks are generally prepared to offer this product to clients; was succinctly put by Corbett JA (1985: 191), as quoted in Huxham et al (2005), when assessing the preference share policy of Standard Bank:

The Bank does participate...in a small number of redeemable preference share transactions at the customer's request. Generally the Bank is prepared to do so in order to accommodate special customers, with whom it has a long banker/customer association which might be prejudiced by a refusal, and also customers of high financial standing where there is a possibility of expanding the Bank's business with that customer.

For the purposes of this thesis and forming an integral and recent addition to the range of strategic transactions for which a financier may want to utilise its preference share capacity is black economic empowerment transactions. The emphasis and importance that the South African Government has placed on local companies selling equity to BEE entities, as shown through various legislative enactments, regulations and specific sector charters, has presented the financial sector especially, with increased funding opportunities.

In addition therefore, Zinman (2004) discusses the need to consider the set of circumstances that are required in order for a bank client to enjoy the maximum benefits of issuing preference shares to the institution as opposed to simply taking out a loan from the bank. He (Zinman: 2004) claims that there are various circumstances where preference share funding is suited to both the issuer and the investor. Two of the more common examples are discussed hereunder.

Firstly, according to Zinman (2004: 40) "Where a company receives only income that is exempt from taxation, e.g. a special purpose vehicle (SPV) or holding company that receives dividends as its only source of income, or where the company is exempt from tax, this provides an ideal opportunity to issue preference shares". Since the income earned by these types of entities is not taxable, any expenditure incurred in the production of that income is also not deductible – including interest expenditure. Therefore, by paying dividends, as opposed to interest, as the cost for its finance, the entity is not 'missing out' on the deductibility of interest, and can take advantage of the lower rate of financing that a bank would offer on preference share funding when compared with conventional loan finance.

BEE companies often fall into the above category. In these transactions, typically, a special purpose vehicle is specifically created to hold the shares in a company that is selling off a portion of its equity to BEE partners. Zinman (2004: 42) explains that:

An SPV has as its sole source of income the dividends that flow to it from the shares it owns (but has not yet paid for). Therefore, this SPV is a prime candidate to be funded through preference shares, as opposed to through a traditional loan. Since the income earned by the SPV is not taxable, any expenditure incurred in the production of that income is also not deductible, including interest on a loan.

As outlined by Mahabane (2005), preference shares have indeed been used to fund investment holding companies in BEE transactions. Mahabane (2005: 9) further argues that:

The structure employed, in general terms, is such that to finance the purchase of those shares, a bank purchases preference shares issued by the SPV. Provided that the dividends paid on the shares in the company to the SPV are greater than the rate at which the SPV is required to pay dividends to the bank, the SPV (and thereby its BEE owners) will come to own and pay for its shares in the company.

Another common situation where the benefits of preference share funding can be fully taken advantage of is:

[w]here a company is in a tax loss or anticipates being in a tax loss position for the foreseeable future. In this instance, as a result of the tax loss, the company is not able to capitalise on the tax deductibility of the interest expenditure that it would be incurring on a traditional loan (Zinman, 2004: 42).

Therefore, Zinman (2004) says it makes sense for the company to issue preference shares and pay non-deductible dividends, as opposed to taking out a bank loan on which it would pay deductible interest. In this way, Zinman (2004) argues, the company obtains a lower rate of funding, while not being prejudiced because of the fact that the dividends it pays out are not tax deductible. The foregoing situation also forms an important reason why section 8E of the Income Tax Act was introduced as an anti-avoidance provision. The provisions of this section are discussed in more depth below.

In many instances, as Mahabane (2005) argues, the cost of the financing for the BEE entity to enable it to purchase shares is critical to the economic viability of many BEE transactions. Therefore, the lower cost of financing that preference shares provides, has made this instrument an often essential element of many BEE deals. Arguably therefore, these structures, are to a significant extent, important instruments of the attainment of the government's BEE objectives. Hence there is a strong argument, as advised by Koltz et al (2004), that in order to accelerate investment, government should introduce financial and tax incentives in empowerment transactions and/or structures, as it is argued that preferential tax provisions will encourage largely white-owned companies to

take the steps necessary to integrate previously disadvantaged individuals into the economy.

Although the writer of this thesis agrees with the above mentioned contention, it must be noted, however, that where the real economic benefits and entitlement to profits accrue to the private sector, it is unjustifiable to lobby that the inherent business risks are inequitably borne by the public sector. Additionally, whereas the need for BEE policy implementation and practice is an undeniable business and government imperative, the processes to be followed should also embrace enhanced business efficiency. This echoes a need for big business, while empowering previously disadvantaged groups to own businesses, to enjoy financial independence and self-determination.

4.3 The impact of section 8E

Scholtz (2005) explains that section 8E of the Act is a provision aimed at the use of redeemable, or potentially redeemable, preference shares. Where the provisions of this section apply, the dividends paid on the particular shares are treated as interest income in the hands of the recipient. However, the same proceeds will continue to be treated as dividends at the level of the company which issued the dividends. Additionally, as Meyerowitz (2004: 13) states, section 8E “was enacted to overcome a situation where a company, usually with a tax loss, issues short term preference shares so that the holder can enjoy the tax exemption on dividends instead of paying tax on interest on a loan to the company.”

A large number of BEE transactions have featured the prevalent use of preference share funding schemes, which particularly aided the BEE participants to obtain significant funding at competitive rates. In this regard, Scholtz (2005) argues that where the dividend income earned by the financier in a preference share funding scheme is caught by the provisions of section 8E, in view of the income to the financier being no longer exempt from tax, the financier’s return is significantly jeopardized and as such there might be a need to increase the borrowing rate on the finance agreement for the BEE participants.

This section (section 8E), has since been materially amended by the Revenue Laws Amendment Act No. 32 of 2004, which amendments came into effect on 26 October 2004 (Jordaan et al: 2005). According to Scholtz (2005), the effect is that now the dividends earned from preference shares might be classified as interest under a wider

range of circumstances. The discussion which follows below is analysis of the provisions of section 8E before and after the October 2004 amendments.

4.3.1 Section 8E prior to the 26 October 2004 amendments

Section 8E applies to 'affected instruments' issued after the 'effective date' – which is 23 March 1989. However, the dividends of certain 'affected instruments' that were issued before the 'effective date' do fall under the ambit of section 8E, to the extent that those dividends are declared after a certain 'earliest date' that falls after the 23 March 1989 (De Koker et al: 2005). The 'earliest date' is the earliest date upon which such an 'affected instrument':

- became or would have become redeemable or repayable;
- could, at the instance of the holder, have been redeemed or repaid; or
- could, at the instance of the holder, have been acquired by any party by reason of the exercise of a right of acquisition (De Koker et al, 2005: 47).

Additionally, Zinman (2004) advises that if an 'affected instrument', that was issued after 23 March 1989, can be converted into any other share, the 'earliest date' will be the earliest date on which it could be converted by the holder and the other share could have been redeemed at the instance of the holder. For the purposes of this thesis, it has been assumed in all discussions below, that the preference shares concerned were issued after the 'effective date.' The principal reason for the introduction of section 8E is to deem a dividend declared by a company, that qualifies as an 'affected instrument' as defined in section 8E, to be interest received from a source within South Africa in the hands of the recipient of that interest income.

The old section 8E(1) of the Act defines an 'affected instrument' as follows:

- (a) Any redeemable preference share where –
 - (i) The company is obliged to redeem the share in whole or in part within a period of three years from the date of issue; or
 - (ii) The holder has an option to require the company to redeem the share in whole or in part within a period of three years from the date of issue; or
 - (iii) The holder has a right of acquisition which may be exercised within three years from the date of the issue;

- (b) Any other share, where the holder has a 'right of acquisition' in respect of such share which may be exercised within a period of three years from the date of issue of such share, and –
 - (i) Such share does not rank *pari passu* as regards its participation in dividends with all other ordinary shares in the capital of the company; or where the ordinary shares are divided into two or more classes, with the shares of at least one of such classes; or
 - (ii) Any dividend payable on such share is to be calculated by reference to any specified rate of interest; or
 - The amount of capital subscribed for such share; or
 - The amount of any loan or advance made directly or indirectly by the shareholder or any connected person in relation to the shareholder.

The definition of 'right of acquisition' is therefore important to determine whether a particular preference share qualifies as an 'affected instrument'. It, in effect, means a right that a holder of the preference shares has to force another party to buy those shares (Huxham et al: 2003). It is defined in section 8E as follows:

A right which the holder of an affected instrument has to require any party —

- (a) To acquire such affected instrument from such holder; or
- (b) To procure, facilitate or assist with the redemption in whole or in part of such affected instrument or the repayment in whole or in part of the capital subscribed for such affected instrument or the conversion of such affected instrument into any other share which is redeemable in whole or in part within a period of three years from the date of issue thereof.

Furthermore, according to section 8E(2), dividends paid on 'affected instruments' are deemed to be interest received by the recipient (the bank) alone. "This deeming applies only to the recipient and not also to the company declaring the dividend, i.e. as far as the company is concerned it remains a dividend declared by it." (Meyerowitz, 2004: 36). Thus, while the financier would be taxed on the preference dividends that it receives (to the extent that those preference shares are deemed 'affected instruments'), the issuing company is still regarded to having paid dividends and not interest. Therefore, the company is not able to claim those dividend payments as a deduction (since dividend payments are not tax deductible), as it would have been able to do had it paid out interest expenditure, and will still be liable to pay STC on those dividends. It is therefore

clear why section 8E is regarded as a particularly punitive section – in the above scenario, where section 8E applies, the worst possible tax dispensation is created.

4.3.2 Section 8E after the 26 October 2004 amendments

The provisions of section 8E have been amended by the Revenue Laws Amendment Act No. 32 of 2004, which came into effect on 26 October 2004. The definition of the term 'affected instrument' has been deleted and replaced with 'hybrid equity instrument.' Subsequently, the definition of 'hybrid equity instrument' has been enacted and is defined in section 8E(1) of the Act as:

- (a) any redeemable preference share which the relevant company is obliged to redeem in whole or in part within a period of three years from the date of issue thereof, or which may at the option of the holder be redeemed in whole or in part within the said period, or in respect of which the holder has a right of disposal which may be exercised within the said period; or
- (b) any other share if –
 - (i) the holder has a right of disposal in respect of such share which may be exercised within a period of three years from the date of issue thereof or at the time of issue of that share, the existence of the company issuing that share is to be terminated within a period of three years or is likely to be terminated within such period upon a reasonable consideration of all the facts at the time that share is issued; and
 - (ii) such share does not rank *pari passu* as regards its participation in dividends with all other ordinary shares in the capital of the relevant company or, where the ordinary shares in such company are divided into two or more classes, with the shares of at least one of such classes, or any dividend payable on such share is to be calculated directly or indirectly with reference to –
 - (aa) any specified rate of interest; or
 - (bb) the amount of capital subscribed for such share; or
 - (cc) the amount of any loan or advance made directly or indirectly by the shareholder or by any connected person in relation to the shareholder.

According to Clegg (2005), with regard to paragraph (a) above, it should be noted that the provisions of section 8E will not apply to any redeemable preference share where the company is obliged to redeem such share only after three years from date of issue or

is entitled to redeem them within three years. The section will also not be applicable in circumstances where the holder has an option to request redemption of such share after three years or if he has a 'right of acquisition' that may be exercised after three years only.

Under the 'old' section 8E, Meyerowitz's stance (2004) was that section 8E is triggered only if the right to call for redemption within three years is unconditional, and is conferred on the date of issue of those shares. The new, expanded definition of 'date of issue', includes any date after the original date of issue of the instrument, when the holder of the instrument (that is the bank or financial institution) acquires an unconditional 'right of disposal' in respect of that instrument – including the right to force any third party or the issuer of that share to redeem the instrument. The definition of 'date of issue' has been added to the section and is defined in relation to a share in a company as follows:

- the date on which it was issued by that company;
- the date on which its holder at any time after it is issued acquires a right of disposal, otherwise than as a result of its acquisition by him;
- the date on which the company at any time after it is issued undertakes the obligation to redeem it in whole or in part; and
- the date on which its holder at any time after it is issued obtains the right to require it to be redeemed in whole or in part, otherwise than as a result of its acquisition by him.

In the way described above, Meyerowitz's (2004) contention that section 8E is only applicable if the right to call for redemption or to put the instrument to a third party is conferred on the original date of issue is no longer a valid one. With the amendments to section 8E, if the date or right of redemption or ability to put the preference share is changed at any time after the date when the instrument was originally issued (whether it is reduced or extended), this new date will constitute a new 'date of issue'. Likewise, if a put option is granted in circumstances where it previously did not exist, the put option would create a new 'date of issue' for the preference share, even if the original date of redemption remains unchanged.

In addition, the added definition of the 'date of issue' signifies additional situations of disguised debt. According to Mitchell et al (2005), importance is placed on the redemption features added after the initial date of issue of the share. This could be illustrated by way of an example, Assume that a BEE company originally issued a non-

redeemable preference share, and subsequent to the original date of issue, alters the terms of the share to make it redeemable within three years. In this case, section 8E would apply on or immediately after the alteration.

The Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004 provides that the three-year period referred to in section 8E is determined from the date:

- of issue of the share;
- subsequent to its issue, when the company undertakes to wholly or partially redeem it at a future date; and
- subsequent to its issue, when the holder obtains the right to require it to be redeemed in whole or in part.

Moreover, the definition of a 'right of acquisition' has been deleted and replaced by the definition of a 'right of disposal'. In terms of paragraph (a) of the definition of a 'right of disposal', this means a right that the holder of a hybrid equity instrument has to require any party to acquire it from him. Additionally, in terms of paragraph (b) of the definition of a 'right of disposal', this means a right to procure, facilitate or assist with the redemption in whole or in part of it, or the repayment in whole or in part of the capital subscribed for it, or the conversion of it into any other share in whole or in part within a period of three years from the date of issue as defined. This 'right of disposal' is in many ways similar in substance to the previously used 'right of acquisition'. It is interesting to note, however, that the definition of 'right of disposal' distinguishes between a scenario where the holder has a right to put the preference share to a third party, and where the holder has a right to require a third party to assist in the redemption of that instrument. Importantly, the concept refers to the right as such, and not when the right is ultimately exercised. In other words, it is the moment when the right accrues that is critical, not when that right is actually exercised.

Scholtz (2005) correctly notes that although section 8E (as amended) was not intended to inhibit BEE transactions, it will, however, have an inhibitory effect. The reason is that "Any measure which (like section 8E) constrains the obtaining of finance or finance at competitive rates, will inhibit BEE transactions" (Scholtz, 2005: 2).

4.4 The introduction of section 8F

According to the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004, "...the provisions of section 8F came into operation on 26 October 2004 and apply

to any instrument issued or transferred to an issuer during any year of assessment commencing on or after that date”.

In broad terms, section 8F is aimed at countering the prevalent disguising of equity instruments as debt, where the substance of the underlying agreement affords the parties to the ‘hybrid debt’ scheme the right to enjoy the tax benefit afforded by debt obligations, whilst they reserve in effect the right to alter the agreement into equity within a three year period. Mitchell et al (2005) argue that the effect of section 8F is the limitation of the deductions of interest incurred by persons other than natural persons for hybrid debt instruments that are debt in legal form, but have sufficient equity features that they can be placed at the equity-end of the debt equity-scale. In an attempt to match the provisions of section 8E, section 8F will apply to those instruments which are exchangeable into equity shares in a period of three years.

Section 8F provides that the three-year period is determined from either:

- the date on which the instrument is issued; or
- the date on which it becomes convertible into, or exchangeable for, a share if these rights are created subsequent to the actual date of issue.

The following definitions in section 8F are adapted from the comments contained in the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004.

‘date of issue’ in relation to an instrument means—

- (a) the date on which it is issued; and
- (c) the date on which that instrument becomes convertible into or exchangeable for a share at any time in the future.

‘hybrid debt instrument’ means an instrument, where

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

instrument by the issue of shares by the issuer or any connected person in relation to the issuer to the holder of the instrument;

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

In terms of section 8F(2), no deduction is allowed for any amount paid or payable by an issuer in terms of a hybrid debt instrument, that is paid or becomes payable after it becomes a hybrid debt instruments as defined. Therefore, where the provisions of section 8F apply the interest incurred in terms of the hybrid debt instrument will be disallowed as a deduction for the determination of taxable income, whilst the amounts received in terms of the instrument will be taxed as interest income in the normal way.

By way of an example adapted for the purposes of this research from Mitchell et al (2005), section 8F would cover a situation where, for instance, a BEE company issues interest-bearing debentures to Financier A. Each debenture is convertible into BEE Co's shares at the option of the holder within a three year period from the date of issue. There is a substantial appreciation in the value of the shares in BEE Co's shares by the time the debentures are exchanged by Financier A. The appreciation is estimated to be 20 percent. In terms of section 8F(2), where the necessary provisions of section 8F are satisfied, the interest expenditure incurred by BEE Co on this particular instrument is not deductible after it becomes a hybrid debt instrument.

In addition, to confirm the inherent nature of these transactions, section 64C(2)(h) has been amended. This section now provides that for the purposes of section 64B, an amount is, subject to the provisions of section 64C(4), deemed to be a dividend declared by a company when that amount is incurred by the company in question in terms of any

interest to which the provisions of section 8F apply. The effect of this amendment is that for the BEE company in the example above, the interest incurred in terms of a hybrid debt instrument is deemed to be a dividend declared for the purposes of determining secondary tax on companies ("STC") liability. The BEE company therefore would not only be out of pocket from the disallowed interest expenditure deduction, but could also be saddled with additional tax liabilities in terms of STC.

4.5 The general deduction formula

Section 11(a) read with section 23 of the Act, contains the general deduction formula. Clegg (2005) advises that the relationship between these two sections was clearly set out in the case of Oosthuizen v Standard Credit Corporation limited, 1993 (3) SA 891 (A), 55 SATC 338, that:

Section 11(a) provides positively and in general terms what expenditure and losses shall be allowed as deductions from income so derived in order to determine his taxable income. Section 23 prescribes what deductions may not be made in the determination of taxable income. It is generally appropriate to consider whether or not a deduction is permitted by section 11(a) and whether or not it is prohibited under section 23.

Section 11(a) provides for the deduction from income derived from the carrying on of trade, expenditure and losses actually incurred in the production of the income, provided that such expenditure and losses are not of a capital nature. There is a fair amount of literature about the contents of the general deduction formula. Huxham et al (2004) summarises the contents of the general deduction formula as follows:

- Section 11(a) requirements:
 - expenditure and losses;
 - actually incurred;
 - during the year of assessment;
 - in the production of income; and
 - not of a capital nature.

In addition to the above requirements, section 23(g) provides that the deduction of "...any moneys claimed as a deduction from income derived from trade to the extent to which such moneys were not laid out or expended for the purposes of trade..." are

prohibited as deductions. In order to outline an adequate context of the provisions of the general deduction formula, the requirements of section 11(a) are adapted mainly from Huxham (2004) and discussed briefly and in broad terms separately below.

4.5.1 Expenditure and losses

Although there is case law alluding to a difference which may exist between losses and expenditure, it is not clear whether in reality this distinction exists. Nonetheless the Act refers to both expenditure and losses. The case referred to for this distinction is as quoted in Huxham et al (2004: 64), the English case of Allen v Farquharson Brothers and Co, where the distinction between losses and expenditure was considered as follows:

Expenditure means something or other which the trader pays out; I think some sort of volition is indicated. He chooses to pay out some disbursement; it is an expense; it is something which comes out of his pocket. A loss is something different. That is not a thing which he expends or disburses. That is a thing, so to speak, comes upon him *ab extra*.

As previously asserted, the writer of this thesis concedes that this distinction does not appear to be a major consideration for the allowance of deductions in both tax legislation and practice. It is sufficient to incur an amount which is either a loss and/or expenditure.

4.5.2 Actually incurred

Huxham et al (2004) argue that it is not necessary for the amount incurred to have been incurred prudently or not. The requirement to pass the 'actually incurred' test is merely that the amount was incurred, that is, the money is owed. Moreover, as outlined in Huxham et al (2004: 64), in the case of Caltex Oil (SA) Ltd v SIR, 1975 AD, Botha JA stated:

The expression "expenditure actually incurred" in section 11(a)...means all expenditure for which the liability has been incurred during the year whether the liability has been discharged during that year or not.

The principle that is shown by the above statement is that, notwithstanding that the responsibility to pay the amount incurred does not have to be carried out within the

particular current year of assessment, the obligation or the incurrance of the amount must nevertheless be unconditional in the particular year of assessment.

4.5.3 During the year of assessment

Huxham et al (2004: 65) admits that "this particular requirement is not specifically mentioned in section 11(a), but the courts have held that the expenditure which the taxpayer claims as a deduction, must be incurred during the year in which it is claimed". Also quoted in Huxham et al (2004: 65), is the case of Sub Nigel Ltd v CIR, 1948 AD, where it was held as follows:

For the whole scheme of the Act shows that, as the taxpayer is assessed for income tax for a period of one year, no expenditure incurred in a year previous to the particular tax year can be deducted.

To rank for deduction in a particular year therefore, the expenditure and/or losses in question must have been incurred in the year during which the claim for deduction is lodged.

4.5.4 In the production of income

This is arguably the most important requirement of section 11(a) in terms of the general deduction formula. Clegg (2005) advises that if expenditure is incurred in the production of income which is exempt from tax, or it is not incurred in the production of income, it will not rank for deduction. Furthermore, Clegg (2005: 7) also states that "...expenditure incurred for the purpose of earning income is incurred in the production of income, irrespective of whether any income is actually produced..." Quoted in Clegg (2005) is the leading case of Port Elizabeth Electric Tramway Co Ltd v CIR, 1936 CPD 241, 8 SATC 13. The issue at hand was discussed therein as follows:

The purpose of the Act entailing expenditure must be looked to. If it is performed for the purpose of earning income, then the expenditure attendant upon it is deductible. . . The other question is what attendant expenses can be deducted. How closely must they be linked to the business operation. Here, in my opinion, all expenses attached to the performance of a business operation *bona fide* performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or

attached to it by chance or are *bona fide* incurred for the more efficient performance of such operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it.

Concerning the above mentioned case, Huxham et al (2004), comment that what is important for consideration is for the expenditure in question to be "an inevitable concomitant" of the business operations which actually produce income. There must be a close link between the expenditure incurred and the actual 'machinery' (used advisedly) that produces income.

4.5.5 Not of a capital nature

This requirement is considered in tandem with the principles enshrined in the definition of gross income, as contained in section 1 of the Act. Huxham et al (2004: 68) agrees in stating that "...just as capital receipts and accruals do not fall into gross income, capital expenses are not allowed as a deduction from income in terms of section 11(a)". It is important to note however, that there is provision in specific sections of the Act, for the deduction of specific capital expenditure items.

In view of the fact that the Act does not specify which expenditure is capital and which revenue is, Clegg (2005: 10) quotes Watermeyer CJ, when he stated:

The conclusion to be drawn from all these cases seems to be that the true nature of each transaction must be enquired into in order to determine whether the expenditure attached to it is capital or revenue expenditure. Its true nature is a matter of fact and the purpose of the expenditure is the important factor; if it is incurred for the purpose of acquiring a capital asset for the business it is capital expenditure even if it is paid in annual instalments; if on the other hand it is in truth no more than part of the cost incidental to the performance of the income producing operations, as distinguished from the equipment of the income producing machine then it is a revenue expenditure even if it is paid in a lump sum.

Generally, it would appear the above statements allude to the fact that expenditure incurred in the acquisition capital or other tangible assets would have an inherent capital nature and therefore not rank for deduction as envisaged in the general deduction formula.

4.6 Tax deductibility of interest on amounts incurred to acquire shares

For the purposes of this thesis however, the focus is on the tax deductibility of interest incurred on loans raised to acquire shares. This is particularly relevant to the issue of black economic empowerment transactions, where it is often the case that a BEE company would need to raise borrowed funds to acquire a significant shareholding in an enterprise, especially in the context of certain industry charters. According to section 23(f), interest incurred on a loan raised to acquire shares in order to earn tax-free dividend income (dividends are generally tax exempt in terms of section 10(1)(k)), is not deductible. However, Clegg (2005) states that as provided by section 10(1)(k), generally interest arising on funds borrowed to purchase shares will be deductible only if the taxpayer is a sharedealer, since the interest is not necessarily incurred in order to produce dividends which do not constitute income in the hands of the taxpayer.

Clegg (2005) further advises, that in the case of CIR v Shapiro 1928 NPD 436, 4 SATC 29, a taxpayer borrowed money in order to purchase shares in a company from which he derived a salary and commission. He claimed that the interest should be allowable as a deduction against his salary. The court held that the salary and commission were produced not by the shareholding, but by the exercise of his duties, and hence the interest was disallowed. The issue then, the writer of this thesis assumes, was that the taxpayer could not prove to the court that the purchase of the shares was sufficiently closely linked to the generation of the income in question (apart from the tax free dividend income derived).

It can, however, be argued that although the purchase of shares by BEE companies affords them the opportunity to derive tax exempt dividend income, the essential context of these transactions is that of economic emancipation and empowerment. The substance of these transactions is therefore inherently different from the normal share purchase transactions in the commercial sense. Clegg (2005) outlines that in ITC 1553 (1992), 55 SATC 105, the taxpayer sought to deduct interest paid on loans from its subsidiary, which were raised to repay existing loans to its directors. The loans from the directors were originally used to acquire shares in the subsidiary. The court held that the deductibility of the interest in respect of the new loans must be determined by reference to the purpose for which the old loans were raised, which was to acquire the shares and to earn management fees from the subsidiary. The court found that there was no direct link between the expenditure incurred and the income derived by the taxpayer.

In the case of BEE transactions, there is arguably a direct link between the incurrence of interest expenditure on loans raised to acquire shares and the future income (apart from tax free dividend income) earned by the BEE companies in terms of future business growth and establishment, broad based economic empowerment and so on. A significant number of these BEE share purchase transactions feature the postponement of dividend earnings for significantly long periods of time. This is done in order to prioritise the repayment of the debt raised to purchase the shares. There is therefore a mis-match between the time periods within which the Commissioner for the SARS derives revenues from the taxable interest income on the financiers' or supply side, and the time the BEE participants derive the commensurate dividend income on the demand side. This sacrifice, which is a general characteristic of these deals, should at the very least be rewarded by the deduction from income of the interest expenditure incurred on the underlying loan agreements. The potentially adverse result is the situation where the BEE participants are out of pocket because of tax (that is, when no dividend income is yet derived), at times where high and significant debt service obligations are present. This defeats the spirit of empowerment and counters the attainment of the objectives of the BEE Act.

In addition, Huxham et al (2004) discusses the case of CIR v Allied Building Society, 1963 AD, where the court held that the ultimate use or destination of money lent was not to be the decisive factor in determining the deductibility of interest payable on that money. The enquiry to be made is "...what was the true nature of the transaction?" It is important to stress again, that although the form of the share purchase transactions by BEE participants appears to be that of a normal commercial transaction, it cannot be argued that the essence of these transactions is casual investment in shares for the mere purpose of earning of dividend income.

The non-deductibility of interest on money borrowed to buy shares brings in turn an increase in the effective cost borne by the borrower, in this case the BEE participants. Scholtz (2005: 2) rightfully notes that "It is the refusal of the tax system to allow interest deductions on funds borrowed to buy shares which must be the most fundamental brake upon wide equity participation by black people". Furthermore, Scholtz (2005) advises that the Australian tax system treats dividends as 'assessable but rebatable', the rebate granted sometimes more than offsets the tax liability which arises from the entitlement to derive dividend income. Consequentially, the interest incurred on money borrowed to purchase shares is deductible. This approach, Scholz (2005) argues, has made a

significant contribution to the Australian government's goal of making Australia a 'nation of shareholders'.

4.7 Conclusion

This chapter has dealt with certain provisions in the Income Tax Act which may inhibit BEE empowerment structures. This chapter has provided an analysis of the provisions of section 8E both prior to and after the recent amendments to the section introduced by the Revenue Laws Amendment Act, 32 of 2004. On one hand, this chapter analysed the rationale and benefits of the use of preference share funding by banks. This was done through a brief discussion of the case law which exists on the use of similar funding structures by the banks. On the other hand, the thesis also considered the usefulness of preference share funding for the promotion of BEE objectives. In this regard, although the provisions of section 8E have historically been viewed as punitive, the recent amendments to the section further exacerbate these views. The concern is that these provisions, albeit new, may have the ultimate consequence of increasing the costs of preference share funding for the financing sector and ultimately discourage the use of preference share structures that fund BEE as well. The provisions of a new section, section 8F have also been discussed. It was highlighted that this section has the potential to further increase the tax costs of BEE transactions, where 'hybrid debt instruments' are used.

In a certain sense, section 8E may be less restrictive than it appears, as making provision for a redemption period exceeding three years in the original conditions of issue would not present an insurmountable hurdle, but may pose a considerable inconvenience. Section 8F would close certain avenues in BEE transactions, where a BEE company, which finds it difficult to meet its interest commitments, may wish to convert the debt instruments into equity instruments.

Finally, a discussion of the general deduction formula was included. The purpose was to set out the context within which expenditures incurred in the production of income are allowed as deductions in terms of sections 11(a) and section 23 of the Act. Following through from this discussion, was the pertinent discussion of the provisions of section 23(f) which prohibit the deduction of interest expenditure incurred on amounts raised to acquire shares. It is considered that this discussion is particularly relevant to BEE, as most funding used in share purchase transactions is debt funding. BEE transactions are therefore not only saddled with increased tax costs, they are also potentially out of

pocket as a result of the refusal by the South African tax system to allow the deductions from income, of expenditure incurred in the process of acquiring shares.

The unfortunate result of the provisions in the Income Tax Act that have been discussed in this chapter is that transactions structured in a way that makes good commercial sense may have to be re-structured simply to circumvent the tax obstacles.

The next chapter illustrates additional tax hurdles which BEE participants may face, using a BEE structured company case study in the financial sector.

Chapter 5: Case study: A BEE deal in the financial sector

5.1 Introduction

Chapters three and four discussed various provisions in the Income Tax Act which have a potential impact on BEE transactions or structures. In order to highlight the significant tax hurdles inherent in entering into a BEE transaction, this chapter firstly analyses an actual funding structure and outlines the likely tax costs all the parties may be faced with, taking into account the current legislative framework. The analysis of the taxation consequences of these transactions are limited to the following areas:

- the taxation consequences should “Sub Co” and “BEE Co” be considered to be connected persons for taxation purposes;
- whether the Commissioner could successfully attack the purchase price allocation for the sale of the ordinary shares to “BEE Co” otherwise than through the connected person rules;
- whether the share buy-back of the ordinary shares owned by “Hold Co” will be considered a dividend, a capital gain or both;
- whether “Sub Co” would be liable for additional STC if it on-declared dividends received from “Private Co” to Financier 1, to service the preference share dividends; and
- the likely effect of section 8E on dividend income received from preference shares held.

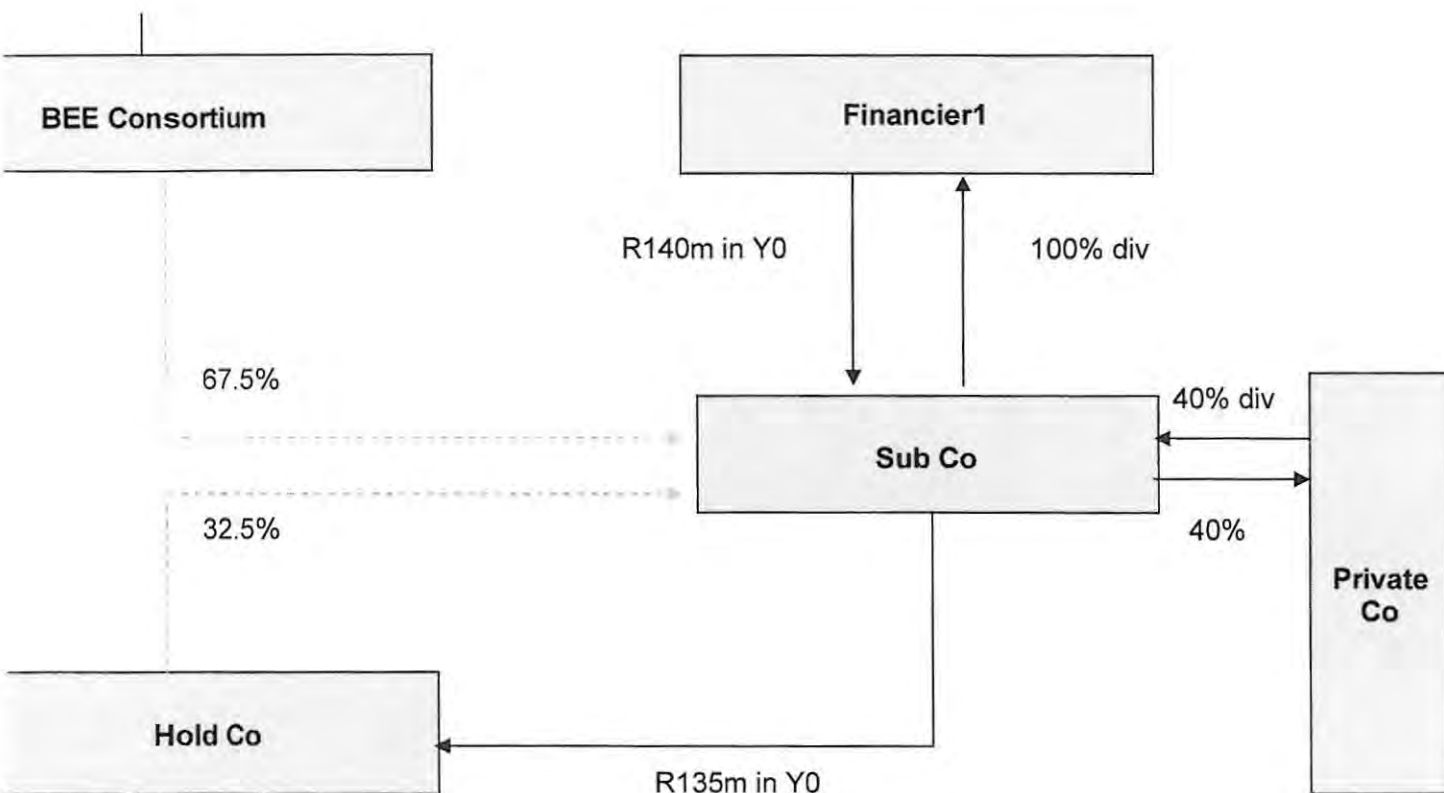


Figure 1¹³

5.2 Outline of the funding mechanism¹⁴

A 100 percent BEE owned consortium entity “BEE Consortium” wishes to acquire shares in “Sub Co” from “Hold Co”. The proposed funding mechanism that would enable BEE Consortium to acquire the shares is as follows:

A merchant bank “Financier 1” will subscribe for R140m preference shares in “Sub Co”. The preference shares will be redeemable after five years and will yield a fixed dividend for the period.

¹³ These details were divulged at an interview between the writer of this thesis and L. Mangquku – Director Investments: Bancar Investments (Pty) Ltd. The names of the parties to the deal are replaced by the artificial names in inverted commas above given by the writer of this thesis in order to maintain confidentiality.

¹⁴ *ibid*

Sub Co will utilize R135m of the preference share capital raised to carry out a share buy back of a portion of the ordinary shares in Sub Co from Hold Co in terms of section 85 of the Companies Act No. 61 of 1973 ("the Companies Act"). The additional R5m will be used to settle the transaction costs.

After the share buyback has been completed, Sub Co will sell 67,5 percent of the shares in Sub Co to BEE Co for R100 000. In addition, BEE Co and Hold Co will enter into a put/call arrangement covering the remaining 32,5 percent of Sub Co shares held by Hold Co. In terms of this arrangement, Hold Co will be entitled to put the remaining shares to BEE Co at any time after year three for R65m ("the put option") and BEE Co will be entitled to buy the shares from Hold Co for R65m ("the call option"). This exercise is dependent upon BEE Co being able to raise the finance needed to acquire the 32,5 percent on the strength of its investment in Sub Co.

The exercise of the options will also be dependent upon BEE Co not defaulting on its banking covenants by entering into the share purchase agreement for the 32,5 percent remaining shareholding held by Hold Co.

Sub Co will cede 100 percent of its income (only dividends from Private Co) to Financier 1. These dividends will be paid into a sinking fund and will be used to service the preference share dividends and any excess will be kept for the early redemption of the preference shares at any time after the expiry of three years.

For the purposes of this research, it has been assumed that the sale by Hold Co of its shares in Sub Co will be treated on capital account so that Hold Co will be liable for CGT as opposed to income tax as a result of this disposal.

When asked to give a detailed breakdown of the areas of concern in terms of the taxation implications of the BEE deal above, which was structured by his company, the following is adapted from the responses that Mangquku (2005) gave at the interview:

5.3 Connected persons provisions

Quoted from the Income Tax Act, the definitions of "connected person" in relation to a trust and a company as set out in section 1, are relevant in this instance.

5.3.1 A Company

A connected person in relation to a company is defined in paragraph (d)(i) to (vA) of the definition of a “connected person” as:

- its holding company as defined in section 1 of the Companies Act;
- its subsidiary as so defined;
- any other company where both such companies are subsidiaries as defined of the same holding company;
- any person, other than a company as defined in section 1 of the Companies Act, who individually or jointly with any connected person holds directly or indirectly more than 20 percent of the equity share capital or voting rights of such company;
- any other company if at least 20 percent of the equity share capital is held by the other company and no shareholder holds the majority of the voting rights of such company;
- any other company if such company is managed or controlled by
 - any person who or which is a connected person in relation to such company; or
 - any person who or which is a connected person in relation to the connected person contemplated above.

It is also important to note that the connected person rules effectively provide that, if A is a connected person in relation to B, then B is also a connected person in relation to A. Mangquku (2005). [Also refer to paragraph (e) of the definition of “connected person”.]

In terms of paragraph 38 of the Eighth Schedule of the Act, if an asset is disposed of to a connected person for a consideration which does not reflect an “arms length price”, then the purchase price will be set at the market value of the asset for tax purposes. Although the Commissioner would generally not be able to adjust the agreed purchase price between parties for the sale of goods for tax purposes, the Commissioner can do this if the parties are connected persons as defined by the Income Tax Act.

According to Figure 1 above, Sub Co owns a 40 percent stake in Private Co. “A valuation by both BEE Co and Financier 1 revealed that this is worth between R190m

and R260m. Sub Co has an option to acquire an additional 14 percent in Private Co for R60m. Sub Co currently has no other material assets or liabilities” Mangquku (2005).

According to the writer of this thesis, it would accordingly seem that the market value of the ordinary shares in Sub Co is R200m, and that the deal reflected in Figure 1 above has been negotiated on this basis.

As can be seen in Figure 1 above, it is proposed that Financier 1 will subscribe for preference shares in Sub Co to the value of R140m. Using a value of R200m for the 40 percent interest in Private Co, the implied market value of the ordinary shares held by Sub Co will be R60m after taking into account the R140m liability of the preference shares issued to Financier 1.

Mangquku (2005) further advised that:

It could be argued that the market value of the 100 percent ordinary shares owned by Hold Co in Sub Co is R60m after the share buy-back, the payment of expenses and the preference share issue. Therefore 67,5 percent sold to BEE Co may have a market value of R40m and that any consideration less than this may result in a CGT liability as such consideration will not be seen as an arm's length price for the 67,5 percent. This could mean that where Sub Co only receives R100 000 for the sale of 67,5 percent ordinary shares, Sub Co will be liable for CGT on R40m upfront if the agreed price is significantly less for the 67,5 percent sale of shares.

Similarly, if BEE Co were to acquire the remaining 32,5 percent of the shareholding in Sub Co for R65m (assuming that Hold Co will exercise the option), and this consideration does not reflect an arm's length price for the remaining 32,5 percent at the time of the transaction, the Commissioner would again be entitled to deem the transaction to have taken place at the market value of that 32,5 percent at the time of the disposal (in this case year 3).

It is therefore quite likely that the Commissioner would attempt to apply paragraph 38 of the Eighth Schedule to increase Sub Co's proceeds from the sale of shares, which would have the effect of increasing BEE Co's cost. It would be up to the parties concerned, according to section 82 of the Act to prove to the Commissioner that the consideration paid for the 67,5 percent sale of shares was indeed an “arm's length price”.

These tax hurdles could be removed if the Income Tax Act could be amended to accommodate the price-setting measures which are necessary to enable BEE parties to purchase such steep levels of ownership inherently out of their reach in terms of funding.

5.3.2 Value shifting

Mangquku (2005) also argued that:

Transactions between connected persons could also in principle be affected by the rules dealing with value shifting arrangements in Schedule Eight to the Income Tax Act, in instances where there is a reorganization of a company's share capital. However, if the change in interest in a company is as a result of a transaction at market value (before the application of paragraph 38 of the Eighth Schedule) then it is not necessary to consider the application of the value-shifting arrangement rules.

However, should the transaction not be at market value, then, in terms of paragraph 35A of the Eighth Schedule, Sub Co will effectively be treated as having disposed of the 67,5 percent shareholding for proceeds equal to the market value of the stake immediately after the transaction, as opposed to the market value prior to the transaction.

It is important therefore for BEE parties to investigate the applicability of the connected person rules and see whether it could be possible to arrange the relationships between the parties so that the potential risk is mitigated.

5.4 Tax treatment of the share buy-back

Additionally, Mangquku (2005) outlined that section 85 of the Companies Act, 61 of 1973, allows subsidiaries to purchase their own shares, up to ten percent from their holding companies.

"Sub Co will purchase its own shares from Hold Co and this will constitute a payment from share premium, which arose on the preference share subscription by Financier 1 in Sub Co" Mangquku (2005). A payment from share premium arising from a fresh share

issue is not considered to be a dividend for taxation purposes and, as a result, Sub Co should not be liable for STC on this payment to its shareholder.

Similarly, Hold Co should treat this payment as proceeds from the disposal of the shares in question and not as a dividend received. However, Hold Co will then not be able to rely on the tax exemption relating to dividends received in terms of section 10(1)(k)(i), but will be liable for CGT, and would not be entitled to deduct the amount received from dividends it declares, for the purposes of calculating the STC on the dividends it declares.

5.5 Possible effect of section 8E

The writer of this thesis argues that if the dividends paid to Financier 1 in terms of the preference share subscription, are caught under section 8E, the end result might be that the dividend income will be treated as interest income for tax purposes. The adverse impact on the BEE parties is this possibility. Financier 1 might be obliged to seek a higher rate of return than that under the preference share scheme, on all the loans that formed part of the facilitation of the overall share purchase transaction. However, it is worth noting, that section 8E is unlikely to have adverse effects on long-term financing arrangements, as this section is meant to affect predominantly the situation where a financier redeems preference shares or disposes them of within the three year period as defined.

5.6 Conclusion

This chapter has considered the adverse taxation effects for BEE transactions, resulting from the 'connected persons' provisions of the Income Tax Act. It was found that where the Commissioner is satisfied that an asset is disposed of to a connected person for a consideration which does not reflect an 'arm's length price', according to paragraph 38 of the Eighth Schedule, the Commissioner can set the price or consideration at the market value of the asset in question for tax purposes. This would increase the cost of the assets being sold and possibly increase the tax liability arising from the transaction in question.

The chapter also discussed the likely effects of value-shifting arrangements in Schedule Eight to the Income Tax Act, which according to paragraph 35A could also increase the price or proceeds to the market-value equivalent for tax purposes. These rules are

however not applicable if the change in the interest in a company is as a result of a transaction which took place at the applicable market values. Lastly, the chapter provided a brief analysis of the tax treatment of share buy-backs, and it was concluded that in a share buy-back, a payment from share premium arising from a fresh share issue would not be considered to be a dividend and therefore no STC liability would arise. The corollary is that the recipient would not treat the proceeds as a dividend received, and would therefore receive them on capital account and would not be entitled to deduct the amount for STC purposes.

It is considered that, although other legal considerations are essential for most successful commercial transactions, tax exposures are increasingly becoming the most expensive and prominent considerations of BEE transactions and businesses. It is also important to understand that although tax is a consideration in major BEE transactions, the provisions of the Act which are seen as inhibitive to the process were not introduced to restrict the flourishing of BEE transactions; these are genuine anti-avoidance provisions introduced to counter the excessive use of financing schemes which may eventually have an erosive effect on the tax base and revenue of the country. The challenge that this poses therefore, is obtaining the necessary alignment in tax legislation between adequate allowances necessary to encourage BEE transactions and anti-avoidance provisions, which aim to prevent the erosion of the tax base.

Chapter 6: Summary of findings and recommendations

6.1 Introduction

This thesis has considered the importance of the relationship between tax legislation, tax practice and black economic empowerment (BEE). This was done by means of a literature review, conducted in order to outline the context of BEE in South Africa. Additionally, the literature review was also carried out with a view of analysing the views of different writers in the context of BEE and taxation. In chapter two the thesis outlined the legislative framework upon which black economic empowerment has been founded. From this discussion it transpired that there is a firm legislative framework to support BEE transactions and other economic empowerment initiatives.

The following is the summary of the findings and recommendations, which have been the subject of the discussion reflected in chapter one to chapter five.

6.2 Corporate restructuring rules

It is argued that the corporate restructuring rules provide scope to some BEE transactions in order to roll over income or capital gains for the purposes of income tax or capital gains tax, provided the provisions of sections 41 to 47 are met. However, it is also considered that the so-called corporate restructuring rules, in so far as they are relevant to the process of the transfer of assets, company formations, amalgamations and share-for-share transactions, are potentially onerous. Although the legislation governing these rules has been amended frequently, this has not been done to simplify the tax provisions for BEE transactions. The restrictive nature of the application of this legislation may have the unfavourable consequence of taxpayer non-compliance, with significant amounts of time and resources devoted to the avoidance of the taxes. Furthermore, taxpayers may even avoid entering into BEE restructuring, lest they fall foul of a provision and be saddled with very significant tax costs, which may ultimately erode the business value in terms of industry charter compliance and the commensurate business opportunities that would have been otherwise gained by executing the restructures. The corporate restructuring rules also do not apply to other forms of enterprise, for example trusts, which may be appropriate vehicles for special categories of BEE deals.

It must be noted that corporate restructures and rationalisations have positive economic effects, for example BEE equity participation and employee share schemes. These structures should therefore be accommodated and encouraged. The simplification of the corporate restructuring rules are all very important tax issues in respect of BEE transactions, and should be a cause for further research and tax policy reform.

6.3 Debt transactions and inter-company loans

This thesis has also analysed the provisions of sections 8(4)(m) and 20(1)(a)(ii) of the Income Tax Act as well as paragraphs 12(5) and 56 of the Eighth Schedule to the Act. These have been analysed in so far as they relate to the conversion of debt obligations (to equity), especially as relating to previously deductible debt-related expenditure. Cognisance also needs to be had of the benefits that could be derived from compromises with creditors in BEE transactions. Such compromise benefits fall within the ambit of either section 8(4)(m) or paragraphs 12(5) and 56 of the Eighth Schedule, and section 20(1)(a)(ii). The company to which such debt relief was made would be subject to tax on the gain made when the loan was written off. The recommendation for BEE taxation, would be the position where the need to retain the funds in the BEE company or the BEE compliant company for further investment in similar projects would be recognised, possibly even as an incentive. This could then lead to an exemption from income tax or capital gains tax, when the debt write-off from a holding company for instance to the BEE subsidiary is the issue in question.

6.4 Taxation of trusts

In addition, trusts have historically proven to be very useful strategic business vehicles. They have also been useful in estate planning, joint ventures, and joint-holdings of business assets and BEE, to represent the interests of the groups of people. In other instances they have been used to facilitate partial company ownership by employees and community broad-based trusts with beneficiaries often not identifiable at formation. Trusts are also attractive business vehicles because of advantages like limited liability, no audit requirement (strictly speaking), and other exemptions applicable only to trusts as opposed to companies (including close corporations) as governed and defined by the Companies Act, 61 of 1973 or the Close Corporations Act, 69 of 1984.

Some concessions granted to companies by the corporate restructuring rules are not available when the party to the rationalisation scheme is a trust. In addition, the

application of the highest marginal tax rate on trust income (except for special trusts) is a further point of concern. Trusts are commonly used as business vehicles and their tax regime appears prejudicial when compared to other business vehicles like close corporations and companies. However, trusts still prove to be useful in commercial structures, for example employee-share trusts and broad-based (community) trusts. It is for the reasons mentioned above that trusts should be considered to be instruments of the future in BEE transactions. It is commonly known that the Commissioner of the SARS dislikes trusts and views them generally as instruments of tax avoidance. It is recommended that the economical use of these trust schemes in the context of BEE should be encouraged either by a reduction in the tax rate applicable to trust income or by taxing trusts in the same way as companies or close corporations and other similar business vehicles.

6.5 Disposal or acquisition of equity shares

It appears that the new section in the Act, section 24N, lends itself to encouraging BEE equity disposal transactions. This section defers the inclusion in gross income or the deduction from income, of amounts arising from a disposal of equity shares, which are not quantifiable in the year of assessment during which the shares are disposed of. Such amounts then only accrue or rank for deduction in the year in which they become due and payable. This is acknowledged as an important contribution of legislation to the cause of black economic empowerment.

6.6 Tax treatment of preference shares and hybrid financial instruments

This thesis has also analysed the advantages for taxpayers and financiers of the utilisation of preference shares as a source of finance. The motivation for this is the fact that financiers are prepared to accept a lower preference share dividend rate, since dividend income is tax exempt, relative to a higher interest rate on a conventional loan, with interest income being fully taxable. The main reasons for financiers to offer preference shares as a form of funding have also been discussed. Other reasons include the attraction and retention of strategic clients and the likely STC credits that accrue to the bank by taking up preference shares.

Additionally, the thesis also discussed the extent to which banks can use preference shares as a means of funding clients. This was based on the judgment in CIR v Standard Bank of South Africa Limited, 47 SATC 179, at 197. Although it is understood

that government has a mandate to fight general tax avoidance, it is important to look into those anti-avoidance provisions which significantly increase the tax burden on financiers and could potentially make BEE funding costly in terms of the taxation implications.

Section 8E of the Act is currently seen in this light. The recent amendments as discussed in this thesis seem to have the potential to make it expensive for financiers to fund BEE transactions using preference share funding, when the shares are redeemable within a three year period. Although the bigger BEE deals are funded over a much longer time frame, it is considered that those BEE transactions which fall within the three-year time frame are made tax expensive by provisions of section 8E, when they are applicable. It is recommended that where the provisions of section 8E are applicable, the expenditure incurred in the production of the deemed 'interest income' be allowed as a deduction or at least for STC to be waived when section 8E is applicable.

Additionally, the provisions of a new section in the Income Tax Act, section 8F have also been discussed. The purpose of this section is to counter the prevalent use of debt instruments, with sufficient equity characteristics such that these instruments could be easily allocated to the equity side of the debt-equity continuum. To match the provisions of section 8E, section 8F also governs 'hybrid debt instruments' that are exchangeable into shares/equity within a three year period from the date of issue. Section 8F has the potential of being a further obstacle to the raising of debt finance for BEE transactions and structures. Where the provisions of this section apply, the interest expenditure incurred on the debt instruments will be disallowed as a deduction, after the debt obligation becomes a 'hybrid debt instrument' as contemplated in section 8F(1) of the Income Tax Act.

6.7 The general deduction formula and tax deductibility of interest expenditure incurred on amounts raised to acquire shares

A discussion of the general deduction formula as contained in sections 11(a) and 23 of the Income Tax Act was carried out. This was done in order to set the foundation for the discussion of the deductibility of interest incurred on loans raised to acquire shares. The deductibility of such interest expenditure is expressly prohibited in section 23(f) of the Income Tax Act. From the analysis it was clear that the provisions of the Income Tax Act prohibiting the deductibility of interest incurred on amounts raised to acquire shares was aimed at countering the deductibility of expenditure incurred in the production of tax exempt income, that is dividend income. It is argued, however, that generally the

purchase of shares by BEE parties is not solely founded upon the desire to earn dividend income. This is reflected in the inherent feature of BEE transactions which postpone the earning of dividend income for prolonged periods of time in order to repay debt raised to acquire such shares. In this regard, it is considered that the interest incurred on loans to acquire shares by BEE participants should be deductible. It is the inability of the current tax system to allow such deductions that appears to be one of the significant impediments to wide-spread equity participation by BEE counterparties.

6.8 Connected persons rules

The thesis illustrated, by way of a case study, the likely adverse effects of the “connected persons” rules in the Income Tax Act as contained in section 1 and paragraph 38 of the Eighth Schedule to the Act and how these could affect BEE deals. The analysis revealed that these tax hurdles could be removed or reduced if the Act could accommodate some price-setting mechanisms, which are designed by taxpayers to aid BEE transactions, as was illustrated in the case study transaction. This should be done bearing in mind the significant funding challenges faced by the parties to BEE transactions.

6.9 Taxation of small business corporations and personal service companies

The thesis outlined the progress which has been made through targeted tax policy reforms in improving the tax regime governing the taxation of small business corporations. Some of these targeted tax provisions are contained in section 12E of the Income Tax Act. Although this was positive, there are still areas of concern, including the taxation of personal service companies as defined in Schedule Four to the Income Tax Act.

The introduction of the provisions governing the taxation of personal services companies was aimed at combating the use of commercial incorporation with its inherent tax benefits for the avoidance of tax. As correctly noted by Black et al (2005) “each country’s tax system has been established over time by many – often unique – forces, one should therefore be careful of generalising”. For this reason, however, it is submitted that the business models of true economic empowerment such as some small, medium and micro enterprises which are adversely affected by the provisions governing the taxation of personal services companies, are unintentionally adversely affected by the current taxation regime. Further, it is asserted that these provisions could not have been

introduced to render non-viable those business schemes and commercial structures aimed at both supporting true broad-based economic empowerment, which are essential agents of employment creation and ultimately economic growth. The offending legislation should therefore either be removed or amended to take into account the importance of encouraging small, medium and micro enterprises businesses in the South African economy and especially in the context of BEE.

6.10 General tax avoidance

It is also imperative for tax authorities to understand that businesses will always seek the most tax efficient means in order to remain competitive. "If tax is seen only as a punishment, it is unlikely to induce more than minimum compliance, with considerable effort devoted to avoidance" (Jones, 1982: 22). It is with this understanding that a BEE transaction, which also results in the reduction or avoidance of some tax, should be encouraged and seen as economically viable. It can be justifiably said that mere compliance with the literal provisions of the legislation is not sufficient. Taxpayers need a clearer or more simple test to apply to business transactions within a comprehensive BEE tax policy framework or at least one that provides specifically for BEE. This would provide the necessary level of certainty (even in advance) that such transactions will not be prone to re-investigation simply because they also afforded the taxpayer in question a tax break.

6.11 Conclusion

It can be argued that effective tax reforms should be targeted at those areas which contribute or could potentially contribute to increased economic empowerment and sustainable economic growth. Additional tax reform goals, as stated in Black et al (2005), should include equitable revenue redistribution, promotion of equity, tax simplification and an efficient allocation of resources. Tax policy has implications for economic empowerment and growth. Moreover, to a significant extent, the funding of BEE structures enables previously disadvantaged groups to own and manage businesses and to obtain much needed expert skills. To this end, there is a pressing need to align government policy objectives pertaining to broad based black economic empowerment and the current tax treatment of the commercial structures, which bring about the realisation of these policy objectives.

However tax policy makers must take particular heed of tax avoidance opportunities, a usually non-targeted effect of tax policy reforms and/or incentives. These have the result of eroding the tax base significantly above the officially anticipated revenue losses for the South African Revenue Service and also result in unforeseen increases in the general tax burden borne by other taxpayers.

It is considered that this thesis makes only a small contribution to the real challenge posed by the subject of taxing black economic empowerment transactions. The intricacies and sophistication in legislation concerning BEE transactions and how these can still be re-engineered to be more conducive to the legal certainty which is essential for business entering into BEE transactions, especially in a developing economy such as South Africa, will continue to be an area of challenging intellectual discussion and further research. However, what has been researched and analysed in this thesis is a contribution to the attainment of the ideal which Brenthurst (2003) stated as follows: "We want to move to where transformation is not a risk factor, but a growth factor". Tax authorities need to appreciate this and take up the challenge of legislating in a way that will be conducive to the South African way of doing business and the attainment of BEE objectives.

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