# SOUTH AFRICA

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## INTERNATIONAL DEVELOPMENTS

### 1. WHAT ARE RECENT TAX DEVELOPMENTS IN YOUR COUNTRY WHICH ARE RELEVANT FOR M&A DEALS AND PRIVATE EQUITY?

In the 2016 Budget Review, tax avoidance schemes involving share buybacks were highlighted for review. Such schemes involve a company buying back shares from its current shareholders to avoid the tax consequences of share disposals. The seller receives payment in the form of a dividend that may be exempt from normal tax and dividends tax, instead of paying tax on the sale of shares. Following the announcement in 2016, no specific countermeasures were introduced in 2017. It was proposed in the 2017 Budget Review that specific countermeasures be introduced to curb the use of share buyback schemes.

### 2. WHAT IS THE GENERAL APPROACH OF YOUR JURISDICTION REGARDING THE IMPLEMENTATION OF OECD BEPS ACTIONS (ACTION PLANS 6 AND 15 SPECIFICALLY) AND, IF APPLICABLE, THE AMENDMENTS TO THE EU PARENT-SUBSIDIARY DIRECTIVE AND ANTI-TAX AVOIDANCE DIRECTIVES?

South Africa is a non-member country of the OECD, however, it has a working relationship with the OECD, and collaborates with it on a variety of policy issues. Action 6: in November 2016, South Africa adopted the Multilateral instrument capable of incorporating tax treaty-related base erosion and profit shifting measures into existing of bilateral treaties. The timeline for the commencement of the Convention is expected to proceed as follows:

- June 2017: a signing ceremony is planned, at which the more than 100 participating jurisdictions (including South Africa) will sign the Convention.
- Ratification of the Convention: the Convention itself will enter into force once five countries have ratified it.
- Effect on specific treaties: the Convention will enter into force for a specific double taxation agreement once all parties to that double taxation agreement have ratified the Convention and a specified period has lapsed in order to ensure clarity and legal certainty.

With regards to Transfer Pricing, the final regulations relating to Country-by-Country Regulations (“CbC”) have been published applying to years of assessments beginning on or after 1 January 2016. The SA Co who is a member of a group of companies and is not the ultimate parent entity must still notify the South African Revenue Service (“SARS”) of the identity and tax residence of the reporting entity.

The SARS is updating the Transfer Pricing Practice Note in line with OECD Transfer Pricing Guidelines to include new guidance on the arms-length principle and an agreed to ensure appropriate pricing on intangibles that are difficult to value.

There are two levels of record keeping which will be included in the Transfer Pricing Policy Document:

- Records in respect of structure and operations where the aggregate of affected transactions exceeds R100 million for a year; or
- Records in respect of transactions where one single affected transaction exceeds R5 million in value for a year.

Other action plans: South Africa already has legislation addressing these action points, however, SARS is reviewing the legislation in this regard to implement further refinements, such as the following:

- digital economy: foreign businesses supplying digital services in South Africa are already required to register as VAT vendors. The regulations are under review. South Africa is a member of the new Task Force for the Digital Economy, which is looking at direct taxes;

- hybrid mismatches: recommendations on transparent entities are being incorporated into the multilateral instrument. South African law has measures to limit double deductions, income exclusions where there is no corresponding deduction, and deductions with no inclusions. Further refinements may be considered in future;
- interest deductions: government is strengthening its efforts to curb excessive debt financing, which erodes the tax base, and will review the current limitation in light of OECD recommendations.

The Final Notice in terms of section 29 of the Tax Administration Act requires SA companies to keep a master file and a local file, irrespective of whether this company is an ultimate holding company or a subsidiary of the group.

## GENERAL

### 3. WHAT ARE THE MAIN DIFFERENCES AMONG ACQUISITIONS MADE THROUGH A SHARE DEAL VERSUS AN ASSET DEAL IN YOUR COUNTRY?

**A) Share deals**

**Tax advantages:**

- Interest incurred on debt acquired to finance the acquisition of the shares may be deductible (subject to the interest limitation provisions).
- The supply of shares is an exempt supply for VAT purposes where the purchaser and seller are registered for VAT.
- The purchaser acquires the tax losses of the target company.

**Tax disadvantages:**

- The entire corporate history of the entity is assumed by the purchaser, and the purchaser would typically therefore require an in-depth due diligence review and/or comprehensive tax indemnities and warranties.
- Securities Transfer Tax (STT) is payable upon the transfer of securities (which includes unlisted shares, shares listed on the JSE, as well as member's interests in close corporations) at a rate of 0.25% on the greater of the consideration given or the market value of the shares in the case of unlisted securities, and the greater of the consideration declared by the acquirer or the closing price in the case of listed shares.

**B) Asset deals**

**Tax advantages:**

- The existing tax liabilities of the target company are not assumed by the purchaser.
- The purchaser may be entitled to certain allowances or deductions on certain assets which are acquired, however, where the purchaser disposes of such assets, a recoupment of allowances or deductions claimed may arise.
- Interest incurred on debt acquired to finance the acquisition of the assets may be deductible (subject to the interest limitation provisions which would apply in instances where the purchaser and the target company are connected persons).
- The amount allocated to the various assets would become the base cost of such assets in the purchaser's hands for Capital Gains Tax ("CGT") purposes, which would, where such base cost is high, result in lower capital gains tax implications upon the disposal of such assets (where the purchaser is subject to South African CGT).
- The purchaser may acquire only part of the target company's business.

**Tax disadvantages:**

- VAT may be payable, thereby increasing the acquisition costs.

## BUY-SIDE

### 4. WHAT STRATEGIES ARE IN PLACE, IF ANY, TO STEP UP THE VALUE OF THE TANGIBLE AND INTANGIBLE ASSETS IN CASE OF SHARE DEALS?

None. As the purchase price would be allocated to the shares, the purchase price would be used to determine the tax cost of the shares and would have no impact on the value of the underlying assets.

### 5. WHAT ARE THE PARTICULAR RULES OF AMORTISATION OF GOODWILL IN YOUR COUNTRY?

No depreciation may be recognised in respect of goodwill for tax purposes, and the parties should therefore ensure that the purchase price is allocated as much as possible to other asset categories that qualify for tax deductions or allowances.

### 6. WHAT ARE THE LIMITATIONS TO THE DEDUCTIBILITY OF INTEREST ON BORROWINGS IN THE CASES OF ACQUISITION OF SHARES AND ASSETS?

**Asset deal:**
The Income Tax Act No. 58 of 1962 (the "Act") provides that interest will be deductible by the taxpayer where such interest is incurred for the purpose of earning taxable income in the course of a taxpayer's trade. Where the purchaser is a trading entity and acquires the business/assets of the target company in order to derive taxable income from its operations, the interest would be deductible from its income.

**Share deal:**
Generally, interest incurred on debt acquired to fund the acquisition of shares would not be deductible as it would not be incurred for purposes of earning taxable income, as the dividend income earned by shareholders is generally exempt income. However, the Act provides that the purchaser will be entitled to a deduction on the interest incurred for the acquisition of the shares where the target company is an "operating company" and the purchaser would, at the close of the day of the transaction, be a controlling group company in relation to the target company i.e. will hold more than 70% of the shares in the target company.

The amount of interest which may be deducted by the purchaser would be limited by the interest limitation provisions of the Act, in terms of a formula which provides that the taxpayer may not deduct interest exceeding 60% of its so-called "adjusted taxable income" in any year of assessment. Any interest which is not deducted may be carried over and deducted in the following year of assessment. The interest deduction limitation would not affect the purchaser too adversely where the acquiring entity has a high "adjusted taxable income".

### 7. WHAT ARE USUAL STRATEGIES TO PUSH-DOWN THE DEBT ON ACQUISITIONS?

Typically, a South African intermediary holding company is incorporated by a foreign purchaser as a vehicle to purchase the shares in an existing target company, which newly incorporated intermediary holding company may then incorporate a subsidiary which will then acquire debt to acquire the shares of the target company. The business and/or assets of the target company are then acquired (by either the intermediary holding company or the subsidiary of the intermediary holding company) utilising the tax roll-over intra group transaction relief provisions of the Act. As the debt will be incurred by the entity which will be conducting the trade, the interest incurred on the debt to acquire the assets of the target company should be deductible, subject to the interest deduction limitations (see 3 above).

### 8. ARE THERE ANY TAX INCENTIVES FOR EQUITY FINANCING?

Yes. The return of equity funding is generally exempt from tax in the hands of the lender. The Act does however, contain anti-avoidance provisions which re-characterises  exempt divided income as taxable income in the hands of the lender were the equity instrument contains loan type features.

## 9. ARE LOSSES OF THE TARGET COMPANY(IES) AVAILABLE AFTER AN ACQUISITION IS MADE?

The tax losses of the target company are retained by the purchaser in the case of a share deal, but not where assets are acquired.

## 10. ARE THERE ANY ITEMS THAT SHOULD BE INCLUDED IN THE SCOPE OF A TAX DUE DILIGENCE THAT ARE VERY SPECIFIC TO YOUR COUNTRY?

No

## 11. IS THERE ANY INDIRECT TAX ON TRANSFER OF SHARES (STAMP DUTY, TRANSFER TAX, ETC.)?

STT is levied upon the transfer of shares in listed and unlisted companies at a rate of 0.25% on the greater of the market value of the share or the consideration given in the case of an unlisted share, and the greater of the consideration declared by the acquirer or the closing price in the case of listed shares. STT is payable by the company which issued the share in the case of an unlisted share or the person who transfers the share in the case of a listed share, but may in both scenarios be recovered from the person to whom the share was transferred.

VAT is not payable upon the transfer of a share as such transfer is an exempt supply.

No transfer duty would be payable as transfer duty is only levied upon the transfer of immovable property.

## 12. ARE THERE ANY RESTRICTIONS ON THE CORPORATE TAX DEDUCTIBILITY OF ACQUISITION COSTS?

**Costs incurred to acquire shares/assets:**

**Share deal:**
Where the purchaser is a share trader, the shares would likely constitute trading stock and the acquisition cost will be deductible from the purchaser's income. However, the Act contains a provision which deems any expenditure incurred in respect of an equity share to be of a capital nature if that equity share had at the time of that expenditure been held for a period of at least three years. Should this deeming provision be applicable, the cost incurred to acquire the shares and deducted will be recouped.

**Asset deal:**
Where assets are acquired which qualify for deductions or allowances, the purchase price will be allocated to such assets and the purchaser will be entitled to claim such applicable deductions or allowances.

Costs incurred in relation to advisory services:

Generally, fees relating to advisory services provided by financial and legal advisors etc. incurred by a purchaser would not be deductible as such fees would generally be regarded as being expenditure of a capital nature. With regard to certain finance charges, depending on the nature of the charge, such charges may be deductible. The deductibility of advisory fees would be dependent on the contractual nature of such fees. Therefore, fees incurred in relation to the funding of the transaction could possibly be structured in a manner which would render same as deductible.

## 13. CAN VAT (IF APPLICABLE) BE RECOVERED ON ACQUISITION COSTS?

**Costs incurred to acquire shares/assets:**

**Asset deal:**
An input tax credit may be claimed by the purchaser where VAT was charged on a supply of goods or services made to the purchaser and the purchaser utilises the goods or services acquired in the course of furtherance of its enterprise for the purposes of making taxable supplies.

Where the purchaser acquires the business (or part thereof) of the target company as a going concern as envisaged in section 11(1)(e) of the VAT Act, VAT will be payable at a rate of 0%. In order to qualify for the zero-rating, the following requirements must be satisfied: both parties to the transaction must be registered for VAT and agree in writing that the business is sold as a going concern, the business disposed of must be capable of separate operation and must be an income-earning activity on the date of transfer, the assets which are necessary for the carrying on of the business must be transferred to the purchaser, and the purchase price is inclusive of VAT at a rate of 0%.

**Share deal:**
No VAT liability would arise upon the acquisition of shares as the supply of shares is a supply of financial services, which is an exempt supply for VAT purposes.

**Costs incurred in relation to advisory services:**

**Asset deal:**
In respect of an asset deal, an input tax credit may be claimed by the purchaser where VAT was charged on a supply of services made to the purchaser, and the purchaser utilises the goods or services acquired in the course of furtherance of its enterprise for the purposes of making taxable supplies.

**Share deal:**
Generally speaking, VAT incurred on fees for advisory services are not deductible for VAT purposes as the acquisition of shares is not attributable to a taxable supply for VAT purposes as no taxable income will generally be generated from the shares acquired. It appears as though the current policy of SARS is that they require that there must be a direct and immediate link to a taxable supply for VAT on an expense to qualify as input tax – the ultimate purpose of the expense is disregarded by SARS. However, the phrase "in the course of" in the context of the claiming of input tax, requires that there must be some relationship between the consumption or use of the service and the making of taxable supplies – no direct or immediate link to taxable supplies is necessary.

This issue remains a contentious one for VAT purposes and is guided by domestic and foreign case law.

## 14. ARE THERE ANY PARTICULAR TAX ISSUES TO CONSIDER IN THE ACQUISITION BY FOREIGN COMPANIES?

Foreign purchasers should consider the appropriate acquisition vehicle when structuring the acquisition of a South African target company. In this regard, the purchaser may elect to structure the acquisition through a South African intermediary holding company, a subsidiary or a branch.

The incorporation of a local intermediary holding company offers the purchaser limited liability protection (i.e. the intermediary holding company is a separate legal entity and the liability of the shareholders is limited to the value of their shares). Any dividends received by the local intermediary holding company from the SA operating company would be exempt from income tax and dividends tax (levied at a rate of 20%), and interest received from local operating companies would not be subject to interest withholding tax (levied at a rate of 15%). The local intermediary company could therefore be utilised as a vehicle for reinvestment. However, any expenditure incurred by the intermediary holding company would likely not be deductible from its income as it arguably would not be incurred in the production of its income or in the course of its trade.

The purchaser may also elect to operate through a local subsidiary or a branch of the foreign purchaser which is registered in South Africa. A South African resident company is taxed on its worldwide income at a rate of 28% (subject to the applicable DTA which may reduce the rate), while a branch, which is a non-resident, will be taxed on the income sourced in South Africa at a rate of 33% (save for where the entity constitutes a permanent establishment, in which case it will be considered a resident).

Upon the repatriation of funds to the foreign parent company, dividends declared by a subsidiary will be subject to dividends withholding tax at a rate of 20% (subject to the applicable DTA which may reduce the rate), and any interest paid to the parent company will be subject to interest withholding tax at a rate of 15% (subject to the applicable DTA which may reduce the rate). In addition, any profits repatriated to the foreign parent company by way of management and other fees will be subject to transfer pricing rules.

The repatriation of funds by a branch to its foreign parent company will not be subject to any withholding taxes.

Much like a subsidiary, the branch is entitled to a deduction of its expenditure incurred in the production of its income, however, where a foreign parent company operates more than one South African branch, the losses of one branch may be set off against the taxable income of another branch in the determination of the South African tax payable.

## 15. CAN THE GROUP REORGANISE AFTER THE ACQUISITION IN A TAX NEUTRAL ENVIRONMENT THROUGH MERGERS OR A TAX GROUP?

Yes. Various special rules are provided for in the Act to allow for tax neutral mergers, acquisitions, and restructuring. The Act specifically provides for asset-for-share transactions, amalgamation transactions, intragroup transactions, unbundling transactions and liquidation distributions (tax roll-over relief provisions), each with specific requirements which must be met by the parties to the transactions before they will be applicable.

South African has no “group tax provisions”.

## 16. IS THERE ANY PARTICULAR ISSUE TO CONSIDER IN CASE OF TARGET COMPANIES OF WHICH MAIN ASSETS ARE REAL ESTATE?

The Act contains provisions relating to the taxation of Real Estate Investment Trusts (REITs). A REIT is a resident company the shares of which are listed on a recognised exchange as defined in the JSE Limited Listing Requirements. Essentially, the Act allows for a “qualifying distribution” to be made by a REIT or a controlled company (a company that is a subsidiary of a REIT) for which the REIT or controlled company that is a resident gets a deduction from its income for the prior year of assessment to which that qualifying distribution relates. A “qualifying distribution” means dividends paid or payable by the REIT or a controlled company or interest incurred in respect of debentures that form part of a linked unit in that company where 75% of the gross income of that company consists of “rental income”.

Amounts distributed by a REIT are fully taxable in the recipient’s hands. Where such distribution is in the form of a dividend, the dividend is not exempt from income tax in the recipient’s hands. This exclusion from the dividend exemption also applies in respect of dividends distributed by a controlled company.

There are a number of further specific provisions dealing with the taxation of REITs and controlled companies, including, inter alia, provisions dealing with the receipt or accruals by a REIT or a controlled company in respect of a financial instrument, the disallowance of deductions in respect of immovable property and specific rules in respect of the receipt or accrual of amounts of interest in respect of debentures forming part of a linked unit.

Section 25BB of the Act stipulates that REITs are not entitled to claim certain capital allowances. This is because REITs are subject to a special tax dispensation that allows them to deduct their shareholder distributions against rental income as the shareholders bear the tax liability. The REIT is precluded from claiming allowances on its assets, which means that an anomaly arises when a REIT is party to a reorganisation transaction, because its assets would not qualify as allowance assets. This anomaly means the rules on reorganisation do not apply to transactions involving REITs. It was proposed in the 2017 tax amendments.

## 17. IS FISCAL UNITY/TAX GROUPING ALLOWED IN YOUR JURISDICTION AND IF SO, WHAT BENEFITS DOES IT GRANT?

We do have tax deferrals under the corporate group reliefs that are available to the deferral of tax.

There are a number of exemptions under section 10 of the Act.

## SELL-SIDE

### 18. HOW ARE CAPITAL GAINS TAXED IN YOUR COUNTRY?

CGT is payable by residents upon the capital gains arising from the disposal of capital assets.

Non-residents will only be subject to CGT upon capital gains arising from the disposal of:

- immovable property situated in South Africa;
- any interest in or right to immovable property situated in South Africa, where more than 80% of the market value of the interest at the date of the disposal relates directly or indirectly to South Africa immovable property which is not trading stock ("South African property rich company"). An interest would include equity shares in a company where more than 20% is held (together with connected persons) in the company being disposed of, or a right of ownership, or a vested interest.; and
- any asset effectively connected with a permanent establishment of the non-resident in South Africa.

Therefore, where a non-resident acquires an interest in a South African property-rich company, whether South African or foreign, such non-resident will be liable for CGT upon the disposal of such equity shares, subject to treaty relief.

Only a portion of capital gains are taxable, and at the tax rate applicable to the particular taxpayer – for example:

- 40% inclusion in the case of a natural person;
- 80% special trust; and
- 80% in the case of a company.

A foreign company will thus suffer an effective tax rate of 22.4% on capital gains (80% x 28% corporate tax rate).

Where a non-resident disposes of immovable property in South Africa or an interest in a South African property rich company, the transaction may be subject to withholding tax. The purchaser will have a duty to withhold a portion of the purchase consideration where tax is due on the transaction, and remit this to SARS. The amounts to be withheld amount to 7.5% of the purchase price where the seller is a natural person and 10% if the seller is a company and 15% if the seller is a trust. This amount will be allocated towards settling the CGT liability of the non-resident seller, who will be obligated to register as a taxpayer with SARS for purposes of making payment of its CGT liability.

### 19. IS THERE ANY FISCAL ADVANTAGE IF THE PROCEEDS FROM THE SALE OF SHARES ARE REINVESTED?

No

### 20. ARE THERE ANY LOCAL SUBSTANCE REQUIREMENTS FOR HOLDING COMPANIES?

There are no specific substance requirements for obtaining/maintaining South African tax residency.

Foreign incorporated companies will be tax resident in South Africa when they are effectively managed in South Africa. South African incorporated companies will automatically be South African tax resident, unless they are exclusively resident in another country by way of a DTA. It is thus important that, where the holding/finance company wants to apply South Africa treaties and that the company's place of effective management remains in South Africa. Place of effective management is not defined in the Act, and is open to interpretation, but the current SARS view appear to be that a company's place of effective management is the place where key management and commercial decisions that are necessary for the conduct of its business as a whole are in substance made. This approach is consistent with the OECD's commentary on the term "place of effective management".

**Foreign holding companies' tax treatment in SA**

Where foreign holding companies earn SA source income which is not taxed by means of a withholding tax, the SA tax exposure in respect of this will determined in the same way as for SA resident companies and at the same tax rate (28%). Income taxed by means of withholding taxes (interest, dividends, royalties) will be subject to treaty relief, where applicable.

**Beneficial ownership in context of withholding taxes**

Where interest or royalties are paid to or for the benefit of a foreign company, or dividends are paid to a foreign company which is the beneficial owner of the dividend, withholding tax will arise, but may be reduced by an applicable double tax agreement. SA tax law does not contain substance requirements that need to be fulfilled before the withholding tax may be reduced. SA tax law does not contain substance requirements for the purposes of applying treaties.

Furthermore, SA tax law does not define the concept "beneficial ownership", except in relation to dividends (i.e. the person entitled to the benefit of the dividend attaching to a share). When interpreting and applying treaties, SARS will thus likely use the internationally accepted meaning of the concept of beneficial ownership.

Note that in certain treaties which SA has concluded, relief from withholding tax may potentially not be obtained in terms of the treaty where the recipient of the payment is not the beneficial owner of the payment, or alternatively where the recipient and the beneficial owner of the payment differ and they are not residents of the same contracting state. This should be evaluated on a case-by-case basis by making reference to the text of the treaty in question. Note that this is not a domestic law issue.

## 21. ARE THERE ANY SPECIAL TAX CONSIDERATIONS REGARDING MERGERS/SPIN-OFFS?

South Africa does contain special tax incentives for merger/spin-offs under the corporate roll over relief provisions contained under section 44 of the Act.

# MANAGEMENT INCENTIVES

## 22. WHAT ARE THE TAX CONSIDERATIONS IN YOUR JURISDICTION FOR MANAGEMENT INCENTIVES?

In order to prevent employees (especially top management) from obtaining tax advantaged fringe benefits, the receipt of all equity instruments is treated on par with share appreciation rights. Any gains realised by an employee upon the vesting of equity instrument, which gain is the difference between the market value of the equity instrument at vesting and consideration paid by the employee to acquire the equity instrument, is included in that employee's taxable income in terms of section 8C of the Act.

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