Tax relief in sight for BEE transactions

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The tax cost of black economic empowerment (BEE) transactions has been the subject of debate between business and government for a number of years. Business is concerned that transactions entered into to achieve BEE targets often give rise to punitive tax costs that can be minimized only through complex structures. Government, on the other hand, has been reluctant to provide tax relief for BEE transactions. It seems that some “middle-ground” has now been reached with the announcement by Finance Minister Trevor Manuel in the 2007 Budget Speech that some of the unnecessary and costly tax consequences flowing from BEE transactions will be addressed in legislation to be drafted later this year.

Some of the BEE-related tax problems to be addressed in the proposed amendments are:

- The transfer of assets to a black-owned company may give rise to certain tax liabilities and other tax consequences;
- Issuing or transferring shares to a black shareholder can have negative tax consequences; and
- There is considerable uncertainty as to how the proceeds of shares sold to repay debt will be taxed.

Tax liability arising from the transfer of assets

The de-grouping charge

The sale of assets usually gives rise to taxable recoupments or capital gains (or both, in some cases) in the hands of the seller.

Part III of the Income Tax Act No. 58 of 1962 (“the Act”) (comprising sections 41 to 46 of the Act) provides some relief in this regard if various requirements have been met. For example, section 45 of the Act allows assets to be sold from one company to another free of taxable recoupments and capital gains as long as the buyer is a resident and both the buyer and seller are part of the same “group of companies”, that is, one company must hold at least 70% of the equity shares in the other, or at least 70% of the equity shares in each company must be held by a common holding company.

Unfortunately, there is not always a happy ending for these transactions as the tax relief falls away if the buyer, whilst still retaining ownership of the assets, subsequently ceases to be part of the same group of companies as the seller. The buyer will suffer normal tax or capital gains tax, referred to as a “de-grouping charge”, if the group structure changes at any time after the sale of assets and the buyer still owns the assets at the time of the de-grouping.

It was announced in the 2007 Budget Speech that this de-grouping charge will in future apply only if the group structure changes within six years after the initial intra-group disposal of the asset. The proposed amendment recognises that group structures may well change over the course of time and this should not automatically result in negative tax consequences.

Sales between connected persons

The wear and tear allowance available in terms of section 11(e) of the Act and the capital allowance for manufacturing assets, available in terms of section 12C of the Act, both contain anti-avoidance provisions that place a limit on the allowance available to a buyer that acquires a capital asset from a “connected person”.

A “connected person” is defined in section 1 of the Act. In relation to a company, it includes any shareholder owning at least 20% of the equity share capital of the company as well as any other company in the same group of companies (which, for this purpose, requires an equity shareholding of more than 50%).
The effect of this anti-avoidance provision is that, regardless of what the buyer actually paid for the asset, its allowance is based on an amount equal to the lower of the original cost of the asset to the seller and the market value of the asset when it was acquired by the buyer.

For example, if the seller acquired an asset for R10 000 (excluding VAT) and then sells the asset to the buyer some years later when the market value has increased to R50 000 (excluding VAT), the buyer’s tax allowance would be calculated as a percentage of the original cost of the asset, being R10 000. This limitation would apply regardless of the fact that the buyer actually paid R50 000 for the asset.

Trevor Manuel announced in the 2007 Budget Speech that these anti-avoidance rules will be relaxed in future if the transactions are not entered into with a tax-avoidance motive. This will allow the buyer in the above example to claim a wear and tear or capital allowance based on the full purchase price of the asset, being R50 000, giving more realistic tax relief.

Tax consequences of issuing or transferring shares to a black shareholder

The sale of shares from white to black investors in the course of achieving the ownership requirement in the BEE scorecard will usually give rise to capital gains tax in the hands of the seller. The Minister of Finance has proposed tax relief for two specific types of transactions:

1. Cross-issues of shares; and
2. Forced sales of shares under a scheme of arrangement in terms of section 311 of the Companies Act.

Cross-issues of shares

In this type of transaction, a black-owned investor company (“the BEE company”) takes up ordinary shares in an operating company, financed by way of preference shares issued by the BEE company. In time, the BEE company will sell some of the ordinary shares and use the proceeds from the sale to redeem some or all of the preference shares.

The proposed amendments will ensure that the simultaneous disposals of the ordinary and preference shares do not give rise to duplicated capital gains tax. Any artificial losses will similarly be disallowed.

Forced sales of shares

Many investors have already been subjected to capital gains tax on disposals of shares under schemes arrangement entered into by transforming companies in terms of section 311 of the Companies Act. In some cases the shareholders, after selling the requisite number of shares, arrange to purchase the same number and type of shares to restore their portfolios back to the original composition. Although the shareholder holds the same portfolio after these transactions, he would still have suffered capital gains tax on the forced sale of the shares.

The amendment proposed in the 2007 Budget Speech is that the capital gain arising on such a forced sale will be subject to a roll-over provision so that no tax will be payable on the sale if the share is replaced within a certain period. The capital gain will, however be taxed when the replacement shares are eventually sold.

Taxing the proceeds of shares sold to repay debt

BEE transactions are typically highly-geared and it will usually, therefore, be necessary for a black shareholder to liquidate part of its shareholding at some stage to generate the funds required to repay part or all of the underlying debt. In many cases it is uncertain as to whether the proceeds from such a sale would be capital or revenue in nature. Although a safe harbour is available in terms of section 9B of the Act, a five-year holding period is required before the taxpayer can elect that the provision will apply and even then, it only applies to listed shares.
It was announced in the 2007 Budget Speech that the five-year holding period will be reduced to three years and the safe haven provision will apply automatically for disposals of both listed and unlisted shares. The amendment will provide additional certainty for taxpayers but it is still unclear whether the proceeds from shares sold in less than three years will be automatically regarded as revenue or whether the facts and circumstances tests can be applied to determine whether the proceeds are capital or revenue in nature.

Although the specific details of the Budget proposals will not be known until the draft legislation is released later this year, it is generally agreed these amendments will provide long-awaited relief and certainty for parties to BEE transactions.