Dear Sir/Madam

The South African Revenue Service’s Draft Interpretation Note on Determining a “Group of Companies” refers. We hereby present the SAICA National Tax Committee’s response to your request for comments.

Introduction

The draft interpretation note, once issued, will be an “official publication” (as defined in section 1 of the Tax Administration Act, No. 28 of 2011) and will therefore create “practice generally prevailing” as envisaged in section 5 of that Act. Our comments take that fact into account.

Our comments are presented in the order of and under the headings used in the interpretation note. When reference is made to the draft interpretation note itself the abbreviation “draft IN” will be used. The draft IN uses the phrase “corporate rules” and it is accepted that the phrase refers to the special rules contained in Part III of Chapter II of the Income Tax Act. We will also use the same phrase when we refer to the special rules.

Background

The Income Tax Act, No. 58 of 1962 (“the Act”) contains two definitions of a “group of companies” namely, a general definition in section 1(1) which generally applies to the Act as
a whole and a narrower definition in section 41(1) which applies to the corporate rules and a limited number of other provisions in the Act.

*The relevance of section 41 definition to corporate rules*

The corporate rules deals with the tax consequences of certain transactions between companies forming part of a “group of companies” amongst others. The statement that “Under qualifying circumstances, the corporate rules make it possible for companies in such a group of companies to transfer assets between each other without adverse tax consequences” is misleading.

Not all the provisions require transactions to be between groups of companies in order to qualify for relief. Rather, certain of the corporate rules require transactions to be between companies forming part of the same group of companies to qualify for relief in certain circumstances.

The use of the phrase “without adverse tax consequences” is also not entirely correct as these rules allow for the tax consequences to be deferred and not to disappear.

*The scope of section 41 definition*

It is also stated that “The definition in section 41(1) excludes certain companies which might otherwise have qualified for relief under the corporate rules”. It is submitted that this statement is only partially correct.

Firstly, it should be made clear what is meant by the definition excluding certain companies. What it does is that it excludes certain companies that form part of a group of companies as defined in section 1 from being part of a group of companies as defined in section 41.

Secondly, in addition to excluding certain companies from being part of the group of companies, it also deems certain equity shares not to be equity shares for purposes of applying the definition.

*Application of the law*

The draft IN states that: “The proviso to the definition in section 41(1) then proceeds to exclude certain companies from consideration”.

This statement is incorrect. The proviso does not exclude companies from “consideration” in applying the section 1 definition. Rather, what it does is exclude certain companies that form part of a group of companies as defined in section 1 from being part of a group of companies as defined in section 41. Such an interpretation by SARS can only be given effect to by
substituting the actual words of the proviso for its own. The proposed interpretation could only be correct if paragraph (i) of the proviso read as “a company shall not be taken into consideration in determining if any company forms part of a group of companies if-”.

This misapplication of the proviso has a fundamental effect on the determination of which companies form part of a group of companies as defined in section 41. The plain wording of paragraph (i) of the proviso is clear and there is no circularity between the section 1 and section 41 definitions. What the section 41 definition requires is that a group of companies must be determined in accordance with the section 1 definition. Paragraph (i) of the proviso then requires that the specified companies be excluded from that group of companies for purposes of section 41. Nowhere does it suggest that the section 1 definition must be reapplied without having regard to the specified companies.

**Submission**

It is submitted that the interpretation of paragraph (i) of the proviso advanced by SARS is incorrect and should be reconsidered to the effect that the specified companies should simply be excluded from the section 1 group of companies for purposes of determining whether a company forms part of a group of companies.

**Example – Result of stated facts**

If paragraph (i) of the proviso is (correctly in our view), interpreted as submitted above, the result in the example is incorrect as Companies B, C and D will continue to form part of the group of companies as defined, with Company A being excluded.

**Submission**

It is submitted that the result of the example should be amended to reflect what, in our view, is the correct interpretation of the proviso.

**Basis of exclusion of Company A**

It should also be noted that Company A is not excluded on the basis that it is a non-resident as suggested in the example. Rather, it is excluded on the basis that it is a company incorporated under the laws of a country other than South Africa and does not have its place of effective management in South Africa.

Similarly, any South African incorporated company that is effectively managed in another country may not be a resident as a result of the application of a tax treaty, but would not be excluded from a section 41 group of companies in terms of paragraph (i) of the proviso.
Submission
It is submitted that the (draft) IN should specifically address the application of paragraph (i) of the proviso in the above circumstances.

Non-discrimination
A further point to note is that, if the interpretation advanced in the draft IN is correct (and we disagree with SARS in this regard), it could be argued to be discrimination as contemplated in article 24(5) of the OECD Model Tax Convention and therefore unenforceable. See the recent English case of The Commissioner for Her Majesty’s Revenue and Customs v FCE Bank Plc [2012] EWCA Civ 1290 where the Court of Appeal held that the denial of group relief between UK resident companies in similar circumstances to those of Companies B and C in the example were discriminatory on the basis that if Company A was a UK resident company Companies B and C would have qualified for UK group relief.

Submission
It is submitted that the (draft) IN should address SARS’s interpretation of proviso (i)(ee) in the context of treaty non-discrimination provisions in the event that SARS maintains its interpretation stated in the draft IN to the effect that Companies B and C in the example do not form part of a section 41 group of companies.

Scope of the draft IN
Given the heading of the draft IN, it purportedly addresses the section 41 definition of group of companies in full. However, the content limits itself to the interaction between the section 1 and section 41 definitions. No consideration is given in any detail to the excluded companies and no consideration is given whatsoever to paragraph (ii) of the proviso.

Submission
It is submitted that the IN should address in detail which companies are excluded under paragraph (i) and SARS’s interpretation of paragraph (ii) of the proviso.

General
The IN does contain sufficient examples to clarify the application of the definition in each of the corporate rules. If one takes the definition of “asset-for-share transaction” contained section 42(1)(b) as an example, it contains various references to group of company, sometimes referring to the section 1(1) definition and sometimes not - see below. It is very difficult to follow and the IN can add value if these issues are explained.
Submission
We recommend that the draft IN be expanded to include more examples. We recommend that you consider the following further examples.

Example 2:
Facts:
The facts are the same as above however Company A, although incorporated in the United States of America, is effectively managed in South Africa.

Result:
Application of the definition of a “group of companies” in section 1(1) to Companies A, B, C and D

Companies A, B, C and D meet the requirements of the definition in section 1(1) because Company A directly holds at least 70% of the shares in Companies B and C. As such, Companies B and C are “controlled group companies” as defined. Company A indirectly holds at least 70% of the shares in Company D through another controlled group company, namely, Company C.

Companies C and D meet the definition in section 1(1) because Company C holds at least 70% of the shares in Company D.

Application of the definition of a “group of companies” in section 41(1) to Companies A, B, C and D

Company A, although registered in the United States of America is a resident for South African tax purposes. It is included from consideration as part of the group of companies as paragraph (i)(ee) of the proviso to the definition in section 41(1) does not apply.

As none of the exclusions in paragraph (i) or deeming provisions in paragraph (ii) of the proviso to the definition in section 41(1) apply to Companies A, B, C or D, all the companies meet the requirements of the definition of section 1(1) read with section 41(1).

Example 3:
Facts:
Companies A, B, C and D are incorporated in South Africa. Company A directly holds 100% of the equity shares in Companies B and C. These shares are held on capital account and
there are no contractual obligations, rights or options to purchase or sell the share under particular circumstances.

Company C directly holds 100% of the equity shares in Company D which is also incorporated and effectively managed in South Africa. These shares are held trading stock.

Result:
Application of the definition of a “group of companies” in section 1(1) to Companies A, B, C and D

Companies A, B, C and D meet the requirements of the definition in section 1(1) because Company A directly holds at least 70% of the shares in Companies B and C. As such, Companies B and C are “controlled group companies” as defined. Company A indirectly holds at least 70% of the shares in Company D through another controlled group company, namely, Company C.

Companies C and D meet the definition in section 1(1) because Company C holds at least 70% of the shares in Company D.

Application of the definition of a “group of companies” in section 4(1) to Companies A, B, C and D

Companies A, B and C meet the requirements of the definition in section 1(1) because Company A directly holds at least 70% of the shares in Companies B and C. As such, Companies B and C are “controlled group companies” as defined.
The deeming provision in paragraph (ii)(aa) of the proviso to the definition in section 41(1) applies to Company D. Company D is therefore not part of the same group of companies as Companies A, B and C.

Please do not hesitate to contact us, should you have any questions regarding the above.

Yours faithfully

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