Dear Sir,

"GROUP OF COMPANIES" DEFINITION IN SECTION 41 OF THE INCOME TAX ACT

This submission refers to the “group of companies” definition in section 41 of the Income Tax Act No. 58 of 1962 (the Act) which needs to be dealt with by National Treasury for the purposes of section 44 of the Act. We set out our submission comments in relation to this issue by way of the following example:

Assume A Co and B Co are both SA resident companies and are 100% subsidiaries of C Co (a non-South African resident). The group wishes to rationalise its South Africa operations by transferring all the assets of A Co to B Co and liquidating A Co. This can be done using the provisions of section 44 of the Act. The effect of this is that the transfer of the capital assets (including allowance assets), trading stock and section 24C allowance from Co A to Co B may be made without the incidence of tax. The section envisages that the transfer will be from Co A to Co B in return for shares and/or the assumption of certain liabilities. Thereafter, Co A would be liquidated, and any shares in Co B held by Co A as a consequence of the transaction would be distributed to the shareholder (Co C), tax free, i.e. no Income Tax, CGT or STC.

In addition, there would be no donations tax on the transfer of the assets to from A Co to B Co even if the consideration is not market value (section 56(r)).

Section 44 of the Act allows this transaction to take place as set out above notwithstanding that C Co is a non-resident.

However, if the assets are transferred to from Co A to Co B at less than market value, the question arises as to whether an STC liability arises under section 64C of the Act. Section 64C of the Act deems there to be a dividend declared by a company to a shareholder, for purposes of section 64B of the Act if “any asset …is …transferred by that company to or for
the benefit of that shareholder or any connected person to that shareholder’. Thus, if the assets are transferred to Co B, a connected person to the shareholder (Co C), for less than their market value, a benefit will have been derived by Co B (who is connected to their joint shareholder (Co C)) and a deemed dividend could be viewed as arising.

Section 64C(4) of the Act includes various exemptions to the deeming provision.

The exemption in section 64C(4)(k) of the Act requires that:

- the connected party receiving the benefit (Co B) and the shareholder (Co C) must form part of the same group of companies as the company that is deemed to have declared the dividend i.e. (A Co);
- if the profits of the company declaring the dividend (A Co) are reduced as a result of the dividend, the exemption only applies to the amount which represents a corresponding increase in profits in the recipient of the deemed dividend (B Co).

A review of the remaining exemptions in section 64C(4) of the Act indicates that there is no other exemption available in this scenario.

Thus, contrary to the intention of the legislation, that the transfer of the assets, trading stock and section 24C of the Act allowance should be capable of being made tax free even if all the other requirements are fulfilled, it would appear that an STC liability may arise if the assets are not transferred at market value:

A group of companies is defined in section 1 of the Act as:

‘any two or more companies in which one company (hereinafter referred to as the “controlling group company”) directly or indirectly holds shares in at least one other company (hereinafter referred to as the “controlled group company”) to the extent that –

(a) at least 70% of the equity shares of each controlled group company are directly held by the controlling group company, one or more other controlled group company or any combination thereof; and
(b) the controlling group company directly holds at least 70% of the equity shares in at least one controlled group company’

Thus, Co’s A, B and C would all constitute a group of companies under section 1 definition, and each entity would form part of that same group of companies.

However, section 41 of the Act introduced a further definition of ‘group of companies’ in the 2008 Amendment Act (which applied from 1 October 2007 in relation to *inter alia* the corporate rules and the STC rules) and this states:
“Group of Companies” means a group of companies as defined in section 1. Provided that for the purposes of this definition—

(i) any company that would, but for the provisions of this definition, form part of a group of companies shall not form part of that group of companies if—

... (ee) that company is a company contemplated in para (b) of the definition of “company” unless that company has its place of effective management in South Africa’

Para (b) of the definition of ‘company’ relates to a company which is incorporated outside South Africa.

Thus, a company that is not South African resident for tax purposes shall be excluded from the group of companies for the purposes of the corporate rules and the STC rules. The other companies, however, remain part of the group of companies.

Applying these rules to the example, A Co and B Co remain part of a ‘group of companies’ as defined in section 1 of the Act, and not excluded by section 41 exclusions. C Co does not form part of a group of companies as it is excluded by virtue of section 41 of the Act. Thus, since, for purposes of section 64C(4)(k) of Act B Co and C Co must form part of the same group of companies as Co A the exemption does not apply.

This problem could be solved if the exemption simply required B Co and A Co to be part of the same group of companies since then the exemption would apply and the intention that the transfer be effected with no tax would be realised.

Thus, we request that National Treasury amends the exemption under section 64C(4)(k) of the Act as indicated above or, more preferably, inserts into the legislation a specific exemption from STC for the transfer of assets between a transferor and a transferee for the purposes of section 44 of the Act.

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

Yours faithfully

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