KPMG

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Proposed amendment to section 40CA: Acquisition of assets in exchange for shares or debt issued

Section 40CA was introduced into the Income Tax Act with effect from 1 January 2013 as a result of a policy decision made by SARS/National Treasury that companies should obtain a base cost where an asset is acquired by it in exchange for the issue of shares. The introduction of section 40CA was necessary as a judgement[1] recently delivered then by the Supreme Court of Appeal had found that the issue of shares by a company does not amount to "expenditure actually incurred". Furthermore, and for reasons that remain unexplained, section 40CA was also drafted to apply where, instead of shares, debt is issued by the company to acquire the asset.

The introduction of section 40CA also came with an accompanying amendment to the so-called connected person rule as encapsulated in paragraph 38 of the Eighth Schedule to the Income Tax Act. *Inter alia*, paragraph 38 deems the disposal of an asset to a connected person to be made for proceeds equal to market value, but the accompanying amendment rendered the provisions of paragraph 38 inapplicable where section 40CA applies to the transaction. This amendment created a loophole for companies to dispose of assets in a tax neutral manner, which proved particularly useful for transactions between group companies where the provisions of the so-called "corporate rules" were

[1] CSARS v Labat Africa Ltd (669/10) [2011] ZASCA 157

not accessible. The mechanics of this loophole are perhaps best explained by means of an example.

Example:

Facts:

- "Company A" and "Company B" are both incorporated and tax resident in South Africa.

- Company A and Company B are sister companies in that they are each wholly owned by "Foreign Holding Company", which is incorporated and tax resident in a foreign jurisdiction.

- As Company A and Company B have the same majority shareholder, these companies are connected persons as defined for purposes of the Income Tax Act. Company A and Company B are however not a group of companies as defined for purposes of the corporate rules as their controlling shareholder is a foreign company.[2]

- As part of a global restructure, a significant part of Company A's business is to be carved out and sold to Company B. This business has been valued at R1 billion by independent valuation experts.

- Included in the valuation of R1 billion is self generated goodwill valued at R750 million and which has not been recognised for accounting purposes. The goodwill has no base cost for tax purposes. The remaining assets that comprise the business have a book value of R250 million, which is also equal to the market value of those assets.

Analysis:

- If Company A agrees to dispose of the business to Company B for its book value in exchange for R250 million payable in cash, the provisions of paragraph 38 will apply and, as a result, Company A will be deemed to receive proceeds of R1 billion for the sale of the business. It follows that Company A will then incur a significant capital gains tax liability on the disposal of the business as a result of the application of paragraph 38.[3]

- If Company A agrees to dispose of the business to Company B for its book value, but instead of receiving cash the amount of R250 million is left outstanding on loan account, then section 40CA would apply (given that Company B has issued debt) and as a result paragraph 38 would not apply. Company A would thus not incur any capital gains tax liability on the disposal of the business to Company B.[4]

SARS has seemingly only recently become aware of this loophole in the legislation, and has clarified that this is an unintended consequence of the amendments made when section 40CA was first introduced. To remedy this loophole, the 2020 Draft TLAB

[2] As per SARS' interpretation of the meaning of "group of companies" for purposes of the corporate rules outlined in Interpretation Note 75 (Issue 2).

[3] For completeness sake, it is noted that Company A may also be liable for dividends tax to the extent that the business is sold for less than its market value.

[4] Ignoring the potential application of the general anti-avoidance rules.

proposes to do away with the application of section 40CA in instances where debt is issued.[5] Consequently, going forward section 40CA can only apply in instances where shares are issued by a company as consideration for the acquisition of an asset.[6]

We agree with the proposed amendment, noting that the issue of debt in any event gives rise to an amount of "expenditure actually incurred" under normal rules.

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Regards
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FOOTNOTES

[1] CSARS v Labat Africa Ltd (669/10) [2011] ZASCA 157
[2] As per SARS' interpretation of the meaning of "group of companies" for purposes of the corporate rules outlined in Interpretation Note 75 (Issue 2).
[3] For completeness sake, it is noted that Company A may also be liable for dividends tax to the extent that the business is sold for less than its market value.
[4] Ignoring the potential application of the general anti-avoidance rules.
[5] With effect for acquisitions made on or after 1 January 2021.
[6] This loophole does not exist where shares are issued due to the provisions of section 24BA of the Income Tax Act.

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