APPLICATION OF THE PARTICIPATION EXEMPTION TO THE DISPOSAL OF SHARES BY A CONTROLLED FOREIGN COMPANY

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INTRODUCTION

The participation exemption provides a useful and simple tax planning tool which should always be considered when dealing with cross-border merger and acquisition transactions which involve multinational groups having South African tax resident holding companies.

Binding Private Ruling No 279 ("**BPR 279**") deals with the application of the participation exemption in paragraph 64B[1] to the disposal by a Controlled Foreign Company ("**CFC**") of its entire shareholding in two wholly-owned non-resident subsidiaries.

The participation exemption, introduced by the Revenue Laws Amendment Act, No 45 of 2003 with effect from 1 June 2004, allows South African tax residents and CFCs to dispose of equity shares in non-resident companies on a tax-free basis where such equity shares are held as assets of a capital nature if certain requirements are met.

The purpose of the participation exemption in paragraph 64B is to complement the participation exemption in section 10B(2)(a) which exempts from income tax any dividends declared by non-resident companies to a South African tax resident holding at least 10% of the equity shares in such companies. The policy rationale behind the participation exemption in paragraph 64B is that the profits realised from the sale of shares represent unrealised dividends and that such profits would in any event have qualified for the participation exemption in section 10B(2)(a) had they been declared as a dividend to the resident shareholder. The participation exemption, therefore, requires a resident to disregard any capital gain or capital loss resulting from the disposal of the resident shareholder's equity shares in a non-resident company, if the disposal meets the requirements in paragraph 64B.

FACTS IN BPR 279

The Applicant was a vested trust and tax resident in South Africa. I towned all of the issued share capital of a non-resident company ("**Co-Applicant**") which in turn, owned all of the issued share capital of two non-resident companies ("**Co A**" and "**Co B**"). The Co-Applicant and an independent non-resident company ("**Counterparty**"),

1 All references to paragraphs in this article are to paragraphs of the Eighth Schedule to the Income Tax Act, No 58 of 1962 ("**Act**") and all references to sections are to sections of the Act.

both of which were principal investors in multinational development projects, were planning to enter into a merger in terms of which the Co-Applicant and Counterparty contributed certain investments of equal value to a newly formed non-resident subsidiary of the Counterparty ("**NewCo**") in exchange for shares in NewCo.

The value of the assets contributed by the Counterparty to NewCo were less than the value of the assets that contributed by the Co-Applicant to NewCo, which consisted of the Co-Applicant's entire shareholding in Co A and Co B. To equalise the contributions, the merger was implemented in terms of the following consequential steps:

1. The Counterparty incorporated NewCo in a foreign jurisdiction with a nominal amount in exchange for the issue of a single equity share;
2. The Counterparty transferred its assets to NewCo in exchange for further shares in Newco;
3. The Counterparty subscribed for additional shares in NewCo on a cash basis in order to equalise its collective investment value with the collective value of the Co A and Co B shares that were contributed to NewCo by the Co-Applicant; and
4. The Co-Applicant disposed of its entire shareholding in Co A and Co B to NewCo in exchange for the issue of shares in NewCo to the extent that it holds 50% of the issued share capital of NewCo.

In providing the ruling, SARS was required to determine whether the Co-Applicant's disposal of its equity shares in Co A and Co B qualified for the participation exemption in paragraph 64B.

CONTROLLED FOREIGN COMPANY RULES

Prior to explaining BPR 279, a basic understanding of South Africa's CFC rules is required.

South Africa's income tax system changed from a source-based system to a residence-based system for years of assessment commencing on or after 1 January 2001. The result being that South African tax residents are subject to income tax on their world-wide receipts, accruals and capital gains, subject to the provisions of an applicable Double Tax Agreement ("**DTA**"), while non-residents are only subject to income tax on receipts, accruals and capital gains from a South African-source, subject to the provisions of an applicable DTA.

South Africa's adoption of a residence-based system of taxation required the enactment of complex anti-avoidance rules that are aimed at preventing South African tax residents from incorporating non-resident companies to hold their offshore investments in order to prevent the foreign-sourced passive income produced by such investments from being subject to income tax in South Africa.

Section 9D was introduced in order to curb the above avoidance by requiring the "net income" of a non-resident company that qualifies as CFC to be imputed into the income of its South African tax resident shareholders. A non-resident company will generally be a CFC if South African tax residents, directly or indirectly, hold more than 50% of its issued share capital.

The net income of a CFC is determined on the notional basis that the CFC is a South African taxpayer. It follows that the net income of a CFC includes the world-wide receipts, accruals and capital gains of the CFC, subject to the provisions of an applicable DTA. A portion of the CFC's net income which is commensurate to the resident shareholder's percentage shareholding in the CFC must then be included in the resident shareholder's income for South African income tax purposes. The CFC rules in section 9D do, accordingly, not subject the CFC to tax in South Africa – it notionally imputes a portion of the taxable income which the CFC would have made had it been a South African taxpayer into the taxable incomes of its South African tax resident shareholders.

As the Co-Applicant was a non-resident company and all of its issued shares were held by the Applicant which was a South African tax resident, the Co-Applicant was a CFC. So too were Co A and Co B as the Applicant indirectly held 100% of their issued shares. It follows that any capital gain resulting from the disposal by the Co-Applicant of its shareholding in Co A and Co B must be included in its net income and must thereafter be imputed into the taxable income of the Applicant in terms of section 9D, unless the disposal qualifies for the participation exemption in paragraph 64B

PARTICIPATION EXEMPTION

The participation exemption requires any person ("**alienator**"), including a CFC, to disregard any capital gain or capital loss resulting from the disposal of equity shares in a non-resident company if all of the following requirements are met:

1. The alienator, whether alone or together with any other company forming part of the same group of companies as the alienator (if the alienator is a company), holds at least 10% of the equity shares and at least 10% of the voting rights in the company whose equity shares are being disposed of ("**interest**");
2. The alienator held such interest for a period of at least 18 months prior to that disposal;
3. The interest is disposed of to a non-resident which is not a CFC or a connected person in relation to the alienator; and
4. The interest is disposed of for proceeds that are equal to or exceed the market value of the interest.

FINDINGS IN BPR 279

SARS held that all of the requirements in paragraph 64B were satisfied in relation to the disposal by the Co-Applicant of its equity shares in Co A and Co B to NewCo and that the disposal did, accordingly, qualify for the participation exemption in paragraph 64B. It follows that the capital gain resulting from the disposal of Co A and Co B did not form part of the net income of the Co-Applicant for CFC purposes and would, therefore, not be imputed into the taxable income of the Applicant.

The point forming the subject matter of BPR 279 is whether the Co-Applicant would dispose of its shareholding in Co A and Co B to NewCo in exchange for proceeds that are equal to or exceeded the market value of the Co-Applicant's shareholding in Co A and Co B. This required that the contribution by the Counterparty to NewCo be of equal value to the shareholding in Co A and Co B. This was achieved by the Counterparty subscribing for additional shares in NewCo on a cash basis in order to equalise the value of the contributions made by the Counterparty and the Co-Applicant.

Interestingly, BPR 279 does not opine on the implications resulting from the fact that Co A and Co B ceased to be CFCs because of the merger (as the Applicant no longer indirectly held more than 50% of the issued share capital of Co A and Co B subsequent to the merger). In this regard, the Act contains a deemed disposal rule in section 9H(3)(b) which deems a CFC to have disposed of its world-wide assets to a resident on the day immediately before the day on which it ceases to be a CFC for proceeds equal to the market value of such assets and to have reacquired such assets on the day on which it ceases to be a CFC for a tax cost equal to the said market value. This deemed disposal would, depending on the nature of the assets held by the CFC, result in income tax and/or CGT, unless a specific exclusion applies

Section 9H(5) does, however, state that the deemed disposal rule in section 9H(3)(b) does not apply if a CFC ceases to be a CFC as direct or indirect result of a disposal of equity shares in the CFC where such a disposal qualifies for the participation exemption in paragraph 64B. Based on the facts in BPR 279, this exclusion found application with the result that the deemed disposal rule in section 9H(3)(b) would not have found application as a result of Co A and Co B ceasing to be CFCs as a result of the merger.

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