CONTENTIOUS DRAFT TAX AMENDMENTS: RECENT DEVELOPMENTS

By Doelie Lessing, Director

LEGAL BRIEF
OCTOBER 2017

Two of this year's draft tax amendments are extremely contentious. These are the draft amendments in relation to:

> share buybacks; and
> the characterisation of offshore companies owned by offshore trusts as controlled foreign companies (CFCs) in certain circumstances, which characterisation impacts the taxation of distributions from the offshore trusts.

THE PROPOSED NEW SHARE BUYBACK RULES

The draft proposal was to include in disposal proceeds (whether on capital or revenue account) all exempt dividends received in an 18-month period prior to, as well as a result of, the disposal by a SA tax resident company of shares in another company in which it holds a substantial interest (certain thresholds are specified in this regard).

When the draft legislative amendments were published on the 19th of July 2017, this rule was announced as becoming effective immediately, and it was said to apply to all disposals on or after that date.

In the draft response document which was issued during mid-September by National Treasury and SARS, based on the report-back hearings to the Standing Committee on Finance, some concessions have been made, including:

> in order to deal with the retrospectivity of the announcement, arrangements which were finally agreed upon on or before 19 July 2017 will not be subject to these rules;
> not all dividends received during the preceding 18-month period will be deemed to form part of disposal proceeds, but only excessive dividends. The excessiveness (or not) of a dividend will be determined with reference to the amount of dividends received in the 18-month period as a percentage of the market value of the shares disposed of. The market value of the shares, in this regard, will be the higher of their market value 18 months prior to the disposal and their market value on disposal; and
> preference shares with a coupon of 15% or lower will not be subject to these rules.

Unfortunately, the draft response document is silent on certain important aspects, for example the issue as to why the rules apply to all disposals and not to buybacks.

THE CFC TREATMENT OF FOREIGN COMPANIES OWNED BY OFFSHORE TRUSTS

The draft amendments include in the definition of a CFC any offshore company if 50% or more of the participation rights or voting rights of that company are held by an offshore trust in which a South African tax resident holds an interest.

Another, but related, amendment provides that all distributions from these offshore trusts will be subject to full income tax in the hands of South African tax resident beneficiaries.

The draft response document addresses some concerns raised by the public in relation to the proposed, obviously problematical, draft amendments.

The Revenue Authorities give an indication that the rules will be revised to be more focussed on the mischief they seek to address. This indication was given in response to a comment that a threshold needs to be built into the level of interests which South African tax resident beneficiaries must hold before the trust becomes a tainted trust that could result in the underlying company being regarded a CFC.

It will be an interesting space to watch to see how a threshold is built into the interests in discretionary trusts. Discretionary trusts are by their very nature discretionary so that it is not possible to determine the interest of any one beneficiary.

It could, however, be that the Revenue Authorities are not contemplating the introduction of a threshold, but that they plan to introduce rules in terms of which the general CFC attribution *idea* will be applied. This could mean that amounts in the trust as shareholder of the CFC will be characterised with reference to what they were in the hands of the company.

Such characterisation can then be extended to the existing rules relevant to distributions from offshore trusts or the imputation of amounts to South African "donors" or settlors, which rules are based on the characterisation of the amounts in the trust. This could be why the draft response document indicates that care will be taken to avoid any duplication in taxes raised through the existing attribution rules applicable to "donors" or settlors and the existing rules for the taxation of distributions by foreign trusts to South African beneficiaries.

Two important questions raised by the draft amendment therefore remain unexplained:

> why offshore trusts holding underlying subsidiary-type companies are to be penalised compared to offshore trusts holding their investments directly; and
> why offshore companies that are held by foreign discretionary trusts in which South African residents hold an interest are characterised as CFCs if the CFC attribution rules are not applied, and are not capable of being applied, to these companies (no attempt was made to amend the definition of "participation rights", and quite clearly beneficiaries of discretionary trusts do not hold indirect participation rights in the underlying company).

The latter mystery could be explained by the draft response document's indication that the amendments will be focussed on the mischief which the Revenue Authorities seek to address, but it is not clear whether that is:

> the introduction of a threshold interest, which may signal an intention to, indeed, apply the CFC attribution rules; or
> the characterisation of the amounts in the offshore trust with reference to the nature of the amounts in the underlying company, so that, for example, distributions from an offshore trust out of a dividend funded by interest income earned by the underlying company, will be treated as (fully taxable) interest income in the hands of the beneficiary, and not as a potentially tax exempt dividend.

The above was the position at the time of writing the article. Hopefully by the time of publication the final response document will be available and hopefully the lacunas and uncertainties referred to above are addressed in the final response document.

MEET THE AUTHOR

DOELIE
LESSING

Title:	Director
Office:	Stellenbosch
Direct line:	+27 (0)21 809 6147
Switchboard:	+27 (0)21 809 6000
Email:	dlessing@werksmans.com

Doelie Lessing is a specialist in corporate Tax matters with specific emphasis on the tax issues associated with mergers and reorganisations of corporate entities; private equity deal structuring and black economic empowerment transactions. Her expertise extends to tax planning for international corporates, executives and wealthy families, tax structuring for local and international investment funds, Africa-specific investments and employee incentive plans. She has undertaken Tax-related Litigation, Alternative Dispute Resolution and settlements for a variety of clients.

Doelie is named amongst the world's leading private client lawyers in *Who's Who Legal*: Private Client 2014 and *Who's Who Legal* 2015 – Compendium Edition. She is also named as a highly-regarded practitioner in the *International Who's Who of Corporate Tax Lawyers* (2013), where the publication states that she is known for "delivering high-end work in a timely manner".

She is ranked as a leading lawyer in Tax by *Chambers Global* (2013,2014 and 2017), where the publication quotes sources noting that, "*she is very good technically and always up to date with the newest legislation*" and "*incredibly responsive, personable and pleasant to deal with*".

Doelie is further recognised in the International Tax Review's World Tax 2011 and is named as a leading practitioner in the 3rd and 4th Editions of Euromoney's Expert Guide to the World's Leading Women in Business Law.

Doelie is a member of the International Tax Planning Association. She is the co-founder and past chairman of the Society of Trust and Estate Practitioners (STEP), Cape Town and acts as external examiner for the Tax Masters course offered by the University of Cape Town. Doelie is the co-author of the South Africa chapter of the Practical Law Private Client Multi-jurisdictional Guide, 2014 edition.

She holds a BCom (Stellenbosch), an LLB (Stellenbosch) and an MCom (Tax) (with distinction) (Stellenbosch).

> Keeping you close for 100 years

The Corporate & Commercial Law Firm
www.werksmans.com

A member of the LEX Africa Alliance

ABOUT WERKSMANS ATTORNEYS

Established in the early 1900s, Werksmans Attorneys is a leading South African corporate and commercial law firm, serving multinationals, listed companies, financial institutions, entrepreneurs and government.

Operating in Gauteng and the Western Cape, the firm is connected to an extensive African legal alliance through LEX Africa.

LEX Africa was established in 1993 as the first and largest African legal alliance and offers huge potential for Werksmans' clients seeking to do business on the continent by providing a gateway to Africa.

With a formidable track record in mergers and acquisitions, banking and finance, and commercial litigation and dispute resolution, Werksmans is distinguished by the people, clients and work that it attracts and retains.

Werksmans' more than 200 lawyers are a powerful team of independent-minded individuals who share a common service ethos. The firm's success is built on a solid foundation of insightful and innovative deal structuring and legal advice, a keen ability to understand business and economic imperatives and a strong focus on achieving the best legal outcome for clients.