

**THE TAX IMPLICATIONS OF A PRIVATE EQUITY BUY-OUT: A CASE
STUDY OF THE BRAIT - SHOPRITE BUY-OUT.**

**by
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DECLARATION

This project is an original piece of work which is made available for photocopying and for inter-library loan.

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Patrick Mawire
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SUMMARY

This treatise examines the history of private equity as a context in which to understand its role in the economy and specifically, the background for the high profile leveraged buy-outs that have been entered into in the past year.

The treatise then focuses specifically on the Brait-Shoprite buy-out, examining its structure and the tax implications.

The treatise then reviews the reaction of the South African Revenue Authority (“SARS”) to the buy-out and evaluates whether it was the best approach that could have been taken under the circumstances.

As a result of the research, the following conclusions have been reached:

Private equity transactions

Private equity transactions have a role to play in the business world despite the apprehensions of tax authorities. The perception that these transactions are tax driven as part of an avoidance scheme is not justified.

Structure of the Shoprite buy-out transaction

- The Shoprite buy-out transaction was structured to obtain deduction for interest.
- The transaction was also structured to utilise the relief provisions of Part II of Chapter II (Special Provisions Relating to Companies) of the Income Tax Act no.58 of 1962, as amended (“the Act”). The relief was for capital gains tax (“CGT”) on disposal of the Shoprite assets.

Finally, the transaction was designed to allow the existing shareholders to exit their investments free of Secondary Tax on Companies (“STC”).

The reaction of SARS to the Shoprite buy-out transaction

Whereas SARS may have been justified in questioning the structure and its impact on fiscal revenue, the response in the form of withdrawing STC relief from amalgamation transactions in section 44 was not in the best interest of a stable tax system and the majority of tax payers who are not misusing or abusing loopholes in the income tax legislation.

It may have been possible for SARS to attack the structure based on the General Anti-Avoidance Rule (GAAR) in part IIA of the Chapter III of the Act.

KEY WORDS

Amalgamation transaction

Capital reduction

Capital repayment

Carrying on a trade

Distribution

Dividend *in specie*

Group of companies

In the production of income

Intra-group transaction

Leveraged buy-out

Private equity

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CHAPTER 1 - INTRODUCTION

Private equity funds have dominated the business landscape in the last few years. As private equity funds have entered into multi-billion dollar transactions, often resulting in substantial profit, calls have grown for fiscal authorities to change the way they are taxed. In the United States where private equity funds are mainly subjected to capital gains tax, there have been calls for profits from private equity transactions to be subjected to income tax.¹ Such calls intensified following the listing of US private equity giant, Blackstone from which the promoters stood to gain over US \$7bn.

South Africa has not been spared this debate, with SARS recently announcing that it was keenly watching developments in countries such as the United States, Britain and Australia with regard to the taxation of private equity funds². It is clear that whatever positions fiscal authorities take in these countries will soon be replicated in South Africa.

In South Africa, attention to the activities of private equity fund was ignited by, among other private equity transactions, the attempted buy-out of Shoprite Holdings Limited by private equity company Brait Private Equity, a private equity fund in a R13bn transaction.

In a statement³, which did not refer specifically to the Shoprite buy-out transaction, the Commissioner of the SARS criticised the aggressive structuring of transactions, alleging they were a threat to the country's revenue base.

Among the objections raised by SARS were:

¹ SARAH LUCEK, JESSE DRUCKER AND BRODY MULLINS 'Congress hunts for tax targets among the rich' *Wall Street Journal* 22 June 2007 © Dow Jones & Company Inc [online]

² SARS to wait a while on private equity taxes. *Business Report*. April 2, 2007 © Business Report 2007 [online]

³ Aggressive Tax Structuring. *Press statement issued by Pravin Gordhan: Commissioner South African Revenue Service* 10 January 2007

- a) The high gearing created by the transaction would lead to substantial interest deductions, leading to loss of revenue by the state.
- b) The rollover relief provided in sections 41 to 45 of the Income Tax Act No. 58 of 1962, as amended (“the Act”) were not meant to apply to transactions such as the Brait acquisition of Shoprite.

This treatise examines the background of private equity and investigates its commercial significance. The treatise then addresses the validity of the common perception that private equity transactions are tax driven.

Having established this background, the treatise then focuses on the Shoprite buy-out transaction in detail examining the structure of the transaction and the tax implications. The treatise also examines how the structure was influenced by tax strategy.

The information used in the treatise with regard to the structure was sourced from publicly available information, mainly the cautionary notices filed by Shoprite Holdings Limited with the JSE Limited. No confidential information was used in the preparation of this treatise.

Finally the treatise examines the reaction of tax authorities to the transaction.

CHAPTER 2 - BACKGROUND AND HISTORY OF PRIVATE EQUITY FUNDS

2.1 What is a private equity investment?

The private equity sector typically makes equity or equity linked investments in unlisted companies or in listed companies or parts of listed companies that are being turned into private companies. According to Katherine A. Cattanach, Mary Frances Kelly and Gail Sweeney⁴ these companies range from start-up enterprises to middle market firms to public firms needing private financing for specific projects. In some cases, private equity firms invest in companies where the listed shareholders are aiming to realise the value of their investment.

Private equity can be broadly classified into three subclasses⁵, namely:

- Venture capital
- Development capital
- Buy-out funding

Venture capital

Venture capital can either be funding for research, evaluation and development of a concept or business before the business starts trading (seed capital) or funding for new companies being set up for the development of those which have been in business for a short time (start-up and early stage capital), usually between one to three years.

⁴ Private Equity and Venture Capital *Journal of Private Portfolio Investment*, Volume 2, Number 1, 1999 © Euromoney Institutional Investor PLC [online]

⁵ Venture Capital and Private Equity Industry Performance Survey of South Africa covering the 2006 calendar year. *KPMG and SAVCA* May 2007 © KPMG Services (Pty) Ltd

Development capital

Development capital is funding for growth and expansion of a company which is breaking even or trading profitably.

Buy-out capital

Buy-out capital can either be “Leveraged buy-out or buy-in”. Buy-out capital is debt funding to enable a management team or empowerment partner, either existing or new, and their backers to buy from existing owners. Replacement capital is funding for the purchase of existing shares in a company from other shareholders through the stock market.

Unlike venture and development capital, the proceeds of buy-outs are generally paid to the previous owners of the entity.

The majority of private equity investment is directed at buy-outs with the remainder directed at venture capital. The Shoprite buy-out was a leveraged buy-out.

2.2 Development of private equity

Worldwide

Private equity has evolved from what was essentially the preserve of wealthy individuals and high net worth families in the early 1970’s to an asset class dominated by institutional investors.

The growth of private equity is inseparably linked to the emergence and growth of the information technology industry. The private equity market became very active with the commercialisation of microprocessors in the late 1970’s. This growth in private equity activity was mainly driven from the United States.

According to Katherine A. Cattanach *et al*, In the United States, two key events shaped the growth of the private equity industry.

- The passage of the Employee Retirement Income Security Act of 1974 (ERISA) (Pub.L. 93-406, 88 Stat. 829, September 2, 1974) which allowed pension funds to move out of bonds (generally government bonds) and high quality publicly traded shares into more aggressive investments
- The lowering of the capital gains tax rate, which triggered a resurgence in the stock market and made venture investing much more attractive to wealthy individuals and high net worth families.

Most pension funds were slow to allocate money to private equity immediately after the introduction of ERISA but the legislation gave much impetus to private equity.

In the mid to late 1980's, the stock market encountered a major correction including the famous Black Monday (19 October 1987). Whilst private equity had been focussed on venture capital in its early stages (the 1970's), the 1980's saw the emergence of buy-outs. The correction of the markets in the late 1980's refocused private equity funds away from venture capital which was considered too risky to buy-outs. Venture capital struggled to match the returns generated by buy-out funds.

Just as buy-outs were peaking in the late 1980's, the major buy-out funds ran into major problems with the collapse of Drexel Burnham Lambert ("Drexel"). Drexel was a major Wall Street investment banking firm, which first rose to prominence and then was driven into bankruptcy in the 1980s by its involvement in

illegal activities in the junk bond market, driven by Drexel employee Michael Milken. At its height, it was the fifth-largest investment bank in the United States⁶.

The subdued buy-out market was as a result of Drexel not providing leadership in raising junk bond capital to finance highly leveraged buy-out activity. Potential investors also become increasingly risk averse.

With the subdued activity, middle market buy-out slowly emerged as a distinct preference, replacing the huge highly leveraged buy-outs which had hitherto dominated the market.

As the markets stabilised in the early to mid 1990's, venture capital slowly regained favour among institutional investors. Mega buy-outs returned to prominence, driven by the renewed enthusiasm for mega mergers and acquisitions. This was however accompanied by less leverage.

This was followed by the “dot.com” explosion in the information technology sector in which start-up with even moderate prospects of commercial success could attract substantial private-equity investment.

With the bursting of the “dot.com bubble” in the early twenty-first century, the markets looked increasingly fragile. This provided more impetus for public funds, corporate pension funds and foundations to increase their allocations to private equity. The objective was to tap into the higher returns generated by private equity investments over time.

⁶ STONE, DAN G. (1990). *April Fools: An Insider's Account of the Rise and Collapse of Drexel Burnham*. New York City: Donald I. Fine. ISBN 1556112289.

The number of private equity funds is estimated to have grown from 610 in 1990 to 9 575 in the first quarter of 2007 with assets of over US\$1 600bn (R11 000bn). Private equity fundraising reached record levels in 2006 with estimates of US\$432bn (R3 000bn) in committed funds.⁷

South Africa

In South Africa, the private equity was boosted by the large number of leveraged and management buy-outs in the 1980's. This activity was the result of the widespread divestment of multinationals from the country at the height of apartheid. These transactions were structured, financed and managed by major commercial, merchant and investment banks.

The widespread involvement of local banks went against the global trend in the United States and Europe toward s the formation and management of private equity funds whose capital was sourced from third party investors such as pension funds and other institutional investors.

As apartheid fell away in the mid 1990's, there was a renewed need for financing for South African companies wishing to expand into newly accessible markets. In addition, the advent of Black Economic Empowerment saw the emergence of private equity as a major source of funds for empowerment transactions⁸.

During this time, there was a clear separation of private equity funds into captive funds, run by banks and other financial

⁷ MARTIN WOLF The new capitalism – How unfettered finance is fast reshaping the global economy' *Financial Times* 19 June 2007 © 2007 The Financial Times Limited [Online]

⁸ Big Appetite for SA Private Equity, *Financial Mail* 19 May 2007 © BDFM Publishers [Online]

institutions as in-house investment arms and independent funds. Among the major captives were ABSA Capital, Nedbank Capital Private Equity and RMB.

Captives dominate the South Africa private equity market with a 61% share. The figure includes the share of government captives such as the Industrial Development Corporation (IDC) at 18% and other non financial institution captives at 12%.

Independents hold the remaining 39%. Major independents include Brait, Actis, Bain Capital and Ethos.

Locally, it is estimated that the private equity industry boasted funds under management of R56.2bn at the end of 2006. This was an increase of 32% from the year 2005⁹.

The year 2006 saw the private equity industry's two biggest ever deals at the time. The R16bn buy-out of Venfin by Vodadone UK and the R5.4bn acquisition of building company Waco International by CCMP capital Asia.

This was followed in 2007 by the country's biggest deal, the R33bn leveraged buy-out of Edcon by Bain Capital. Edcon subsequently delisted from The Johannesburg Stock Exchange ("JSE"). Also complete was the R6.2bn buy-out of glass manufacturer Consol in which Bain Capital was once again involved.

These transactions were closely followed by the announcement of the proposed R15.2bn leveraged buy-out of Shoprite Holdings by Brait. It was at this point that, as will be discussed in the later,

⁹ Venture Capital and Private Equity Industry Performance Survey of South Africa covering the 2006 calendar year. *KPMG and SAVCA* May 2007 © KPMG Services (Pty) Ltd

both the National Treasury and SARS took notice and stated that the leveraged buy-outs were threatening fiscal revenues¹⁰.

¹⁰ Business Report '*SARS to wait a while on private equity taxes*' April 3, 2007 © Business Report 2007 [Online]

CHAPTER 3 - BUSINESS REASONS FOR LEVERAGED PRIVATE EQUITY BUYOUTS

Before considering the tax implications of private equity buy-outs such as the Shoprite buy-out transaction, it is worth examining the various justifications that have been used by companies to enter into private equity transactions. This examination will put into context any apprehensions that the public, SARS and the treasury may have. Rather than just being motivated by tax savings, supporters of the industry have argued that it is an indispensable part of commerce and has a wider benefit for the economy.

3.1 Long-term focus in investments

It is often stated that management of public companies are constrained by the expectations of shareholders to produce quarterly or half-yearly results. As such, management can look no further than the next six months.

This argument was used to justify the leveraged buy-out of Edcon by Bain. Management of Edcon stated that they had been spurred into action by the consistent underrating of Edcon stock on the JSE.¹¹ The final purchase price paid by the private equity investor of R46/share, 53% above the share price before the offer was cited as proof of the markets undervaluation. It was argued that the private equity investors were able to offer a higher price as they had a longer term focus.

¹¹ Private Equity Finds New Ark in South Africa, *Financial Mail* © Financial Mail 18 May 2007 [Online]

3.2 **Increased efficiency**

It has been argued that because of the high leverage that buy-outs bring, managers are forced to maximise the available resources in order to optimise returns. In contrast, it is argued that most public companies are cash-flush and do not see any need to optimise the use of resources¹².

One of the hallmarks of private equity is stated as the ability to keep idle cash to an absolute minimum. Robert C Prozen also argues that the cash hoard can tempt managers to engage in ill considered transactions. This he argues is not the case with private equity run business which typically have to service higher interest liabilities or raise their cash dividends.

3.3 **Optimisation of capital structure**

Robert C Prozen also argues that closely related to the high cash levels of public companies are their relatively low ratios of debt to equity. Private equity funds are well known for increasing debt and reducing equity in companies they acquire.

However, many public company executives resist increasing the leverage ratios of their companies. For them, increased leverage, threatens the credit ratings on the company's debt. In turn, that lower credit rating will substantially increase the company's borrowing costs. A combination of the increased leverage and the lower credit rating will be to substantially decrease the appeal of the company's shares to public investors.

¹² ROBERT C PROZEN, If private equity sized up your business, *Havard Business Review* © 2007 by the President and Fellows of Havard College

Defenders of private equity argue that whilst it is true that leverage beyond a certain point will lead to a lower credit rating for the company's debt, the increase in borrowing costs for lower credit ratings has been modest until the recent turmoil in the debt markets. More important, investors in public companies have become comfortable with firms that have higher leverage ratios.

3.4 **Increase in shareholder value**

While increased leverage has contributed to the success of private equity, improved operating performance of acquired companies has been more important.

3.5 **Maximising executive performance**

Proponents of private equity claim one of the distinguishing characteristics of private equity funds is how they compensate the top executives of the companies they control. It is often the case that the private equity buy-outs also involve management buy-outs. As such, the equity stakes held by senior management in these companies are much larger than in public companies.

When Steven Kaplan studied the matter, he estimated that the stock interest of CEO's increased by four times when a company was acquired by private equity¹³.

¹³ STEVEN N KAPLAN, ANTOINETTE SCHOAR (2005), Private Equity Performance: Returns, Persistence, and Capital Flows, *The Journal of Finance* 60 (4) [Online]

The Shoprite buy-out included a significant management buy-out portion. It was argued by the promoters that this would optimise management performance by fostering a sense of ownership.

Given the above commercial reasons for private equity transactions most of which were argued for the Shoprite buy-out, the following chapter examines the structure of the Shoprite buy-out in greater detail.

CHAPTER 4 - STRUCTURE OF THE SHOPRITE BUY-OUT TRANSACTION

In its cautionary announcement to the JSE, Shoprite indicated that it was pursuing an amalgamation transaction (“amalgamation”) as envisaged in section 44 of the Act¹⁴. The general steps were as follows:

1. Create a New Operating Company (“New Opco”) capitalised by Brait with debt and equity.
2. Create a New Retail Company (“New Retail”)
3. New Opco acquires assets of Shoprite Checkers (Pty) Ltd (“Shoprite Checkers”).
4. Shoprite Checkers distributes proceeds consisting of New Opco R11,900mn debentures and R700mn equity to Shoprite Holdings Ltd (“Shoprite”) as a dividend *in specie*
5. New Retail acquires Shoprite’s assets and liabilities in an amalgamation as envisaged in section 44 of the Act (“the internal re-organisation”).
6. Shoprite distributes New Retail shares to Shoprite shareholders as a dividend in specie (“distribution”).
7. Shoprite delisted from the JSE (“the delisting”)
8. Shoprite liquidated (“the liquidation”)
9. New Retail capital reduction payment of R25.99 to its shareholders (“the capital reduction”).

The above steps are illustrated in Appendix 1 and examined in detail below:

¹⁴ Internal Re-Organisation, In Specie Distribution, Delisting, Liquidation and Further Cautionary Announcement, *Shoprite Holdings Limited*, 26 November 2006

4.1 Steps 1 to 5 – The internal re-organisation

Step 1

The first step was the creation of New Opco a 100% private subsidiary of Shoprite Checkers. Shoprite Checkers being a 100% operating subsidiary of Shoprite.

New Opco would be funded by R9 464 million debt sourced from domestic and international markets and R2 536 million equity contributed by Brait, a Broad Based Black Economic Empowerment consortium, management, re-investing shareholders and the underwriters. This would give the company a gearing of almost 80%, which is typical of leveraged buy-outs.

Step 2

Create New Retail Company (“New Retail”) a subsidiary of Shoprite.

Step 3

Shoprite Checkers would dispose of its business to New Opco in exchange for approximately R11 900 million in New Opco debentures and R700 million in New Opco equity.

Step 4

Shoprite Checkers would distribute this consideration to Shoprite as a dividend *in specie*.

Step 5

Subsequent to the transfer by Shoprite Checkers to New Opco and the declaration of the dividend to Shoprite, Shoprite would dispose of the entire undertaking of Shoprite to New Retail including:

- It's entire business as a going concern
- All assets and liabilities

The disposal to New Retail would be for approximately R13 191 million in exchange for New Retail ordinary class B shares with a par value of 0.1 cent in the issued share capital of New Retail ("New Retail class B shares") issued at **R26.00** per share. These shares would be held as an asset in Shoprite.

Rationale for the internal re-organisation

According to the cautionary announcement, the internal re-organisation would have enabled Shoprite to:

- realise a more efficient capital structure;
- facilitate the injection of gearing in an efficient manner;
- facilitate the introduction of a Black Economic Empowerment ("BEE") partner into the business; and
- implement a new capital structure that would realise value for shareholders and allow them to consider their investment alternatives.

Anticipated tax consequences

In order for the internal re-organisation to benefit from the relief provided by Section 44, it was envisaged that it would need to meet a number of requirements including, inter alia, taking the required steps for the liquidation and/or deregistration of

Shoprite within six months of the internal re-organisation or such extended period as SARS would allow ("allowed period").

If Shoprite did not, or was unable, to take the required steps for the liquidation and/or deregistration of the company within the allowed period, and Brait together with the board of Shoprite agreed to waive the condition precedent relating to Section 44, the internal re-organisation and the distribution would proceed outside of Section 44 and the tax relief provided therein.

If ordinary shareholders did not pass the special resolution in respect of the liquidation and/or deregistration of the company, it was expected that STC on the dividend in specie portion of the distribution would be applicable and the value distributed to ordinary shareholders by means of the New Retail class B shares would be reduced by the STC payable of approximately R2.69 per share from R26.00 to R23.31 per New Retail class B share.

The consequence of receiving a New Retail class B share of R23.31 per share is that the New Retail capital reduction would also be reduced from R25.99 to R23.30 and the cash portion of the New Retail capitalisation right paid to New Retail class B shareholders accepting the New Retail capitalisation right ("the capitalising shareholders") would be reduced from R205.85 to R178.95 for every ten eligible New Retail class B shares.

4.2. The distribution.

The next step was a capital reduction and payment of a dividend *in specie* on the Shoprite ordinary shares ("ordinary share(s)"), in terms of which Shoprite ordinary shareholders ("ordinary

shareholders") would receive one New Retail class B share for every ordinary share held. The New Retail class B shares would be distributed to ordinary shareholders as a capital reduction and/or payment of a dividend in specie in terms of Section 90 of the Companies Act, 1973.

4.3 The delisting

As Shoprite's only asset at the time (New Retail class B shares) would have been distributed to the shareholders, it would have no assets and its shares would then be delisted from the Main Board of the JSE

4.4. The liquidation

Devoid of any assets at this stage, Shoprite would be liquidated within 6 months of the re-organisation as required by section 44 of the Act.

The above steps 1-4 would collectively constitute "the amalgamation" for purposes of Section 44.

4.5 New Retail Capital reduction Repayment and Capitalisation Right

After the completion of the distribution, New Retail was obliged, under its Articles of Association, to make a capital reduction payment in the amount of R25.99 per New Retail class B share to all New Retail class B shareholders ("the New Retail capital reduction");

In terms of the “New Retail Capitalisation Right”, eligible New Retail class B shareholders were granted the opportunity to elect to receive, in lieu of the New Retail capital reduction payment, a combination of cash, New Opco debentures and New Retail class A shares. New Retail class A shares had significantly higher voting rights attached to them.

The New Retail Capitalisation Right was offered to all eligible New Retail Class B shareholders to receive for every ten (10) eligible New Retail Class B shares held, in lieu of the New Retail capital reduction payment:

- A cash payment of R205 (or R178.95 if the transaction did not proceed in terms of section 44 and was subject to STC)
- One New Opco debenture issued at R28.49; and
- One New Retail class A capitalisation share (with a par value of R2.56) issued at R25.56.

CHAPTER 5 - TAX OBJECTIVES OF THE SHOPRITE BUY-OUT STRUCTURE

Commercially, the Shoprite buy-out transaction was a typical leveraged buy-out. It faced several tax implications as follows:

5.1 Deduction of interest

Debt and equity were introduced into the company with the objective of buying out the existing shareholders and optimising the deductions for the interest resulting from the high leverage. The high leverage being a hallmark of private equity transactions which aim at achieving an optimal capital structure that minimises equity and maximises debt. With this leverage however came high interest charges which would have possibly been disallowed for tax purposes.

5.2 Capital gains tax

Shoprite's disposal of assets would have given rise to CGT.

The disposal of any asset is subject to capital gains tax under the provisions of the Eighth schedule of the Act. A disposal is defined in paragraph 11 as:

“(1) Subject to subparagraph (2), a disposal is any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset, and includes—

(a) the sale, donation, expropriation, conversion, grant, cession, exchange or any other alienation or transfer of ownership of an asset;

(b) the forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry or abandonment of an asset;”

An asset is defined in paragraph 1 as including:

“(a) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and

(b) a right or interest of whatever nature to or in such property;” (Emphasis mine)

The disposal of Shoprite Checkers operating assets to Brait would therefore have given rise to a capital gain in terms of paragraph 11 of the Eighth Schedule read with the definition of an asset in paragraph 1. Any capital gain on disposal of an asset would be included in Shoprite Checkers’ the taxable income in terms paragraph 26A of the Act. Section 26A states that:

“There shall be included in the taxable income of a person for a year of assessment the taxable capital gain of that person for that year of assessment, as determined in terms of the Eighth Schedule.”

The challenge of the transaction was to achieve a structure that would ensure that the incidence of CGT was mitigated.

5.3 Secondary tax on companies (“STC”)

The proceeds of the disposal accrued to the shareholders and a tax efficient method had to be found to facilitate the exit of the

existing Shoprite shareholders from their investment in the company. If the exit of the investment was either a dividend or a capital distribution, tax liability would arise in the form of STC for dividends or CGT for capital distributions.

5.4 Value Added Tax (“VAT”)

The disposal would also have given rise to VAT liability which is imposed on the supply of goods and services by a registered vendor in the republic. Section 7(1) of the Value Added Tax Act 89 of 1991, as amended (“the VAT Act”) states that:

“Subject to the exemptions, exceptions, deductions and adjustments provided for in this Act, there shall be levied and paid for the benefit of the National Revenue Fund a tax, to be known as the value-added tax-

a) on the supply by any vendor of goods or services supplied by him on or after the commencement date in the course or furtherance of any enterprise carried on by him”

A supply is defined in section 1 of the VAT Act as:

““supply” includes performance in terms of a sale, rental agreement, instalment credit agreement and all other forms of supply, whether voluntary, compulsory or by operation of law, irrespective of where the supply is effected, and any derivative of “supply” shall be construed accordingly;”

The definition of a supply is all inclusive and will cover most transactions. In *VAT in South Africa*¹⁵ AP de Koker & D Kruger state that:

“It would appear from the definition in the Act that a ‘supply’ is intended to cover almost every conceivable type of transaction. The Oxford English Dictionary defines ‘to supply’ as ‘to furnish’ or ‘to provide’; essentially, therefore, the making available to another person of an identifiable asset or service constitutes a ‘supply’.”

As indicated above, almost every conceivable type of transaction would constitute a supply. The disposal of business by Shoprite to Brait would constitute a supply subject to VAT.

It is worth noting that in terms of section 8(25) of the Vat Act, a special rule applies where goods or services are supplied by one vendor to another under a company formation transaction, an amalgamation transaction, an intra-group transaction or a liquidation, winding-up and deregistration as set out in Part III of Chapter II of the Act (“corporate rules”). The rule deems the vendors, for purposes of that supply or subsequent supplies, to be the same person. Effectively, therefore, no VAT needs to be levied on supplies under the corporate rules.

The following chapters examine each of these challenges in detail and also examine how the transaction was structured to mitigate these tax risks. The challenges of achieving these objectives are examined with reference to legislation and case law.

¹⁵ DE KOKER AP & KRUGER D, *VAT in South Africa* ©Lexis Nexis – Butterworths [electronic]

CHAPTER 6- HIGH LEVERAGE AND DEDUCTION OF INTEREST

The introduction of debt into New Opco gave rise to the prospect of interest charges. With the leverage at 80%, it is clear that interest expenses would be a significant charge against the company's income. This is a common feature of private equity transactions. In its first reporting period following its leveraged buy-out, Edcon reported a substantial net loss after interest, as opposed to a net profit after interest in previous years¹⁶.

Ideally if Brait was to avoid non-deductible interest, it had to show that all borrowings had been raised in order to generate "income". Alternatively, Brait had to show that it had not borrowed in order to acquire "non-income earning" assets such as investments in shares etc.

6.1 Deductibility of Interest

Interest is consideration for the use of money. The term is not defined in the Act.

Silke ¹⁷ states that:

"Save for the specific inclusions in the definition of 'interest' in s 24J(1) (see § 17.63), the term 'interest' is not statutorily defined. In its ordinary connotation it is consideration for the use of money. In Riches v Westminster Bank Ltd, Lord Wright described the essential nature of interest in a manner broadly applicable to all payments received for the use of money:

¹⁶ Edcon feels the first pangs of private equity deal, *Business Report*, 2 December 2007 © Business Report

¹⁷ DE KOKER AP *Silke on South African Tax* 2007 on 7.34 © LexisNexus Butterworths [Electronic]

‘ . . . the essence of interest is that it is a payment which becomes due because the creditor has not had his money at the due date. It may be regarded either as representing the profit he might have made if he had the use of the money, or, conversely, the loss he suffered because he had not that use. The general idea is that he is entitled to compensation for that deprivation.’

Prior to 1 January 2005, section 24J of the Act – *Incurral and accrual of interest* was not a charging section. It did not allow the deduction of interest incurred, or result in an inclusion in income in respect of interest earned, it merely determined the amount of interest incurred or accrued in a particular tax year. In other words it regulated the timing of the interest deduction or inclusion in income. The deductibility of interest was determined in terms of the general deductions contained in section 11(a), section 11(bA) or section 11(bB).

In 2004, Section 24J(2) was amended by section 24(1)(h) of Act 32 of 2004. It now states the following:

- “2) *Where any person is the issuer in relation to an instrument during any year of assessment, such person shall for the purposes of this Act be deemed to have incurred an amount of interest during such year of assessment, which is equal to--*
- a) the sum of all accrual amounts in relation to all accrual periods falling, whether in whole or in part, within such year of assessment in respect of such instrument; or*

- b) *an amount determined in accordance with an alternative method in relation to such year of assessment in respect of such instrument;*

which must be deducted from the income of that person derived from carrying on any trade, if that amount is incurred in the production of the income;” (my emphasis)

For the purposes of section 24(J), “issuer” is the borrower as defined in section 24J(1):

“issuer”, in relation to any instrument--

- a) *means any person who has incurred any interest or has any obligation to repay any amount in terms of such instrument; or;*
- b) *at any particular time, means any person who, if any interest payable in terms of such instrument was due and payable at that time, would be liable to pay such interest;”*

The only requirements that this section imposes is that:

- the issuer (Brait) must have income derived from carrying on a trade against which the interest must be deducted, and
- such interest incurred must be incurred in the production of income

The term “instrument” is defined in section 24J(1) as:

“instrument” means any form of interest-bearing arrangement, whether in writing or not, including--

- a) *any stock, bond, debenture, bill, promissory note, certificate or similar arrangement;*
- b) *any deposit with a bank or other financial institution;*

- c) *any secured or unsecured loan, advance or debt;*
- d) *any acquisition or disposal of any right to receive interest or the obligation to pay any interest, as the case may be, in terms of any other interest-bearing arrangement; or*
- e)..."

Therefore, for Brait as an issuer of an instrument as defined (the funds borrowed for investment in Shoprite) to obtain a deduction for interest incurred, it had to show the existence of income from carrying on a trade.

Once this was proven, Brait had to show that the interest that it would seek a deduction for would arise from the production of income.

The trade requirement (carrying on a trade) and the production of income are examined in detail below. The manner in which the Shoprite buy-out was structured to meet these requirements is also discussed.

6.2 **Carrying on a trade**

The first requirement for deduction of interest under section 24J(2) is that the interest must be deducted from income derived from carrying on a trade. The word trade is defined in section 1 of the Act as:

“trade” includes every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent as defined in the Patents Act, 1978 (Act No. 57 of 1978), or any design as defined in the Designs Act, 1993 (Act No. 195 of

1993), or any trade mark as defined in the Trade Marks Act, 1993 (Act No. 194 of 1993), or any copyright as defined in the Copyright Act, 1978 (Act No. 98 of 1978), or any other property which is of a similar nature

Whereas the term trade is extensively defined in section 1 of the Act, little light is shed in the Act as to the meaning of carrying on a trade.

One has to turn to the courts which have dealt with the question of whether a taxpayer's activity amounts to carrying on a trade.

In *Modderfontein Deep levels Ltd v Feinstein, 1920 TPD 288*, a mining company from time to time bought articles of clothing and resold them to their employees from a store in the premises without making a profit. The court ruled that making a profit was not the essence of trading. The Company was "carrying on a trade" within the meaning of the respective Act. Per **Wessels J**

"The essential idea underlying trade is buying and selling. We may say with certainty that if a person buys and sells with the intention of making a gain or a profit out of his transaction, he is carrying on a trade. He may however be carrying on a trade even if he does not contemplate a profit."

...

No doubt as a rule a trade or business is carried out for the purpose of making a profit, but profit making is not of the essence of trading."

In *ITC 1275 – 40 SATC 197*, the court dealt with a taxpayer who derived income from investments and sought to deduct expenditure against that income. Per Van **Winsen J** on page 199

"The law does not allow a taxpayer who derives a portion of his income from investments to deduct from his income expenses he

incurs in watching over those investments, however wisely incurred those expenses may be.”

In *ITC 1385 (1984) 46 SATC 111(T)*, the court dealt with a taxpayer who sought a deduction for a loss incurred in renting out a house. Commissioner allowed deduction to the extent of rental income derived. Commissioner argued that there was no reasonable prospect of appellant earning a profit. Whilst the court found against the taxpayer, the court stated that the appellant’s bleak prospects of earning a profit was not per se decisive against him. Per **Nestadt J**, on page 115,

“It is, however, unnecessary to pursue this matter. I assume that appellant’s bleak prospects of earning a profit are not per se decisive against him. Nevertheless taking them into account, together with certain other considerations, we are of the opinion that he has failed to show that the expenditure which is sought to be deducted was laid out wholly or exclusively for the purposes of trade”.(My emphasis)

The attainment of profit is therefore not necessarily the hallmark of a trading transaction (**Corbett JA** in *De Beers Holdings (Pty) Ltd v CIR 1986(1) SA 8, 47 SATC 229* at page 254).

In *Burgess v CIR 55 SATC 185(A) 1993*, the taxpayer entered into what was known as a “Fenton scheme” in which he borrowed money from the bank which was invested in shares. The shares would later be sold at a substantial profit and the bank repaid. The taxpayer reduced the risk of the transaction by taking up an endowment policy. The endowment policy however had a lower rate of interest than loan, leading to a possibility of a loss if the gain on the shares was insufficient. Unfortunately, the stock

markets crashed in October 1987 and the scheme failed. The taxpayer realised which he claimed loss as a deduction.

The issue before the Appellate Division was whether the deduction of interest claimed by appellant was permissible in terms of the general deduction formula laid down in s 11(a) of Act 58 of 1962 and the first main issue on appeal was whether the Special Court had been correct in its view that appellant had not shown that the expenditure had been incurred in the production of income derived by him *'from carrying on any trade'* within the meaning of s 11(a).

The Commissioner contended that there were two reasons why appellant's activities could not be regarded as the carrying on of a trade.

The first was that appellant's actual purpose in making the investment was to reap the reward flowing from the fiscal advantages and the possibility of the scheme generating a commercial return was contemplated but was merely incidental. In short, on the facts properly construed, appellant did not engage in a trade, the scheme being nothing more than a tax engineering device and the fiscal advantage was the tax deferment arising from the difference in time between the accrual of the liability to pay interest to the bank and the accrual of the benefits under the endowment policy.

The Commissioner also advanced the argument that although the appellant's main purpose in entering into the scheme was to earn a profit, nevertheless "an investment" of the nature in question will not, as a matter of law, and on the common cause of facts amount to the carrying on of a trade.

The sole question before the court therefore was whether the taxpayer was carrying on a trade. The Commissioner did not invoke the anti-avoidance provisions then set-out in section 103 of the Act.

The court found that although there was an expected benefit by reason of the tax deferment, this arose from the very nature of the transaction viz that interest became due before any profit was realized and it was not something which was contrived in an artificial way. If a taxpayer pursues a course of conduct which, standing on its own, constitutes the carrying on of a trade, he would not cease to be carrying on a trade merely because one of his purposes, or even his main purpose, in doing what he does is to obtain some tax advantage; if he carries on a trade his motive for doing so is irrelevant.

Referring to the definition of “trade” in section 1, the court further stated that it is well-established that the definition of ‘trade’ should be given a wide interpretation and includes a ‘venture’ being a transaction in which a person risks something with the object of making a profit.

Per **E M Grosskopf JA** on page 195 of 55 SATC 185;

“...If a taxpayer pursues a course of conduct which, standing on its own, constitutes the carrying on of a trade, he would not, in my view, cease to be carrying on a trade merely because one of his purposes, or even his main purpose, in doing what he does is to obtain some tax advantage. If he carries on a trade, his motive for doing so is irrelevant.”

Addressing the question of whether the word “trade” should be given a wider rather than narrower definition, **E M Grosskopf JA** stated on page 196 of 55 SATC 185 that:

“It is well-established that the definition of trade, which I have quoted above, should be given a wide interpretation. In ITC 770(1953) 19 SATC 216 at p 217 Dowling J said, dealing with the similar definition of ‘trade’ in Act 31 of 1941, that it was ‘obviously intended to embrace every profitable activity and . . . I think should be given the widest possible interpretation.’

In the present case the appellant argued that its participation in the Fenton scheme amounted to a ‘venture’ which is included in the definition of ‘trade’. In ITC 368(1936) 9 SATC 211 at p 212, ‘venture’ is defined as ‘a transaction in which a person risks something with the object of making a profit’. This is borne out by dictionary definitions. Thus The Oxford English Dictionary (2 ed) gives as the appropriate definition ‘an enterprise of a business nature in which there is considerable risk of loss as well as chance of gain; a commercial speculation.’ Webster’s Third New International Dictionary gives ‘a business enterprise of speculative nature.’ See also the definitions quoted in ITC 1476(1989) 52 SATC 141 at p 148. In the Afrikaans text of the Act s 11 speaks of a ‘bedryf’ which is defined to include, inter alia, ‘elke professie, handelsaak, besigheid, diens, beroep, vak of onderneming’. The word ‘onderneming’, which corresponds to ‘venture’ in the English text, seems in general somewhat wider although it is capable of bearing the same meaning. Thus it is translated in Bosman, Van der Merwe and Hiemstra, Tweetalige Woordeboek, as, inter alia, ‘venture, risky undertaking’.

Now in the present case the appellant clearly, in my view, undertook a venture in the above sense. He laid out the money

required to obtain a bank guarantee, and risked the amount of the guarantee, in the hope of making a profit. It was a speculative enterprise par excellence.

In the judgment of the Special Court and the argument on behalf of the Commissioner some doubt was cast on whether the appellant himself realized the risks inherent in the scheme. In my view this does not matter. An undertaking does not in my view cease to be a venture merely because the person pursuing it is of a sanguine temperament.

In conclusion on this point I must make it clear that although an element of risk is included in the concept of a 'venture' in its ordinary meaning, I must not be taken to suggest that a scheme like the present would only constitute a 'trade' if it is risky. Whether it would or not would depend on its own facts. If there is no risk involved, it might still be covered by giving an extended meaning to 'venture' or by applying the rest of the definition, which is in any event not necessarily exhaustive.

The courts interpretation of carrying out a trade is vital for private equity transactions as in most cases, the entities in which they invest operate at a substantial loss because of the high gearing. With reference to the above cases, there is no danger that interest would not be deductible in terms of the requirement in section 24J(2) on the basis that the venture or business did not give rise to a profit and consequently, did not amount to carrying on a trade.

6.3 In the production of income

The second requirement for deduction of interest under section 24J(2) is that the must have been incurred in the “*production of*

income". The phrase is not defined in the Act. However, the courts have dealt with the meaning of the phrase in the context of the general deduction formula set out in section 11(a) of the Act. It is submitted that the interpretation of the phrase in section 24J(2) is identical to the interpretation given by the courts to section 11(a).

Meyerowitz¹⁸ states that:

"Expenditure per se does not produce income. Income is produced by actions, and the question whether expenditure has been incurred in the production of income must be answered by examining the act which produces the income and then judging whether the attendant expenditure can be said to be sufficiently closely linked to that act to be regarded as having been incurred in the production of income (Port Elizabeth Electric Tramway Co Ltd v CIR [93]). If expenditure is an 'inevitable concomitant' of the taxpayer's income-producing operations, it is regarded as being incurred in the production of income (Joffe and Co (Pty) Ltd v CIR [94])." (My emphasis)

'Income' is defined in section 1 of the Act as:

"the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax under Part I of Chapter II;"

Given the definition of income above, a taxpayer can only claim expenditure incurred in producing income that is subject to taxation. Conversely, expenditure incurred in producing exempt income is not deductible.

¹⁸ MEYEROWITZ D *Income tax cases and materials* – Electronic Meyerowitz on 7.1

The question of whether expenditure was incurred in the production of income was considered in *Port Elizabeth Electric Tramway Co Ltd v CIR, 1936 CPD 241, 8 SATC 13*. The taxpayer concerned was a transport company whose driver of one of its cars lost control of the vehicle, which ran into a building, and as a result of which driver suffered injuries and eventually died. The company was compelled to pay compensation and the legal costs incurred when it contested the claim of the deceased's representatives.

In passing his ruling, **Watermeyer AJP** stated on page 16 that:

“The purpose of the act entailing expenditure must be looked to. If it is performed for the purpose of earning income, then the expenditure attendant upon it is deductible.”

He further stated on page 17 that:

“The other question is, what attendant expenses can be deducted? How closely must they be linked to the business operation? Here, in my opinion, all expenses attached to the performance of a business operation bona fide performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are bona fide incurred for the more efficient performance of such operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it.”

The court held that while the compensation paid was incurred in the production of income, the legal costs incurred in resisting the claim were not. The employment of drivers was necessary for the carrying on of the business and carried with it as a necessary consequence, potential liability to pay compensation if those

drivers were involved in an accident, regardless of their negligence. The compensation paid could be regarded as being so closely connected to the income earning acts from which the expenditure arose as to form part of the cost of performing it.

The legal fees were however incurred to defend the company against a demand for compensation. They were not incurred for the purpose of earning income and were therefore not deductible.

Commenting on this decision, R C Williams¹⁹ states that:

“This decision is the locus classicus on the interpretation of section 11(a). Watermeyer AJP held that the section imposes two tests, one subjective (whether the purpose of the taxpayer in the performance of the act which entailed the expenditure, was to produce income), and the objective (whether the expenditure was so closely linked to that act as to be regarded as part of the cost of performing it) – in short, a subjective purpose test and an objective nexus test.

Of critical importance in applying the tests was to identify ‘the act which entailed the expenditure

...

However, it seems that in Port Elizabeth Electric Tramway, when Watermeyer referred to ‘the purpose of the act entailing the expenditure’ he meant the subjective purpose of the taxpayer, and that when he spoke of the requirement that the expenditure be ‘closely connected with the [business operation]’, he meant the objective link between the two.”

¹⁹ WILLIAMS R C (2005) *Income Tax in South Africa, Cases and Materials*, Second Edition, Durban, © LexisNexis Butterworths 2005

As the learned author observes, the test of the purpose of the act entailing the expenditure involves a subjective test in which the taxpayer's state of mind is examined to determine if his intention in engaging in the act entailing the expenditure was to give rise to income. Once this state of mind or intention is established the act itself must be examined to determine if there is a sufficient nexus between the act and the expenditure incurred.

The subjective test of purpose was the subject of *Sub-Nigel Ltd v CIR, 1948 (4) SA 580 (A), 15 SATC 381* in which the appellant company, which carried on the business of mining for gold, had made a practice of taking out policies against loss occasioned by fire. The company insured against loss of net profits and standing charges. Among others, insurance was taken out for the net profit to ensure protection of dividend rate. Insurance in respect of standing charges was also taken out to ensure that company was able to carry out essential services, despite the cessation of mining activities.

The commissioner disallowed the deduction of the premium on the basis that as the expenditure of the amounts by way of premiums produced no income, such expenditure was not incurred in the production of the income and was therefore not deductible. The Commissioner argued that the wording of section 11(a), which is identical to section 24J(2), refers to "the production of **the** income". The Commissioner argued that the sense of the particular clause "the" in the provision should be interpreted to mean that the act entailing the expenditure has to be directly connected to the income.

The issue before the court was therefore whether the insurance premiums were so closely connected to the income as to have

been expended in the production of income, and whether they constituted expenditure of a capital nature.

With regard to the first question which is relevant for the purpose of section 24(J), the court disagreed with the Commissioner and found that any amount received under the policies would constitute a trading receipt and consequently the expenditure on the premiums had been laid out or expended for the purposes of the Company's trade. In passing his judgement, **Centlivres JA** stated on page 394 that:

“It seems to me clear on the authorities that the Court is not concerned whether a particular item of expenditure produced any part of the income: what it is concerned with is whether that item of expenditure was incurred for the purpose of earning income.

...

The mere fact that no income has actually resulted is, in my view, irrelevant: the purpose was to obtain income on the happening of a fire which would prevent the carrying on of income-producing operations. There can, to my mind, be no doubt that, if a fire had occurred, the proceeds paid by the Company's insurer in respect of the policies ensuring net profits would have been of a non-capital nature and would therefore have had to be included in the Company's “gross income” as defined by sec 7 of the Act.”

In passing this ruling therefore, Centlivres established the principle that with regard to the production of income one must consider the subjective test, being the purpose for which the expenditure is incurred independently of whether this purpose actually led to the production of income. As long as the taxpayer can show that the purpose for which the expenditure was incurred was the production of income, it does not matter

whether the expenditure actually led to the production of income. It is submitted that the expenditure, in this case interest, would still have been incurred in the production of income as required by section 24(J).

The objective test set out in the Port Elizabeth Tramway case, being the nexus between the expenditure and the income was the subject of *CIR v Genn & Co(Pty) Ltd 1955 (3) SA 293(A), 20 SATC 113*. In *CIR v Genn*, the taxpayer incurred interest and raising fees on short term loans. In his assessment of the taxpayer, the Commissioner allowed the deduction of the interest paid on the moneys borrowed, but disallowed the deduction of the raising fees paid to the company on the ground that such payments constituted expenditure of a capital nature.

The court found in favour of the taxpayer and held that no distinction in principle could be made between the interest paid to the actual lenders of the moneys borrowed and the raising fees paid to the company which arranged the loans;.

The court held further that interest paid on money borrowed and used for the purposes of a business constituted expenditure actually incurred in the production of the income of the business, whether the loan was for the acquisition of fixed or floating capital.

Schreiner JA stated on page 121 that:

“In deciding how the expenditure should properly be regarded the Court clearly has to assess the closeness of the connection between the expenditure and the income-earning operations,

having regard both to the purpose of the expenditure and to what it actually effects.

...

Interest paid on money borrowed and used for the purposes of a business would appear to be expenditure actually incurred in the production of the income of the business, whether the loan was for the acquisition of fixed or floating capital.”

The principles regarding the deduction of interest and whether it is incurred in the production of income were succinctly set-out in the landmark decision of *CIR v Standard Bank of South Africa Ltd* 1985 (4) SA 485(A) 47 SATC 179. The case involved a bank which utilised some of the deposits received from the public on which it incurred interest to acquire redeemable preference shares which gave rise to exempt dividends. Taking the view that, the moneys given out by the bank in acquiring redeemable preference shares did not produce income as defined in the Act, the Commissioner, when assessing the bank for the years in question, disallowed a proportionate amount of the interest paid by the bank to depositors

In delivering the judgment of the court **Corbett JA**, formulated the following principles, viz:

- (1) Generally, in deciding whether moneys outlaid by a taxpayer constitute expenditure incurred in the production of the income (in terms of the general deduction formula) important and sometimes overriding factors are the purpose of the expenditure and what the expenditure actually effects; and in this regard the closeness of the connection between the expenditure and the income-earning operations must be assessed.

- (2) More specifically, in determining whether interest (or other like expenditure) incurred by a taxpayer in respect of moneys borrowed for use in his business is deductible in terms of the general deduction formula and its negative counterparts in the Act, a distinction may in certain instances have to be drawn between the case where the taxpayer borrows a specific sum of money and applies it to an identifiable purpose, and the case where, as in the instance of the society in *CIR v Allied Building Society (1963 (4) SA 1(A), 25 SATC 343)*, and the Bank in the Standard Bank case, the taxpayer borrows money generally and upon a large scale in order to raise floating capital for use in his (or its) business.
- (3) In the former type of case both the purpose of the expenditure (in the form of interest) and what it actually effects can readily be determined and identified: a clear and close causal connection can be traced. Both these factors are, therefore, important considerations in determining the deductibility of the expenditure.
- (4) In the latter type of case, however, and more particularly in the case of institutions like the Society and the Bank, there are certain factors which prevent the identification of such a causal connection and one cannot say that the expenditure was incurred in order to achieve a particular effect. All that one can say is that in a general sense the expenditure is incurred in order to provide the institution with the capital with which to run its business; but it is not possible to link particular expenditure with the various ways in which the capital is in turn utilized.

- (5) The factors referred to (in (4) above) are these:
- (a) As a matter of commercial necessity the institution accepts, ie borrows, all moneys tendered to it by depositors.
 - (b) All moneys borrowed go into a common pool which constitutes a general fund used for all purposes.
 - (c) Generally the institution's expenditure by way of interest on borrowed moneys is not aimed at any particular form of utilization of the borrowed moneys: it is rather dictated by the very nature of the institution's income-earning operations of cheaply borrowing all money offered and then dearly lending out as much thereof as it can possibly invest.

It is submitted that private equity transactions are usually in the mould of the type of transaction alluded to in 3 above. The causal relationship can easily be traced and both the purpose of the expenditure (in the form of interest) and what it actually effects can readily be determined. The taxpayer therefore has no alternative but to prove that what the interest effected was in the production of income.

6.4 **Interest on loans to purchase shares**

Silke²⁰ states that if interest paid on money borrowed by a company to acquire shares in another company is linked with the actual or prospective receipt by the company of dividends, it cannot be allowed as a deduction, since almost all dividends constitute exempt income. Nevertheless, it does not necessarily follow that interest paid by a company on moneys borrowed to

²⁰ *Silke on South African Income Tax* Online Edition © LexisNexis Butterworths on 7.35

acquire shares may not be deducted from its income. If it can be shown that the sole or main purpose of the acquisition of the shares is the production of income, and that any receipt or accrual of dividends on these shares is purely incidental to the main purpose, interest paid on money borrowed to acquire the shares would properly be allowable as a deduction.

These principles stated by the learned author, which are followed by SARS were established in a number of court decisions.

In *ITC 1124 (1968) 31 SATC 53(T)*, a timber-growing company's main income was the sale of cut timber to another group company which had a saw-mill. The timber growing company bought the shares in two private companies which together owned plantations. These private companies were selling timber directly to the saw-milling company without the intervention of the parent company.

The purchase price of the two shareholdings was financed by the parent company by way of a loan. It was the policy of the group to ensure a constant supply of timber to the saw-milling company, hence the acquisition of the new shareholdings. The claim of the parent company to deduct the interest paid on the borrowed money from its own income was rejected by the court because it could not be proved that the interest was paid in the production of the income of the company within the meaning of section 11(a), dividends being exempt income in the context. In the view of the court, the purpose of the parent company when it obtained control of the two private companies through the acquisition of their shares was not to enable it to procure and resell the timber of these companies to the saw-milling company but to cause them to sell their timber directly to the saw-milling company.

According to the court, the only connection was, at best, an indirect one, and consequently the payment of interest was only indirectly connected with the income-producing operations of the parent company. Since the parent company could not establish a sufficiently close connection between the interest and its income-producing operations its appeal failed.

This case was contrasted with *Commissioner for Inland Revenue v Drakensberg Garden Hotel (Pty) Ltd* 1960 (2) SA 475(A), 23 SATC 251 in which in which a company, in order to obtain absolute control of hired premises from which it derived rent and business profits, thereby ensuring security of tenure and a continuance of its income, borrowed money in order to acquire the shares in another company owning the leased premises.

The decision of the majority of the court was that as the purchase of the shares was not for the purpose of securing dividends, but to ensure the control by the company of its revenue-producing asset, the restriction limiting deductions to expenditure in the production of income did not apply. The majority further held that as the Special Court had found as a fact that the connection between the payment of interest and the production of the respondent's income was sufficiently close to warrant its deduction and as this was a finding which could not be held to be one at which no court could reasonably arrive, the appeal was dismissed.

It is worth noting that in subsequent cases, taxpayers have tried to use the arguments in the Drakensberg case in seeking deduction of interest on loans used to purchase shares. These cases have had mixed success in the courts and in many cases,

the courts have not been persuaded that the interest was deductible²¹.

6.4 Application to the Shoprite Buy-out

It is submitted therefore that on the basis of the provisions of section 24J(2) and the principles established above, namely the requirement that the taxpayer deduct the interest expense from income from carrying on trade and that the expenditure be incurred in the production of income, if a taxpayer is carrying on a trade and is paying interest in respect of the acquisition of an asset which will produce income, that the interest should be deductible.

Since its amendment, Section 24J read with section 11(x) now governs the tax treatment of the interest, the interest of a capital nature would be deductible as long as it is incurred in the production of income as defined above. Section 11(x) allows the deduction of:

“any amounts which in terms of any other provision in this Part, are allowed to be deducted from the income of the taxpayer.”

Therefore, a deduction of interest under section 24J is brought within the scope of section 11 by the provision of section 11(x). Section 24J I therefore a charging section on which a taxpayer can rely to claim a deduction and under which tax liability can arise.

It is therefore submitted that it is not a requirement in section 24J that the interest must not be of a capital nature. All that is

²¹ *Silke on South African Income Tax* Online Edition © LexisNexus Butterworths on 7.35

required is that the interest be deductible against income from the carrying on of a trade and that it be incurred in the production of income.

The principles above are examined in the context of the Shoprite buy-out to determine how the transaction was structured to obtain deduction of interest.

In the Shoprite buy-out, it is clear that the structure was designed to derive a deduction for interest incurred for the following reasons:

1) Formation of New Opco

New Opco was formed to acquire the operating assets of Shoprite Checkers. It would appear that the promoters avoided purchasing shares in Shoprite Checkers. If the promoters had purchased the equity of Shoprite Checkers, the interest deduction would probably have been disallowed on the basis that it was not incurred in the production of income but rather to acquire a dividend producing asset as discussed above.

As demonstrated by Step 1 of the transaction, New Opco was formed to purchase the assets rather than the equity of Shoprite Checkers.

As illustrated in Appendix 1 – the private equity partner (Brait) introduced capital into the structure through the formation of New Opco. New Opco was capitalised with R9.5bn debt and R2.5bn equity. This capital was utilised to acquire the operating assets of Shoprite Checkers. As these were operating assets, the promoters argued that the interest expenditure would be deductible against income generated from carrying of trade with these assets. Furthermore, the position of the promoters was that as these assets were operating assets, there was a sufficient

nexus between the income and the interest to give rise to expenditure in the production of income.

It is submitted that this was a sound argument based on the provisions of section 24J and the case law referred to above. The interest expenditure would have been deductible from income derived from the carrying of trade and would have been incurred in the production of income.

CHAPTER 7 - MITIGATION OF INCOME TAX & CAPITAL GAINS TAX

The disposal of assets by Shoprite Checkers would have given rise to capital gains tax.

In order to mitigate the impact of CGT, the transaction was undertaken under election of section 45 of the Act which provides rollover relief for “intra-group transactions. The implications of section 45 to the Shoprite buy-out are examined in detail below.

7.1 Relief under section 45 – Intra-group transactions

In terms of section 45 of the Act, an asset can be disposed of by a transferor company to a transferee company where both companies are residents and form part of the same “group of companies” at the end of the day of the transaction. An intra-group transaction is defined in section 45(1) as

“‘intra-group transaction’ means any transaction -

- a) in terms of which any asset is disposed of by one company (hereinafter referred to as the ‘transferor company’) to another company which is a resident (hereinafter referred to as the ‘transferee company’) and both companies form part of the same group of companies as at the end of the day of that transaction;*
- b) as a result of which that transferee company acquires that asset from that transferor company –*
 - i) as a capital asset, where that transferor company holds it as a capital asset; or*
 - ii) as trading stock, where that transferor company holds it as trading stock; and*

c) *in respect of which that transferor company and that transferee company have jointly elected that this section applies.”*

“Group of companies”, as defined in section 1 of the Act as:

“group of companies means two or more companies in which one company (hereinafter referred to as the 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 per cent of the equity shares of each controlled group company are directly held by the controlling group company, one or more other controlled group companies or any combination thereof; and*
- b) *the controlling group company directly holds at least 70 per cent of the equity shares in at least one controlled group company;”*

On completion of the series of transactions set out in Appendix A, New Opco and Shoprite Checkers would form part of the same “group of companies” as defined at the end of the day of the transaction. Section 45 could therefore be applied to the disposal by Shoprite Checkers (the transferor) to New Opco (the transferee). It should however be noted that the parties to the transaction must jointly elect that the section applies.

Relief for CGT

In terms of section 45(2)(a), where an asset is disposed of as a capital asset in terms of an intra-group transaction, then for CGT purposes:

- the transferor is deemed to have disposed of the asset at its base cost, and
- the transferee is essentially deemed to have acquired the asset at the same time as it was acquired by the transferor and incurred the same base cost on the same date as the transferor, including the same valuation for the purposes of paragraph 29 of the Eighth Schedule to the Act.
- The effect of the above is that the disposal of the operating assets by Shoprite Checkers to New Opco would not trigger a CGT liability in the hands of Shoprite Checkers.

Trading stock

In terms of section 45(2)(b) when the transferor disposes of trading stock to the transferee and the transferee also acquires it as trading stock, the transferor is deemed to have disposed of the stock at cost. The transferee steps into the shoes of the transferor and the two are deemed to be one person with respect to the cost of the stock and the date of acquisition. There is therefore no realisation of the trading stock arising from the disposal of the assets.

Allowance asset

In terms of section 45(3)(a) when the transferor disposes an allowance asset to a transferee and the transferee also acquires the asset as an allowance asset and steps into the shoes of the transferor and the two are deemed to be one person with respect to the cost of the stock and the date of acquisition and no allowance is recovered or recouped by the transferor. In addition, the remaining unutilized allowances associated with the transferred asset (or liability) are transferred by the transferee. The transferee will continue to claim the deduction and will be taxable on the recovery or recoupments on disposal of the assets as if it was the original owner.

Anti-avoidance provisions

Section 45(4) contains the following anti-avoidance provision:

If the transferor and transferee subsequent to the intra-group transaction but before the disposal of the assets (the business) by the transferee cease to form part of any group of companies in relation to each other, the transferee would be deemed to have disposed of the assets at market value on the date the asset was acquired as part of the intra-group transaction and immediately re-acquired the asset for a cost equal to that market value. This would result in a capital gain being triggered in New Opco.

Section 45(5) contains the following anti-avoidance provisions:

- If the transferee (New Opco) were to dispose of a capital asset within 18 months of acquiring such asset in terms of an intra-group transaction, and a capital gain was made, that capital gain (limited to the capital gain that would have been made had the asset been disposed of at market value on the original intra-group transaction date) would not be taken into account in determining the net capital gain or assessed capital loss for the year. This portion of the capital gain would be used to determine the taxable capital gain as contemplated in paragraph 10 of the Eighth Schedule. The taxable capital gain would also not be set off against any assessed loss.

The effect of this is that the disposal would have been to trigger the payment of CGT by New Opco even if New Opco has an assessed capital loss or is in a tax loss position. This, however, only applied to the portion of the capital gain that would have been brought to account had the original relief not been given.

If New Opco made a capital loss, the capital loss (limited to the capital loss that would have been made had the asset been disposed of at market value on the original intra group transaction date) would be disregarded in determining the aggregate capital gain or loss. The capital loss may however be deducted from any capital gain in respect of the disposal of any other asset acquired by the New Opco from the Shoprite Checkers in terms of an intra-group transaction.

The effect of this is that the capital loss would be ring-fenced in the hands of New Opco to capital gains made on future intra-group transactions with Shoprite Checkers. This, however, only applied to the portion of the capital loss that would have been brought to account had the original relief not been given.

7.2 Application to Shoprite buy-out

In terms of the Shoprite buy-out, it is clear that step 1 and 3 were structured to allow the utilisation of the provisions of section 45. As such, for CGT purposes, New Opco stepped into the shoes of Shoprite Checkers with regard to the following:

- The base cost of any capital assets
- The tax written values of the allowance assets
- The cost of the trading stock

CHAPTER 8 - EXIT OF EXISTING SHOPRITE SHAREHOLDERS FROM THEIR INVESTMENT

The third tax objective of the Brait Structure was the tax efficient exit of the existing Shoprite shareholders. This objective would be achieved if the shareholders mitigated their exposure to STC or capital gains tax on any distributions received from Shoprite.

- The capital gains tax would be avoided by utilising rollover relief in Part III of Chapter II of the Act or by ultimately ensuring that the exit of the proceeds to the shareholders was not a capital distribution subject to CGT.
- The STC would be avoided if such distributions were not dividends as defined or by the use of specific exemptions from CGT. Alternatively, the STC would be avoided by the use of the rollover relief in part III of the Act.

An examination of the steps in the structure reveals that the mitigation of STC and CGT on the exit of the existing shareholders investment was structured into the transaction. The steps that there included in the structure to achieve this objectives are now examined below.

8.1 Declaration of a dividend in specie by Shoprite Checkers to Shoprite in Step 4

In this step, Shoprite Checkers declared the full proceeds of the disposal of it's operating assets as a dividend *in specie* to Shoprite. The assets distributed to Shoprite in step 4 were R11,900 million New Opco debentures and R700 million equity.

The transfer of assets to shareholders would either be a dividend as defined in section 1 of the Act or a distribution in terms of paragraph 74 of the Eighth Schedule.

Section 1 defines a dividend as:

“... means any amount distributed by a company (not being an institution to which section 10(1)(d) applies) to its shareholders...”

Paragraph 74 defines a distribution as follows:

“‘distribution’ means any transfer of cash or assets by a company to a shareholder in relation to a share held by that shareholder, including any issue of shares or debt in that company (or any option thereto), regardless of whether that transfer constitutes a dividend;”

Paragraph further defines a capital distribution as:

“‘capital distribution’ means any distribution (or portion thereof) by a company that—

- a) does not constitute a dividend; or*
- b) that constitutes a dividend which is exempt from secondary tax on companies by reason of section 64B(5)(c)”*

It would appear that the distribution of the New Opco debentures and equity as a dividend *in specie* rather than a capital distribution (a capital distribution being a distribution which is not a dividend) enabled Shoprite Checkers to rely on the provisions of section 64B(5)(f) of the Act. Section 64B(5)(f) exempts from dividends:

“any dividend declared by a company which accrues to a shareholder (as defined in Part III) of that company if –

- i) *that shareholder is a company forming part of the same group of companies as the company declaring the dividend;*
- ii) *...*
- iii) *that shareholder would be subject to secondary tax on companies should that shareholder-*
 - aa) *declare a dividend from that dividend so declared by that company; and*
 - bb) *not elect that this paragraph must apply in respect of that dividend; and*
- iv) *...*
- v) *...*

Provided that ...

Provided further that this exemption shall not apply to the extent to which that dividend—

- aa) *is derived, directly or indirectly, from any profit earned by any company forming part of that group of companies during a period when that company and that shareholder did not form part of the same group of companies; or*
- bb) *consists of any shares in that shareholder;”*

In terms of section 64B(5)(f) therefore, the declaration of the dividend *in specie* by Shoprite Checkers would be exempt if:

- In terms of section 64B(5)(f)(i), Shoprite and Shoprite Checkers were part of the same group of companies as defined in section 1 of the Act. As Shoprite Checkers was a wholly owned subsidiary of Shoprite, the two companies were part of the same group of companies. Therefore this requirement was satisfied.

- In terms of section 64B(5)(f)(iii) Shoprite would be subject to STC if it declared a dividend. As Shoprite was resident in South Africa and was not exempt in terms of section 10 (Exemptions) of the Income tax Act, this requirement was satisfied.
- In terms of the second proviso to section 64B(5)(f), the dividend was derived from profits were earned during the period that Shoprite Checkers was part of the group of companies.

Whilst the detailed analysis of Shoprite Checkers' reserves was not available, it is evident that to the extent that distributable reserves were generated from the disposal of the operating assets, these, together with any other profits that were earned during the time Shoprite Checkers was part of the group would have qualified for this exemption.

Based on the above therefore, it would appear that a substantial portion of the dividend in specie would have been exempt in terms of section 64B(5)(f).

In Step 4 therefore, the proceeds of the disposal were moved a step up the in the Shoprite structure (from Shoprite Checkers to Shoprite) without incurring STC liability.

8.2 Disposal of Shoprite business to New Retail in Step 5

In Step 5, the business of Shoprite including all assets and liabilities was disposed of to New Retail. The assets disposed of to New Retail included the New Opco debentures and equity distributed to Shoprite by Shoprite Checkers in Step 4. These assets were disposed of for approximately R13 191 million in

exchange for New Retail ordinary class B shares with a par value of 0.1 cent in the issued share capital of New Retail ("New Retail class B shares") issued at **R26.00** per share.

The disposal of the Shoprite assets to New Retail was undertaken in terms of section 44 of the Act ("amalgamation transactions"). Section 44 is mandatory for all amalgamation transactions, unless the parties to the transaction elect otherwise.

Section 44 defines an amalgamation transaction as:

*“‘**amalgamation transaction**’ means any transaction –*

- a) in terms of which any company (hereinafter referred to as the ‘amalgamated company’) disposes of all of its assets (other than assets it elects to use to settle any debts incurred by it in the ordinary course of its trade) to another company (hereinafter referred to as the ‘resultant company’) which is resident, by means of an amalgamation, conversion or merger; and*
- b) as a result of which that amalgamated company’s existence will be terminated;*

Provided that the provisions of this section will not apply to a disposal of an asset by an amalgamated company to a resultant company where that resultant company and the person contemplated in subsection (6) form part of the same group of companies immediately before and after that disposal, if that amalgamated company, resultant company and person jointly so elect.

The relief under section 44 for amalgamation transactions only applies if the assets are disposed of in exchange for equity in the

resultant company or if the resultant company assumes a debt of the amalgamated company or both.

In terms of the above definition, Shoprite is the amalgamated company while New Retail is the resulting company. In the absence of the relief in section 44, the disposal would have given rise to capital gains tax implications in the hands of Shoprite. There would also have been recoupment of wear and tear allowances granted on allowance assets. In addition, the issue of new shares by New Retail would have given rise to stamp duty.

Relief for CGT

In terms of section 44(2)(a), where an asset is disposed of as a capital asset in terms of an amalgamation transaction, then for CGT purposes:

- the amalgamated company (Shoprite) is deemed to have disposed of the asset at its base cost, and
- the resulting company (New Retail) is essentially deemed to have acquired the asset at the same time as it was acquired by the transferor and incurred the same base cost on the same date as the transferor, including the same valuation for the purposes of paragraph 29 of the Eighth Schedule to the Act.
- The effect of the above is that the disposal of the operating assets by Shoprite to New Retail would not trigger a CGT liability in the hands of Shoprite.

Trading stock

In terms of section 44(2)(b) when the amalgamated company disposes of trading stock to a resultant company and the

resulting company also acquires it as trading stock, the amalgamated company is deemed to have disposed of the stock at cost. The resulting company steps into the shoes of the amalgamated company and the two are deemed to be one person with respect to the cost of the stock and the date of acquisition. There is therefore no realisation of the trading stock arising from the disposal of the business.

Allowance assets

In terms of section 44(3)(a) when the amalgamated company disposes an allowance asset to a resultant company and the resultant company also acquires the asset as an allowance asset resulting company steps into the shoes of the amalgamated company and the two are deemed to be one person with respect to the cost of the stock and the date of acquisition and no allowance is recovered or recouped by the amalgamated company.

In addition, the remaining unutilized allowances associated with the transferred asset (or liability) are transferred by the resultant company. The resulting company will continue to claim the deduction and will be taxable on the recovery or recoupments on disposal of the assets as if it was the original owner.

Anti avoidance provisions

At the time of the Brait/Shoprite transaction, Section 44 contained the following anti-avoidance provisions, among others:

- The rollover relief would not apply if, within six months after the date of the amalgamation transaction, the

amalgamated company did not take the steps contemplated in section 41(4) of the Act to liquidate, wind up or deregister, at which point the shares in the resultant company will be transferred to the shareholder(s) of the amalgamated company. This was recognised as a risk Shoprite's cautionary notice.

- If the resulting company (New Retail) were to dispose of a capital asset within 18 months of acquiring such asset in terms of an amalgamation transaction, and a capital gain was made, that capital gain (limited to the capital gain that would have been made had the asset been disposed of at market value on the original intra-group transaction date) would not be taken into account in determining the net capital gain or assessed capital loss for the year. This portion of the capital gain would be used to determine the taxable capital gain as contemplated in paragraph 10 of the Eighth Schedule. The taxable capital gain would also not be set off against any assessed loss.

The effect of this is that the disposal would have been to trigger the payment of CGT by New Retail even if New Retail had an assessed capital loss or is in a tax loss position. This, however, only applied to the portion of the capital gain that would have been brought to account had the original relief not been given.

- If New Retail made a capital loss, the capital loss (limited to the capital loss that would have been made had the asset been disposed of at market value on the original intra group transaction date) would be disregarded in determining the aggregate capital gain or loss. The capital loss may however

be deducted from any capital gain in respect of the disposal of any other asset acquired by the New Retail from the Shoprite in terms of an intra-group transaction.

It should additionally be noted that unlike section 45, section 44 would have granted relief from any donations tax or Secondary Tax on Companies (“STC”) liability. Where the consideration for the disposal by Shoprite to New Retail was not an arm’s length consideration, Shoprite would not have suffered donations tax or STC. This relief is further examined in the next section.

8.3 CGT & STC free divestment by existing Shoprite shareholders

CGT relief under section 44

The third challenge in the Shoprite transaction was the divestment of the existing shareholders funds, ultimately being the proceeds of disposal of their investment.

In an amalgamation transaction, the amalgamated company (in this case, Shoprite) should ultimately be liquidated or deregistered after the shares held in the resulting company (New Retail) have been distributed to the shareholders. The shareholders then become direct shareholders in the liquidated company as illustrated in Appendix 2.

In the Shoprite transaction, that was achieved by Step 6, being the distribution of the New Retail Class B ordinary shares as a dividend *in specie*/capital reduction to the Shoprite shareholders in terms of section 90 of the Companies Act No. 61 of 1973, as amended (*Payment to shareholders*).

In terms of section 44(6) when a shareholder disposes of equity shares in an amalgamated company in return for equity shares in a resultant company, the shareholder concerned is deemed to have disposed of the equity shares in the amalgamated company for an amount equal to their base cost if held as capital asset or their cost or trading stock value if held as trading stock. At the same time, he is deemed to have acquired the equity shares in the resultant company on the date on which he acquired the equity shares in the amalgamated company. And he is deemed to have acquired the equity shares in the resultant company at the same base cost or their cost or trading stock value.

The base cost of the equity shares in the resultant company will be determined as follows:

- Where the shares in the resultant company are acquired as a capital asset, their base cost will be equal to the base cost of the shares in the amalgamated company.
- Where the shares are acquired as trading stock, the cost of the shares in the amalgamated company will be used (or ‘rolled over’) to determine the amount to be taken into account as their cost or trading stock value²². []

In this regard, based on the provisions of section 44(6), the the New Retail shares were issued to the Shoprite shareholders at the base cost or trading stock value of the original Shoprite shares. The distribution of the New Retail class B shares to Shoprite shareholders was not subject to CGT.

²² *Silke on South Arican Tax* Online Edition © LexisNexus Butterworths on 24.154E

In addition, the issue of the New Retail shares below market value would not give rise to liability to STC as a deemed dividend distribution. Relief for the distribution was provided by section 44(9) which states that:

“Where an amalgamated company disposes of any equity shares in a resultant company that were acquired by that amalgamated company in terms of an amalgamation transaction that was subject to subsection (2) or (3), to a shareholder of that amalgamated company as part of an amalgamation transaction –

- (a) the disposal by that amalgamated company of those shares must be deemed not to be a dividend with respect to that amalgamated company for purposes of section 64B(3); and*
- (b) any shares acquired by a company in terms of that disposal must be deemed not to be a dividend which accrued to that company for the purposes of section 64B(3)”*

In terms of section 44(9) therefore, the distribution of New Retail shares to the Shoprite shareholders was not deemed to be a dividend and was therefore free of STC liability.

STC Free divestment of existing shareholders

At this point in the transactions, the shareholders had achieved the following:

- CGT free disposal of the assets of Shoprite Checkers to New Opco via Step 3
- STC free distribution of the proceeds from Shoprite Checkers to Shoprite via Step 4
- CGT free disposal of the assets of Shoprite to New Retail via step 5

- CGT and STC free disposal of Shoprite shares in return for New Retail shares via 6, in anticipation of the delisting and liquidation of Shoprite within six months of the amalgamation transaction (steps 7 and 8).

At this point however, the former Shoprite shareholders would still be holding the New Retail shares. This was not the desired outcome as the transaction was a leveraged buy-out in which Brait would acquire the former Shoprite assets now housed under New Retail and take control of New Retail. However, if the former Shoprite shareholders were still be in possession of the New Retail shares, this would be contrary to the objective of the transaction. It would appear that this challenge was to be resolved by the New Retail capital repayment/ capital reduction right.

New Retail capital repayment/ capital reduction right

After the completion of the distribution, New Retail was obliged, under its Articles of Association, to make a capital reduction payment in the amount of R25.99 per New Retail class B share to all New Retail class B shareholders. The exercise of this right by eligible Shoprite shareholders would allow them to divest and realise their investment in cash, New Opco debentures or New Retail Class A shares.

It should be noted that the New Retail Shares were issued at a substantial premium having a nominal value of 1c and an issue price of R26 (share premium of R25.99 per share). This would have been pure share premium created on issue of the New Retail shares. The dividend definition excludes:

“subject to the provisions of the first proviso to this definition, any cash and the value of any asset given to a shareholder to the extent to which the cash and the value of the asset represents a reduction of the share premium account of a company; ...”

The amounts received under the New Retail capital repayment/capital reduction would have been a reduction of the pure share premium of New Retail, as the company would not have generated any profits (realised or unrealised). This distribution would therefore be free of STC.

It can be seen therefore that the structure of the Shoprite buy-out allowed the distribution of the proceeds of the sale of the Shoprite business free of STC to the former Shoprite shareholders as in terms of the dividend definition, the capital repayment/capital reduction was not a dividend as defined.

CHAPTER 9 - SARS REACTION TO THE SHOPRITE TRANSACTION

Once the structure and tax implications of the Shoprite transaction became public, the reaction from both the treasury and SARS was very disapproving. On 10 January 2007, reportedly in reaction to the Shoprite transaction, the

Commissioner of SARS issued a strongly worded statement²³ which stated that:

“The South African Revenue Service has become aware of certain transactions which are structured in such a way that they show complete and reckless disregard for tax morality and South African tax law. Through elaborate structuring, these deals seek to deliberately avoid the tax consequences that should flow from the associated transactions thereby robbing not only the fiscus of tax revenue, but all South Africans.

The South African Revenue Service gives notice that it intends to carefully examine these transactions in order to ensure that no impermissible tax loss occurs. The architects of certain tax aggressive structures will not be permitted to abuse South Africa’s tax provisions in ways clearly unintended by the legislature. They will be vigorously challenged.

In certain instances,...

The South African Revenue Service calls upon corporate leaders to take greater responsibility to ensure that the advice that they pursue does not undermine South Africa’s tax base and the compliance morality that we are successfully building in the country.

²³ Press statement issued by Pravin Gordhan: Commissioner SA Revenue Service ‘Aggressive Tax Structuring’ 10 January 2007

We once again urge institutions involved in designing aggressive tax schemes intended to abuse the law and deprive the fiscus of its fair share of revenue to desist from such schemes. These are the activities that lead to complexity in our tax law.”

Shortly after this statement, the Minister of Finance in his budget speech of 21 February 2007 announced the withdrawal of the relief from STC from amalgamation transactions under section 44. The draft Taxation Laws Amendment Laws bill released for discussion following the Ministers speech included a clause deleting sections 44(9) and (10) of the Act. The effective date of the amendment was subsequently queried by the Taxpayer²⁴, SARS confirmed that the amendment came into operation on the date of the Ministers speech (21 February 2007).

Despite the announcement that section 44(9) and (10) would be deleted, the relief from STC was actually withdrawn by the introduction of section 44(9A) which was inserted by section 34(1)(c) of the Taxation Laws Amendment Act No. 8 of 2007. Section 44(9A) deems the resulting company's share capital and share premium arising from an amalgamation transaction to be profit available for distribution.

As such, New Retail's share capital and share premium arising from Step 5 of the Shoprite buy-out transaction would have been profit available for distribution and would have been subject to STC on distribution to the Shoprite shareholders under Step 6 of the transaction (New Retail capital repayment/ capital reduction right).

This amendment came into operation on 21 February 2007, before that the Shoprite transaction was completed. According to press reports,

²⁴ The Taxpayer '*Substituting Shareholder's' Tax on Dividends in Place of STC* June 2007 (Volume 56 No 6)]

the change resulted in STC liability of R1.6bn²⁵. According to the cautionary note that had been issued to shareholders, any STC liability would have been recovered from the proceeds received from Brait.

SARS in its response to the Shoprite buy-out, among others, resorted to amending the law. The amendment deprived taxpayers engaging in amalgamations of relief from STC, even if the transactions were not tax driven. It is worth considering why SARS did not in the alternative, challenge the transactions using the general anti-avoidance rule (“GAAR”) in Part IIA of Chapter III of the Act.

The GAAR was introduced by Section 34(1) The Revenue Laws Amendment Act No. 34 of 2006 to replace section 103 of the Act and came into effect on 2 November 2006. The anti avoidance provisions of Part IIA are targeted at “impermissible avoidance transactions”. Part IIA includes the following definition of an impermissible avoidance transaction in section 80A:

“An avoidance arrangement is an impermissible avoidance arrangement if its sole or main purpose was to obtain a tax benefit and—

(a) in the context of business—

- (i) it was entered into or carried out by means or in a manner which would not normally be employed for bona fide business purposes, other than obtaining a tax benefit; or*
- (ii) it lacks commercial substance, in whole or in part, taking into account the provisions of section 80C;*

(b)...

(c) in any context—

²⁵ Business Report ‘Taxman hits Shoprite deal for R1.6bn’ February 22, 2007. © Business Report 2007

- (i) *it has created rights or obligations that would not normally be created between persons dealing at arm's length; or*
- (ii) *it would result directly or indirectly in the misuse or abuse of the provisions of this Act (including the provisions of this Part)."*

In order for the General Anti-Avoidance Rule (GAAR) in part IIA of Chapter III to apply, the following must be present in a transaction.

- a) In terms of section 80A, there must be an arrangement. An arrangement is defined in section 80L as a transaction, operation or scheme, agreement or understanding, whether enforceable or not, including any parts of it. The Shoprite buy-out would therefore have been a transaction as defined.
- b) The arrangement must be an avoidance arrangement. An avoidance arrangement is defined in section 80L as an arrangement that results in a tax benefit. The determination of whether a tax benefit has accrued to a taxpayer is an objective test as stated by **Corbett JA** in *SIR v Gallagher 1978 (2) SA 463 (A) 40 SATC 39*:

"By an objective test in this context is evidently meant a test which has regard rather to the effect of the scheme, objectively viewed, as opposed to a 'subjective' test which takes as its criterion the purpose which those carrying out the scheme intend to achieve by means of the scheme."

An objective test focuses on the identifiable outcome of the arrangement. With respect to the Shoprite buy-out, it is submitted that the transaction resulted in a tax benefit as detailed in the previous chapters.

- c) The sole or main purpose must be to obtain a tax benefit. As stated in *CIR v Gallagher* supra, the test of purpose is a subjective test as it entails determining the mind of the taxpayer when entering into the transaction.

In *CIR v Conhage (Pty) Ltd (formerly Tycon (Pty) Ltd) 1999 (4) SA 1149 (SCA)*, the taxpayer had entered into two sets of agreements with a bank whereby its manufacturing plant and equipment were sold to the bank and thereafter leased to it by the bank. The Commissioner contended that the agreements were not true 'sale-and-leaseback' agreements when the taxpayer had sought to deduct the rentals paid as expenditure incurred in the production of income in terms of section 11(a). The Commissioner contended that the taxpayer did not sell and 'lease back' its equipment, but in substance borrowed the 'purchase price' from the bank.

The Supreme Court of Appeal confirmed the decision in the court a quo (ITC 1636) that the parties had every intention of entering into agreements of 'sale-and-leaseback' and of putting the agreements into effect. Moreover, the transactions made perfectly good business sense and there was nothing indicating that they were disguised agreements. It held, furthermore, that it was by no means unusual to find provisions in a sale and leaseback which did not typically appear in a contract of purchase and sale, or in a contract of lease, and although a sale and leaseback comprises an agreement of sale as well as an agreement of lease, it must be treated as one composite transaction and accordingly upheld the Special Court's finding in favour of the taxpayer. The court found that the purpose of the

arrangement was to obtain finance and not to obtain a tax benefit.

In this regard, to challenge the Shoprite buy-out, SARS would have to prove that the sole or main purpose of the transaction was to obtain a tax benefit. Clearly, this would have been a difficult challenge to make given that the Shoprite buy-out was a purchase of business which is a commonplace commercial transaction.

- (c) There must be an element of abnormality in the transaction. The test of abnormality set out in section 80C is that the transaction must have been entered in a manner not normally employed for bona fide business reasons or it must lack commercial substance. Section 80C states that:

“(1) For purposes of this Part, an avoidance arrangement lacks commercial substance if it would result in a significant tax benefit for a party (but for the provisions of this Part) but does not have a significant effect upon either the business risks or net cash flows of that party apart from any effect attributable to the tax benefit that would be obtained but for the provisions of this Part.

- (2) *For purposes of this Part, characteristics of an avoidance arrangement that are indicative of a lack of commercial substance include but are not limited to—*
- (a) *the legal substance of the avoidance arrangement as a whole is inconsistent with, or differs significantly from, the legal form of its individual steps; or*
 - (b) *the inclusion or presence of—*

- (i) *round trip financing as described in section 80D; or*
- (ii) *an accommodating or tax indifferent party as described in section 80E; or*
- (iii) *elements that have the effect of offsetting or cancelling each other.”*

Therefore, in terms of section 80C, a transaction lacks commercial substance if;

- It results in a tax benefit without an attendant effect in business risk or net cash flows, other than cash flows arising from the tax benefits;
- Has the characteristics that include but are not limited to the items listed in section 80C(2) above.

It is not clear whether sufficient data on private equity transactions would have been available for SARS to determine if the Shoprite buy-out had been entered into in a manner not normally employed for bona fide business reasons. It is submitted that this would also have been a difficult challenge for SARS to make.

The commercial substance test has not been ruled upon by the courts as it is a new test. The various elements of the definition would have to be examined against the transaction and it would appear that SARS was unwilling to put the commercial substance test before the courts of law.

However, in terms of section 80A(c)(ii), an arrangement could be challenged if it results in the misuse or abuse of provisions of the Act. The Part IIA does not define what misuse or abuse of

the provisions Act means. Neither is this expression explained anywhere else in the Act.

It is also worth noting that this is a new test which has not been considered in our courts. It is submitted that as SARS argued that private equity transactions were an abuse of the provisions of the Act, this provision should have been applied to challenge the transactions. Assuming the taxpayers were willing to challenge SARS in the courts, the resulting litigation might have enabled the courts to rule on this important test. It is submitted that this would have been a better alternative for SARS to follow rather than amend the law which was alleged to be the subject of abuse or misuse.

Subsequent legislative developments

During the Ministers budget speech on 27 February 2007, it was announced that to private relief to private equity investors, disposal of qualifying unlisted shares held for at least 3 years would be deemed to be capital in nature. This was to avoid reliance on the capital versus revenue tests applied to the gross income definition. The Ministers announcement was translated into a new section 9C which was inserted into the Act by Section 14(1) of Act 36 of 2007.

It is worth noting that the treasury has however since announced that it will not take further steps to introduce specific legislation for the private equity sector but rather it will keenly monitor developments in developed markets with regard to private equity before taking any further legislative steps²⁶.

²⁶ Business Report 'SARS to wait a while on private equity taxes' April 2, 2007 © Business Report 2007

The private equity sector has also announced an initiative to engage the treasury in order to discuss the latter's concerns with regard to large transactions that result in de-listings such as the Shoprite buy-out²⁷.

²⁷ Polity *'Private equity moving to allay Treasury's fears'* © Creamer Media (Pty) Ltd

CHAPTER 10 - CONCLUSION

The treatise has examined the history of private equity and the commercial reasons for private equity transaction, this shows that there is a place in business for private equity and it continues to contribute to economic growth.

The treatise has also examined the level of private equity transactions in South Africa and the impact they are making on the commercial landscape. Not all private equity transactions are tax driven.

The Shoprite buy-out transaction was a leveraged buyout which made use of the provisions of the Act to avoid liability to CGT, STC and income tax. SARS objected to the transaction, among others, on the basis that it was an abuse of the provisions of the Act.

It is submitted that SARS should have attacked the transactions using the GAAR on the basis that they were a misuse or abuse of the provisions of the Act rather than amend the legislation to withdraw relief from STC for amalgamation transactions. The withdrawal of STC relief has also affected amalgamation transactions which were not tax driven.

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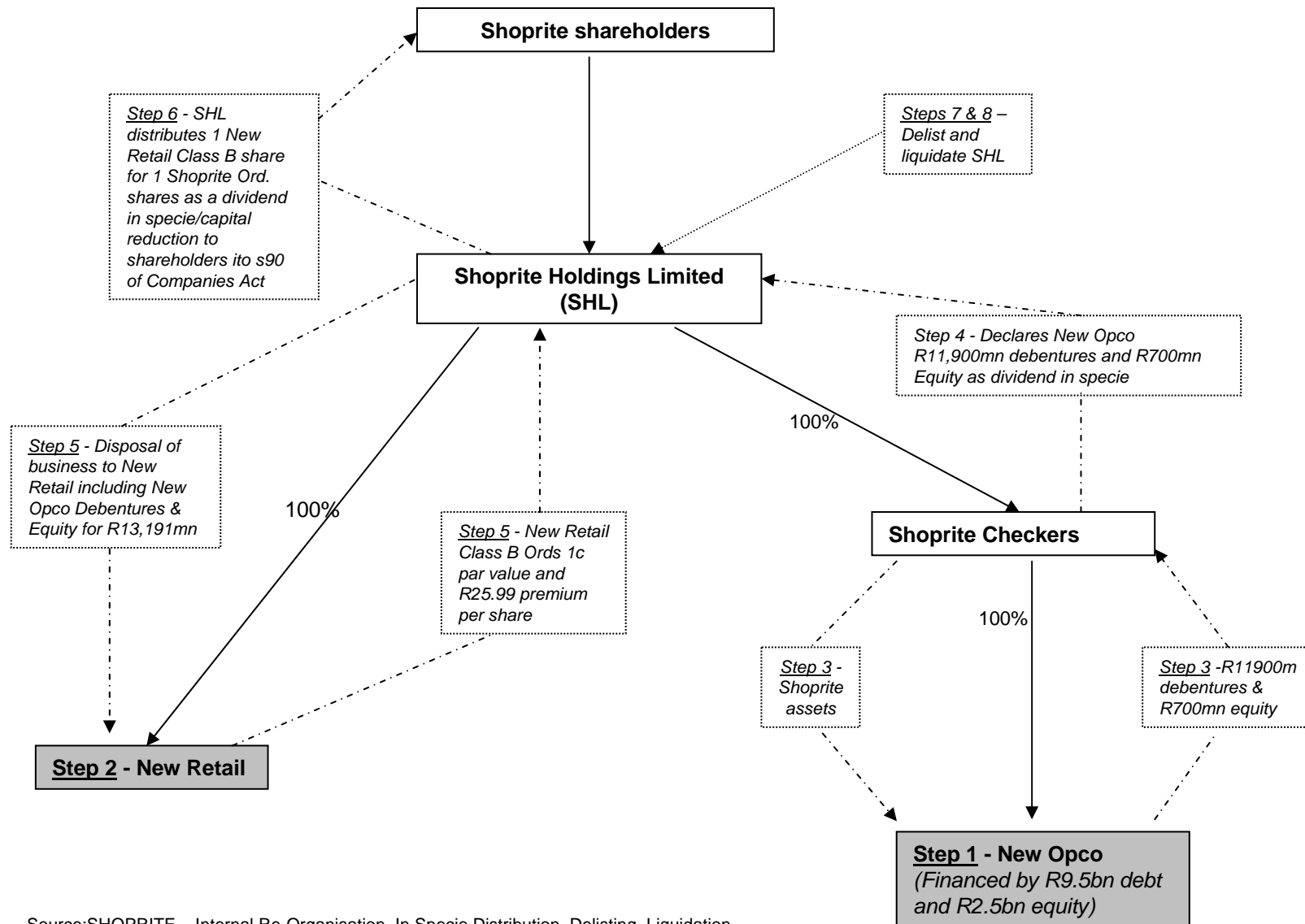
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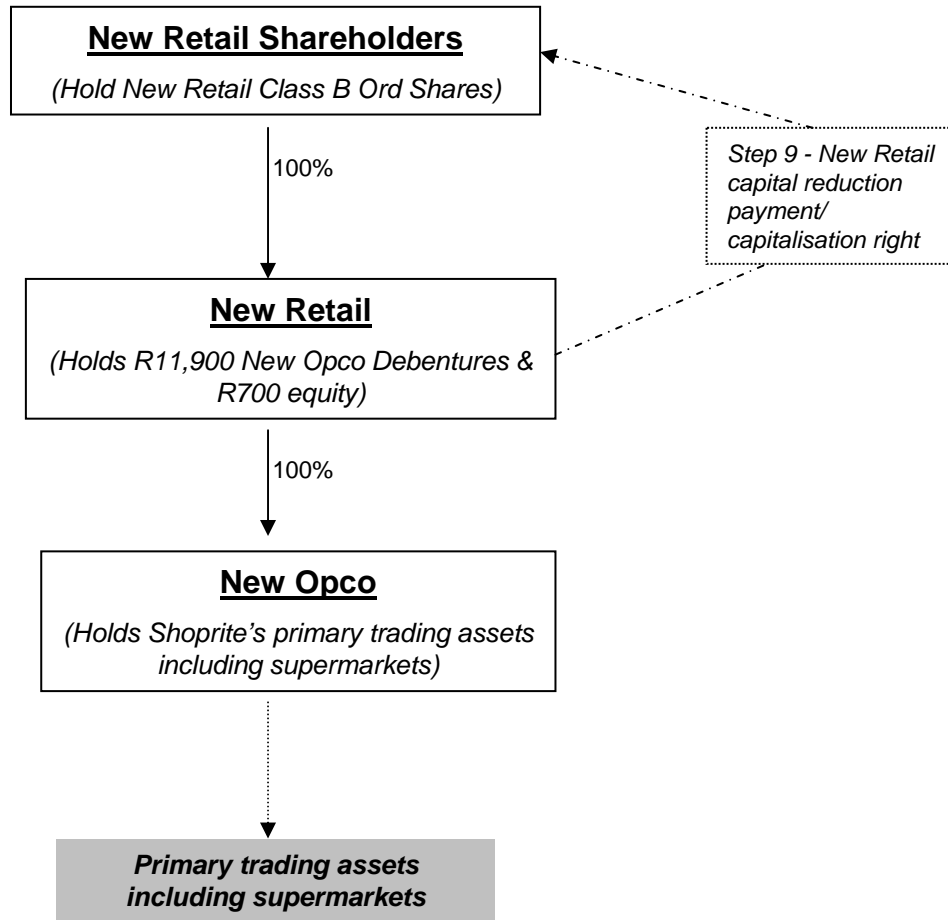
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Appendix 1: Steps in the Shoprite buy-out transaction



Source:SHOPRITE – Internal Re-Organisation, In Specie Distribution, Delisting, Liquidation and Further Cautionary Announcement *Shoprite Holdings Limited* 26 November 2006

Appendix 2: Shoprite buy-out transaction on completion



Source:SHOPRITE – Internal Re-Organisation, In Specie Distribution, Delisting, Liquidation and Further Cautionary Announcement *Shoprite Holdings Limited* 26 November 2006