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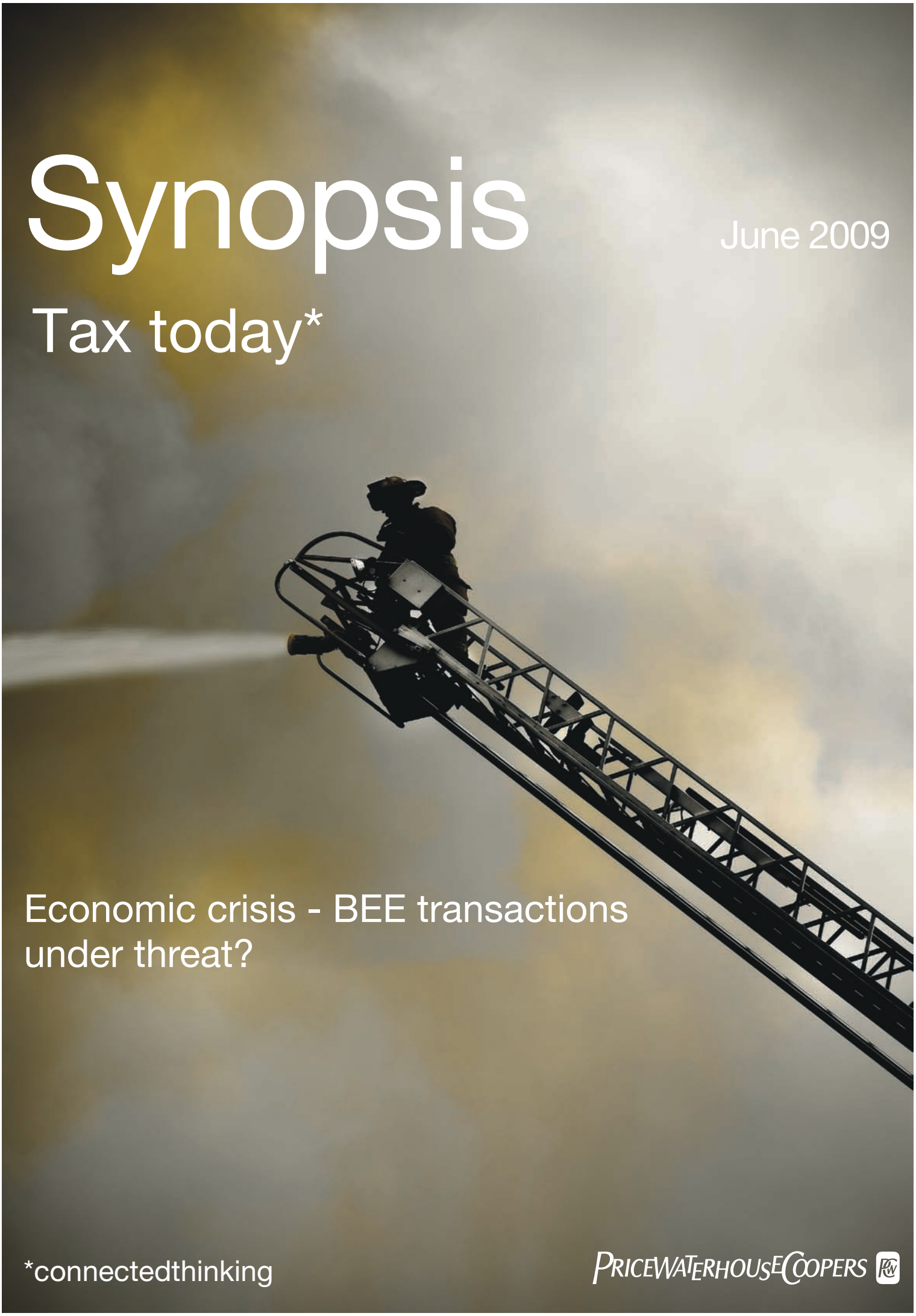

Economic crisis - BEE transactions under threat?

*connectedthinking

PRICEWATERHOUSECOOPERS

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Economic crisis - BEE transactions under threat?

Black economic empowerment (BEE) is an important strategy in the process of transforming the economy in post-apartheid South Africa. Transactions designed to transfer significant ownership in South African companies to previously disadvantaged persons have been financed by major financial institutions and vendors.

The ability of the new owners to service the financing arrangements in these transactions depends principally on the profitability of the entities in which they are investors. The economic crisis which has developed over the past year raises questions concerning the viability of the BEE transactions.

Are BEE transactions faced with a sub-prime scenario?

While the global economic crisis will have had a significant effect on BEE transactions in South Africa, the issues faced are unique and cannot be likened to the subprime issue facing the banking sector. BEE structures were tailored to the specific requirements of the transaction and were not designed for mass on-selling. In addition, the debt servicing was linked to the cash flows projected to be generated by the underlying company.

Remedies for BEE deals under water

BEE deals may be under threat as the underlying company share prices have plummeted in conformity with international markets. The prolonged economic downturn is also likely to have a negative impact on the cashflows in the companies concerned. This will have a knock-on effect on the dividends which BEE investors may expect to receive, and place them at risk of non-performance on their contracts with the financiers. Remedial restructuring, including extension of repayment periods for the BEE partner, may place pressure on the score achieved for the net equity element of the BEE ownership scorecard.

Given the commercial benefits that empowered companies have over companies without BEE ownership, it is in the interests of all parties, being the underlying company, the banks and the BEE shareholders, to keep these deals intact. This may require one or a combination of the following steps:

- Restructuring the funding structure in order to align with the changed economic conditions and the outlook for the underlying company;
- Engaging with financially robust BEE groups to effectively merge or consolidate, which will enable the facilitation of sustainable BEE structures; and
- Obtaining State-sponsored finance solutions to bridge any funding gaps on a temporary basis.

Accounting, tax and valuation considerations

While these remedies may assist in rescuing BEE transactions that are under

water, the accounting and tax implications, if any, should be considered, as well as the market reaction to such rescue packages. For example, a share disposal in respect of a share held for a continuous period of not less than three years will be deemed to be of a capital nature. Earlier disposals may carry a risk of taxation as a trading transaction. It may be possible to merge operations without triggering adverse current tax exposures using group relief provisions in the Income Tax Act. In addition, mergers of BEE groups should only be undertaken once detailed valuations and due diligences have been concluded. A detailed valuation will prevent companies from overvaluing investments and serve as a safeguard against the unexpected future erosion of profits as a result of impairment charges.

Preventative measures

BEE transactions that do not appear to be under immediate threat may come under threat due to difficulties faced by their customers or suppliers. BEE companies would be advised to examine their current trading arrangements carefully and take preventive measures to avert unnecessary risk. Internally, they may also consider whether they may implement strategies to optimise their cash flows in a slowing economy, such as streamlining processes and implementing controls designed to reduce and manage costs.

Difficult circumstances demand difficult decisions. BEE companies that successfully manage the risks that may affect their status stand to gain enormously.

Profile of the in-house corporate tax function in SA

The PricewaterhouseCoopers Total Tax Contribution survey conducted among 50 of the largest South African companies for the period 1 April 2007 to 31 March 2008 included an investigation into the role and function of the in-house tax specialist. 36 of the respondents to the survey included data concerning their tax departments.

The size and composition of this specialist capability varied markedly. The head count reflected that the smallest such department consisted of one person, while the largest employed 33 persons. On average, the tax department comprised of seven persons, indicating that, generally this area of tax is the domain of a small number of specialists.

It was clear from the responses that certain tax functions may be performed outside of the tax department (for instance human resources would manage payroll taxes) and the degree of internal "outsourcing" may, in part, explain differences in the employee numbers in specialist tax departments.

Spending on tax services by the respondents revealed that some 80% of the expenditure relates to internal costs (mainly salaries, overheads, travel and training) and just less than 20% on external consultants.

The study reveals a considerable diversity between the various performance criteria that are applied in evaluating the effectiveness of the tax function within the corporate environments. 20% of respondents are judged on meeting compliance deadlines, while 17% are required to ensure that there were "no surprises" and 15% are evaluated on the result of tax authority audits. At the other end of the spectrum, only 17% were evaluated in relation to the management of cash (reduction of cash taxes and cash flow management) and only 9% in relation to the effective tax rate. This would tend to indicate that tax specialists in the main operate in a middle-management operational environment as opposed to a strategic managerial environment.

These results to an extent reflect the reality that almost 60% of time is devoted to tax compliance and tax accounting with only some 14% being applied to tax planning and mitigation. In relation to tax type, the focus is primarily on profit taxes (income tax and STC – 59%) with a lesser emphasis on product taxes (primarily VAT, customs and excise – 26%) and PAYE (14%)

A reassuring note that emerged is the degree of integration of the tax processes in the overall risk management framework of the respondents. Here, it was found, 74% have tax risk policies in place, 86% of the respondents have tax risk management processes and these processes include the audit committee (86% of companies) and/or the board of directors (80%).

These results would indicate that tax specialisation in the corporate environment is in relatively early stages of evolution, with considerable emphasis being placed on operational rather than strategic effectiveness. At the same time the large businesses are becoming increasingly aware of the risks that an entity may incur in relation to its tax affairs and have implemented policies and processes that are designed to manage and control these risks.

The full report, which includes comprehensive results and background on the Total Tax Contribution Framework, is available from http://www.pwc.com/za/eng/pdf/pwc-total-tax-contribution-may2009.pdf.

Can the payment of interest constitute expenditure "of a capital nature"?

Any certainty dispelled by this judgment

We have been unable to identify a decision by a South African court which has held that the payment of interest on borrowed money constituted expenditure "of a capital nature" and on that ground did not qualify for deduction in terms of section 11(a) of the Income Tax Act 58 of 1962.

At first blush, it might seem that expenditure by way of interest on borrowed moneys is inevitably and inherently of a non-capital nature, in that it is merely consideration given for the temporary use of money and does not result in the acquisition of any asset by the borrower.

Any such certainty in this regard will have been dispelled by the judgment, on 25 May 2009, of the Federal Court of Australia in St *George Bank Ltd v Commissioner of Taxation [*2009] FCAFC 62, which held that, on the particular facts of that case, the interest paid by the St George Bank on moneys borrowed as a result of a merger with another bank, was of a capital nature and therefore not deductible.

The facts

In 1997 the St George Bank Ltd implemented a merger with Advance Bank Australia Ltd.

The merger, however, adversely affected St George's capital adequacy ratio, chiefly as a result of the cash payment of $767 million made by St George to Advance shareholders. It was therefore essential for St George to raise further capital to comply with the capital adequacy ratios laid down by the Reserve Bank of Australia. The sole reason why St George embarked on a raising of capital was to satisfy the RBA's requirements in this regard.

The solution suggested by Merrill Lynch to St George, in regard to the raising of capital, was a proprietary capital securities product known as a "US$ Tax Deductible Perpetual Preferred" or "TDPP".

In essence, the raising of capital was achieved as follows: on 18 and 19 June 1997 a special purpose Delaware vehicle – LLC – raised US$350 million by the issue of certain securities. Having raised those monies, it on-lent them to St George in return for a debenture. The interest received by LLC from St George was used by LLC to pay dividends to its shareholders. The interest payments made by St George to LLC precisely mimicked the dividends that the LLC was to pay its shareholders

Between 1999 and 2003, and in terms of that debenture, St George paid LLC interest of some AU$250 million and, in each of those tax years, St George claimed the interest as a deduction.

In 2005 the Australian Commissioner of Taxation disallowed those deductions, and issued amended assessments for each of those years.

In the lower court, a single judge dismissed St George's appeal against the amended assessments and, on further appeal, the matter came before the Full Federal Court, which dismissed St George's appeal, and confirmed the Commissioner's decision that the payments of interest constituted expenditure of a capital nature and were therefore not deductible.

Arguments put forward by St George

Predictably, St George argued that interest payable under a loan to secure capital or working capital is inherently of a revenue nature and, hence, that the interest payable in terms of the

Fortunately South African banks faced with a similar issue can rest easily. Our law prescribes that when interest is deemed to have been incurred, the amount so determined in respect of any year of assessment "must be deducted … if it is incurred in the production of the income."

debenture in issue in this case should have been allowed as a deduction.

St George also argued that the recurrent nature of the interest payments stamped them as being of a non-capital nature.

The Commissioner, on the other hand, contended that the transaction, viewed as a whole, was a capital-raising transaction, and that the interest in question should be characterised as being of a capital nature.

It was common cause that the interest paid by St George to LLC was expenditure incurred "in the production of income". The only issue was whether it was expenditure "of a capital nature" and, on that ground, non-deductible.

The general deduction formula as applied to the facts

As in South Africa, there is no provision in Australia's tax legislation specifically stating that expenditure in the form of interest is deductible.

As in South Africa, the Australian tax legislation provides, in its counterpart to our section 11(a), that expenditure is not deductible if it is of a capital nature, but there is no statutory definition of what constitutes expenditure of a capital nature.

The capital or revenue nature of interest, outlaid by a taxpayer, must therefore be decided on the facts of each particular case in accordance with common law principles, that is to say, principles laid down by the courts.

In the St George case, the Commissioner argued that that the interest in question, outlaid by that company, was of a capital nature. The argument in this regard was advanced on the basis of four propositions, namely –

the entire set of transactions entered into by St George and its group needed to be examined in determining whether the interest payments were of a capital nature;

so viewed, the interest payments were the "consideration for the acquisition of a capital asset, namely the perpetual capital raised", and since the interest payments were the consideration for the acquisition of a capital asset it followed that their character was of a capital nature;

the payments made by St George to LLC were properly to be seen as securing the advantage to St George of maintaining sufficient capital and thereby, complying with the conditions of its banking licence;

the capital nature of the payments was also to be derived from the close analogy with the payment of dividends by LLC to the holders of the capital securities.

The judgment

The court noted that, in terms of the rules of the Reserve Bank of Australia in regard to the determination of a bank's capital adequacy ratio, subordinated debt was eligible to be regarded as a category of capital, provided that it had an original maturity of at least seven years.

The court also pointed out that categorising an outgoing as "interest" does not of itself answer the question as to whether the outgoing is of a capital nature, and the court noted that there was specific authority in Australia for the proposition that interest is capable of being an outlay of a capital nature. (See *Ure v Federal Commissioner of Taxation* [1981] FCA 9; (1981) 34 ALR 237.)

Thus, interest would be of a capital nature where, in the particular circumstances, the purpose of the outlaid interest was "something other than the raising or maintenance of the borrowing".

The court then went on to explain, in some detail, that the concept of "capital" has a special meaning in the case of a company. This, said the court, flows from the fact that a company has a legal identity, separate from its members, and the relationship between a company and its members is unlike the relationship between natural persons.

Thus, a company, unlike a natural person, can issue interests in itself, and the raising of capital by a company is a sui generis activity not analogous with the activities of natural persons. In the context of a company, the characterisation of an amount as an outgoing of "capital", said the court, must extend beyond the company law meaning of that term.

The court went on to say that –

The existence of shareholders' equity in a bank increases its ability to absorb losses. The absorption of losses is, no doubt, a benefit to any business, but in the case of banks that utility has the additional beneficial effect of maintaining the confidence of its depositors. The sudden evaporation of that confidence may lead to a significant proportion of depositors withdrawing their funds which, in turn, may expose a bank to a risk of insolvency. It is precisely the need to avoid such losses of confidence and their concomitant damage to the economic system which has led to the introduction of capital adequacy requirements.

In this case, compliance by St George with the RBA's requirements had the immediate effect of improving the ability of St George to withstand losses. That ability went to the heart of St George's business as a bank, namely, its continued ability to maintain the confidence of its depositors.

It was held that the increased ability of St George Bank to maintain the confidence of depositors and the associated ability to increase the size of its loan book were advantages "of a lasting character" and therefore of a capital nature.

St George attempted to meet this argument by contending that the payment of interest in this case did not secure any advantage for St George Bank other than the use, for a limited time, of the loan funds advanced in terms of the debenture.

The court did not accept this argument, and held that –

The payments of interest were an important – indeed essential – element in an overall transaction whose purpose was to achieve the structural advantage to which reference has been made. ...The essentiality of those payments can be seen from the evidence that it was the requirements of the RBA which constituted the sole necessity for the capital raising.

The court said that was no evidence that St George needed the funds extended to it in terms of the debenture, although it was accepted that the funds were used in the ordinary course of its business. The capital adequacy requirements of the RBA, said the court, would have been met even if the funds had remained in LLC. For that reason, *the predominant purpose underpinning the payments of interest was the securing of the structural advantage flowing to St George itself from the increase in the shareholders' equity in LLC.*

The court therefore concluded that the interest payments in question, made by St George to LLC in terms of the debenture, were of a capital nature, and were therefore not deductible for income tax purposes.

The implications of the judgment

Fortunately South African banks faced with a similar issue can rest easily. Our law on the deduction of interest is found in section 24J of the Income Tax Act. This section prescribes rules that establish when interest is deemed to have been incurred, and, in subsection (2), provides that the amount so determined in respect of any year of assessment "must be deducted … if it is incurred in the production of the income."

Expenditure actually incurred in acquiring trademarks

An as yet unreported case from the Tax Court in the Western Cape (Case No. 11486) dealt with the right of a taxpayer to claim deductions in terms of section 11(gA) of the Income Tax Act in respect of expenditure actually incurred in acquiring any trademark.

The taxpayer in this case had acquired a radio station from the SABC in 1996 for a consideration of approximately R65 million. In the agreement, the parties had allocated the purchase price in such manner that designated operating assets were acquired for R5 million, goodwill for R10 million and the trademarks and trade name for R50 million.

The taxpayer had then claimed deductions over a number of years in respect of the expenditure incurred in acquiring the trademarks.

SARS disallowed the deductions on a number of grounds, one of which that the expenditure of R50 million had not been actually incurred in acquiring the trademarks and related intellectual property.

The Tax Court, in a closely reasoned judgment on the various matters at issue, found in favour of the taxpayer on all but one of the points of conflict, including the question whether the amount of R50 million allocated to the trademarks had been actually incurred.

The judgment, at paragraph [26] deals with the assertion by SARS that the expenditure of R50 million was not expenditure actually incurred. The thrust of the argument put forward by SARS in this regard was that the value of the trademarks was not R50 million, and therefore the expenditure could not have been actually incurred in the acquisition of the trademarks (but in something other than the trademarks). This approach is summarised thus:


Judgment provides a useful reminder of the importance of understanding and applying the wording of fiscal legislation.

"What stands out on even a cursory reading of the correspondence that originated from the officials who represented the Commissioner in this matter, is their almost myopic enchantment with the notion that the market value of a trademark is the decisive criterion for determining whether the amount actually expended in acquiring it is allowable as a deduction in terms of section 11 (gA) of the Act."

"Cost" and "value"

There is a distinction, the Court explained, between the concepts of "cost" and "value". This distinction may be found by contrasting the wording used in section 11(e), which permits an allowance for the diminution in value of tangible assets used by a taxpayer in carrying on a trade and, where the diminution is based on cost, prescribes rules that deem the cost to be equal to an arm's length price. The reason for the difference in approach between tangible and intangible assets appeared to lie in the fact that there was a palpable difficulty in valuing intangible assets, and the Court pointed to the fact that some 400 pages of evidence had been taken up in the matter with expert evidence adduced by experts called by both parties as to the market value of the trademarks.

Full purchase price

The Court then considered the argument that the expenditure had not been actually incurred *in the acquisition of the trademarks.* It was found that the payment of the full purchase price had been made by cheque, and that the cheque had been honoured on presentation. The payment of the amount of R50 million forming part thereof had been made "in fact" or "really". Based on the evidence, it was further held that the purchaser had intended to acquire the trademarks and that the seller's advisors had considered the value allocated to the trademarks as reasonable.

No "sham"

Finally, the Court rejected the argument that the allocation of R50 million to the trademarks was a "sham". For this to be the case, it would have to have been shown that the SABC and the purchasers did not intend that R50 million represented payment for the trademarks but that there was a tacit understanding between them which they wished to conceal in order to deceive the outside world or secure some advantage. In finding for the taxpayer on this submission, the Court noted that at no time had the suggestion been put to the representatives of the purchaser in cross-examination that they had been party to such an arrangement.

In the result, the Court came to the inescapable conclusion that the expenditure of R50 million was expenditure actually incurred in the acquisition of the trademarks.

The judgment on the point of "expenditure actually incurred" provides a useful reminder of how important it is to understand and apply the wording of fiscal legislation.

“Pay now – argue later” back in the spotlight

Some years ago the principle that a taxpayer who is assessed to tax would have to make payment of the tax due before bringing action to dispute the assessment was critically considered in our Courts.

It appears that there is concern over the findings of Olivier JA in the matter of *Anil Singh v C:SARS* 65 SATC 203 (SCA), in relation to the Value-added Tax Act, to the effect that the relevant legislation lays down a series of procedures which will ultimately determine when SARS will have the right to take judgment in respect of amounts assessed. In summary, the findings were that:

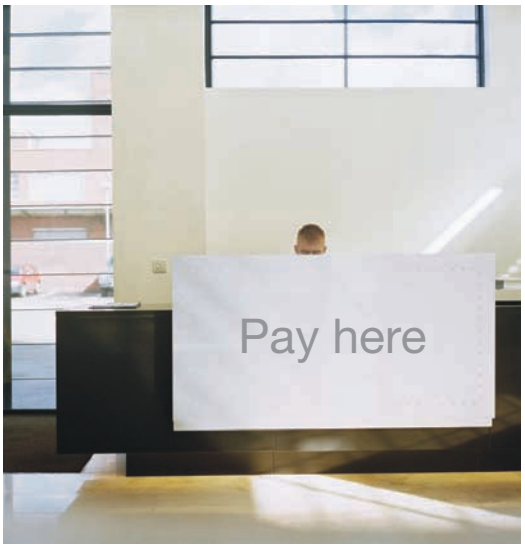
An assessment does not become final and conclusive on issue;

If no objection is lodged against the assessment, it will become final and conclusive on expiration of the period within which an objection may be filed against it;

In the event that an objection to the assessment is filed, the assessment will only become final and conclusive if the objection is withdrawn or disallowed, and then only to the extent that it is disallowed.

Both the Income Tax Act (section 88) and the Value-added Tax Act (section 36) provide that “the obligation to pay … and the right to receive or recover any tax… shall not be suspended by any appeal or pending the decision of a court of law…”

The dicta of Olivier JA indicate that SARS does not have a legally



enforceable right to recover tax until the happening of the relevant events noted above. However, once an appeal is noted, the learned Justice of Appeal confirmed (by reference to section 36 of the Value-added Tax Act) that the right of SARS to demand and take proceedings to recover the tax assessed is no longer suspended.

It is clear that, in practice, SARS has not interpreted the law in the same way, and has frequently sought recovery of tax assessed before disposing of an objection made to an assessment.

The issue will be placed beyond doubt

The draft Taxation Laws Second Amendment Bill, currently being considered for submission to Parliament, proposes amendments to section 88 of the Income Tax Act and section 36 of the Value-added Tax Act which stipulate that the payment of any tax assessed shall not be suspended by any objection or appeal.

However a procedure to obtain a discretionary suspension is also included in the proposed amendments, so that the Commissioner may, having regard to a specified set of circumstances, consent to a request for a deferral of payment, These circumstances have been suggested by the Courts. Linked to this is a power to withdraw such a deferral in the event that the circumstances indicate that the recovery of the taxes might become prejudiced. These principles were developed by SARS in response to the finding of the Constitutional Court related to section 36 of the Value-added Tax Act in the appeal of Metcash Trading Limited in 2000.

These proposed amendments, while extending the right of SARS to demand payment of assessed taxes, will also clarify the principles that should be considered in determining whether a taxpayer may be granted a deferral.