The Taxation Laws Amendment Bill, 2017: A private equity perspective

20 November 2017

In brief

The private equity ("PE") industry continues to operate in a changing environment.

This Tax Alert highlights some of the potential tax issues for PE houses arising from the Taxation Laws Amendment Bill, 2017 ("the TLAB, 2017), which was introduced in Parliament on 25 October 2017.

In detail

Carried interest update

Carry incentive measures remain appropriate mechanisms to incentivise and reward deal professionals.

The tax treatment of carried interest continues to be a hot topic globally and South Africa is no different. Many countries have specific tax rules aimed at taxing management carry as ordinary income (rather than as capital gains or dividend income).

As a general rule, the tax rules aim to tax certain carried interest amounts received as dividend income (e.g. where these amounts are derived directly or indirectly from *inter alia* share repurchase transactions or liquidation/ deregistration distributions). The exact tax treatment of a carried interest amount depends on the particular facts and circumstances involved.

There are, however, currently no rules dealing specifically with the tax treatment of carried interest amounts in South Africa, and none are proposed in the TLAB, 2017.

Globally mobile deal teams

As PE houses increase their international outlook and operations, we are witnessing more cross border movement of deal professionals.

Generally speaking, South African resident deal professionals who are rendering services outside South Africa for more than 183 days during any 12-month period currently benefit from an exemption for their foreign (i.e. non-South African) service remuneration.

From 1 March 2020, only the first R1 million of such foreign service remuneration will be exempt from South African tax.

Acquisition and exit transactions and anti-dividend stripping rules

A South African resident shareholder company disposing of a target portfolio company may, prior to exiting the investment, declare a dividend.

Such a pre-sale dividend is exempt from dividends tax. This pre-sale dividend also decreases the value of the target's shares. As a result, the exiting shareholder can extract value from the company by effectively selling the shares through tax exempt dividends. A further consequence would be that the shares would be sold at a lower price, resulting in a smaller taxable capital gain. There are currently some anti-avoidance rules that, in certain circumstances, prevent this practice by treating the pre-sale dividend as proceeds from the disposal of the target company shares.

The TLAB, 2017 proposes an expansion of these anti-avoidance rules. For example, in a non-listed context, where the seller (together with any connected persons) holds at least:

- 50 per cent of the equity shares in the unlisted target; or
- 20 per cent of those shares if no other person holds the majority of the equity shares,

the pre-sale dividend will be added to proceeds on disposal of the shares in the non-listed target company.

It is further proposed that, in a listed context, the rules will apply where the seller holds 10 per cent of the shares in the listed target.

The new rules will apply in respect of any disposals on or after 19 July 2017, unless the terms of the agreement in terms of which that disposal was made were finally agreed before that date.

Group restructuring and contributed tax capital ("CTC")

The restructuring of groups with South African portfolio companies and foreign parents may involve the transfer of the shares in portfolio companies to a South African holding company ("HoldCo"), which could, for example, be used as a regional headquarter company.

HoldCo would generally benefit from an increase in its CTC: this could enable it to increase its capital distributions to its foreign shareholders (which would generally not be subject to capital gains tax), as opposed to making payments of dividends (which would attract dividends tax).

Certain anti-avoidance measures aimed at discouraging this practice are proposed in the TLAB, 2017. In particular, a measure is proposed that adjusts the value of the consideration received for the issue of shares by HoldCo to the extent that the consideration:

- consists of; or
- is used to directly or indirectly acquire,

shares in a portfolio company that forms part of the same group of companies (which requires a 70% or more common shareholding) as the foreign parent. Essentially, therefore, HoldCo's resulting CTC will be equal to the value of the CTC in the portfolio company as at the date when this company formed part of the same group of companies.

The take-away

PE houses should continuously monitor how tax could impact the ways that the interests of key persons are aligned with those of the PE Fund's investors and, where possible, refine their structures to achieve and optimise the alignment.

PE houses and deal professionals should consider the impact of the revised foreign service remuneration exemption on employment contracts and their personal circumstances. This may involve an assessment as to whether formalisation of tax residence status in SA or elsewhere would be appropriate.

The impact of the new rules relating to dividend stripping on any proposed acquisition or exit transactions should be considered carefully.

Lastly, the potential impact of the proposed new anti-avoidance rules relating to contributed tax capital on any group restructurings should be evaluated.

Let's talk

At PwC we have an established PE practice. Our capabilities include assistance with PE fund and management set-up and tax structuring, acquisitions and deal executions, monitoring and restructuring portfolio companies, carry planning, value chain analysis, transfer pricing, ongoing tax functional support and tax compliance and, where applicable, foreign exchange control planning and compliance.

For a deeper discussion of how the above issues might affect your business, please contact:

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