Tax Alert

7 February 2014

Retroactive Amendments: Value Shifting & Residence of Companies

Retroactive amendment of fiscal legislation has – regrettably – again reared its head with the recent promulgation of the 2013 Taxation Laws Amendment Act.

Two retroactive amendments may have a significant impact on transactions or activities undertaken in the 2013 calendar year. These are the backdated repeal under the Income Tax Act of a relaxation of the residence definition for companies, and the reversal of the exclusion of companies from the 'value-shifting' rules under the Capital Gains Tax regime.

These amendments came about in controversial style: the provisions of the Income Tax Act itself were not amended, as is customary, but provisions of past Amendment Acts, themselves amending the Income Tax Act, were repealed with retroactive effect.

Deletion of 'resident' exclusion

For some years, it has been pointed out that the way in which legislation determined a company's South African tax residence in the context of a South African based multinational, was not functioning as a balanced revenue raising measure, and was not aligned to the commercial reality of how groups operated, especially in Africa.

Often, there is not much (if any) tax to be gained in South Africa if foreign group subsidiaries operating in Africa (where high corporate taxes usually apply) are regarded as resident in South Africa simply because they may be effectively managed from a central location in South Africa. The South African tax system did not act as a revenue raising measure in such instances and merely caused an undue hindrance to cross-border activities.

In recognition of this, the National Treasury enacted a relaxation to the SA residence requirements specifically aimed at corporate groups with foreign operations in so-called 'high tax' jurisdictions (*i.e.* the tax payable in other countries amounts to at least 75% of the tax payable to South Africa had the company been resident here). For years commencing on or after 1 January 2013 it no longer mattered whether South African based multinationals effectively managed their 'high tax' foreign subsidiaries in South Africa.

This move was widely welcomed in the business community and was seen as being supportive of the competitive advantage of South African based groups, especially in Africa. It was also in line with government's initiatives to promote South Africa as a gateway to Africa.

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This much welcomed and business orientated measure has been retroactively repealed, with no clear explanation for the repeal.

Taxpayers that availed themselves of the relaxation in the legislation are therefore advised to review their tax positions since 1 January 2013.

Consequences of the repeal

The practical consequences of the repeal have started to emerge, and these can be problematic.

For example, a foreign incorporated company may now be liable for South African income tax (including income from a non-South African source).

Another problem may arise under South Africa's double tax treaties with potentially negative foreign tax consequences.

Under the (now repealed) relaxation, high-tax foreign subsidiaries effectively managed in South Africa would not have been resident from 1 January 2013. As a result, the residency tie-break provisions of tax treaties would not have applied since that date. Due to the retroactive amendment, tax treaties now become relevant again, as such a foreign subsidiary may be regarded as being (a backdated) SA tax resident, whilst also being, in fact, foreign tax resident during the same period. The application of a tax treaty to such a dual resident, in favour of South Africa, may cause foreign tax to arise because retrospective legislation will arguably not be respected by other countries.

Companies – back in 'value shifting'

The SARS CGT Guide describes value-shifting as involving *"the effective transfer of value from one entity to another without constituting an ordinary disposal for CGT purposes."* Examples that are listed include the issue of shares at a discount, the variation of rights attaching to shares (for example manipulating voting or dividend rights) or the buying back of shares at below market value.

In 2012, the National Treasury introduced new rules to deal with value mismatches on the issue of shares (section 24BA) from 1 January 2013. Accordingly, in the 2012 amending legislation companies were excluded from the value shifting rules as from 1 January 2014.

The repeal of the exclusion of 'companies' from the CGT 'value-shifting' regime was introduced in the final Bill itself, and had not been part of the draft Bill circulated for public comment. This repeal was therefore not available for public comment.

All interested taxpayers potentially affected by the above amendments are invited to contact us to ascertain the risk linked to specific transactions or circumstances.

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