**INTERPRETATION NOTE: NO. 75 (ISSUE 2)**

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**ACT : INCOME TAX ACT NO. 58 OF 1962**
**SECTION : SECTIONS 1(1) AND 41(1)**
**SUBJECT : EXCLUSION OF CERTAIN COMPANIES AND SHARES FROM A "GROUP OF COMPANIES" AS DEFINED IN SECTION 41(1)**

***Preamble***

In this Note unless the context indicates otherwise –

- **"section"** means a section of the Act;
- "**the Act**" means the Income Tax Act No. 58 of 1962;
- **"the corporate rules"** mean the special rules relating to asset-for-share transactions, substitutive share-for-share transactions, amalgamation transactions, intra-group transactions, unbundling transactions and distributions on liquidation, winding-up and deregistration contained in sections 41 to 47 of Part III of Chapter II of the Act;
- **"the definition"** means the definition of "group of companies" in the section indicated;
- **"the proviso"** means the proviso to the definition in section 41(1); and
- any word or expression bears the meaning ascribed to it in the Act.



## 1. Purpose

This Note provides guidance on the application of the proviso to the definition in section 41(1).

## 2. Background

Under certain circumstances the corporate rules provide relief from income tax when assets are disposed of between companies forming part of the same "group of companies" as defined in section 41(1). Generally these relief measures defer the income tax on income and capital gains until the asset is disposed of to a third party or until a degrouping occurs.

The Act contains two definitions of "group of companies", namely, a wider definition in section 1(1) and a narrower definition in section 41(1). The narrower definition generally applies for the purposes of the corporate rules but is also used elsewhere in the Act.

The definition in section 41(1) starts with the definition in section 1(1) and then proceeds to exclude certain companies and shares by way of a proviso.

This Note is concerned with the application and effect of that proviso.

## 3. The law

The definitions in the Act which are used in this Note are reproduced in the **Annexure**.

## 4. Application of the law

### 4.1 Interpretation of the proviso

The first requirement in the definition in section 41(1) is that there must be a "group of companies" as defined in section 1(1). Paragraphs (i) and (ii) of the proviso then proceed to exclude certain companies and shares from consideration.

At issue is whether, after excluding the companies and shares listed in the proviso, the remaining companies meet the requirements set out in the definition in section 1(1) and comprise a group of companies under the definition in section 41(1). If not, the corporate rules may not apply to a transaction conducted between those remaining companies.

*Craies, Statute Law* states the following on the effect of a limiting proviso:[1]

> " '[T]he effect of an excepting or qualifying proviso, according to the ordinary rules of construction, is to except out of the preceding portion of the enactment, or to qualify something enacted therein, which but for the proviso would be within it;……' "

In *Jennings & another v Kelly* Viscount Maugham cited the following extract from *Kent's Commentaries on American Law*[2] with approval:[3]

> " ' "The true principle undoubtedly is, that the sound interpretation and meaning of the statute, on a view of the enacting clause, saving clause, and proviso, taken and construed together, is to prevail." ' "

The effect of applying the proviso to the main enacting clause, namely, the definition in section 1(1), is to exclude from consideration any company listed in paragraph (i) of the proviso and any shares disqualified as equity shares by paragraph (ii) of the proviso.

For a group of companies to exist it must have a "controlling group company" and one or more "controlled group companies". A group that does not have a "controlling group company" after applying the proviso cannot comprise a "group of companies" for the purposes of the definition in section 41(1). Likewise, a company whose equity shares are deemed not to be equity shares by paragraph (ii) of the proviso cannot have a controlling group company and will accordingly be excluded from forming part of a "group of companies" as defined in section 41(1).



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1 7 ed at 218. This passage was cited by Botha JA in *Mphosi v Central Board for Co-operative Insurance Ltd* 1974 (4) SA 633 (A) at 645 when considering the true function and effect of a proviso.

2 12 ed, vol 1 at 463.

3 [1940] AC 206, [1939] 4 All ER 464 at 470.

**Example 1 – Interpretation of the definition in section 41(1)**

*Facts:*

A, a company, was incorporated in the United States of America and is effectively managed in that country. It directly holds 100% of the equity shares in two companies that are incorporated and effectively managed in South Africa, namely, B and C.

C directly holds 100% of the equity shares in D which is also incorporated and effectively managed in South Africa.

All of the shares are held on capital account and there are no contractual obligations, rights or options to purchase or sell the shares under particular circumstances.

*Result:*

*Application of the definition in section 1(1) to A, B, C and D*

A, B, C and D meet the requirements of the definition in section 1(1) because A directly holds at least 70% of the equity shares in B and C. As such, B and C are "controlled group companies" as defined. A indirectly holds at least 70% of the equity shares in D through another controlled group company, namely, C.

C and D meet the definition in section 1(1) because C holds at least 70% of the equity shares in D.

*Application of the proviso to the definition in section 41(1) to A, B, C and D*

A is excluded from consideration as part of the group of companies by paragraph (i)(*ee*) of the proviso as it is a foreign incorporated company which is effectively managed in the United States of America.

None of the exclusions in paragraph (i) or deeming provisions in paragraph (ii) of the proviso apply to B, C or D.

The definition in section 1(1) must now be re-applied to these companies (B, C and D) to determine if there is a group of companies for the purposes of the corporate rules, bearing in mind that A has been eliminated as part of the group.

*Application of the definition in section 1(1) to B, C and D*

Neither B nor C is a controlled group company because A has been excluded from consideration and as a result there is no company still under consideration which alone or together with other permitted companies hold 70% or more of the equity shares in B or C. In the absence of a controlling group company and a controlled group company, B and C are not a "group of companies" as defined.

C and D are a group of companies for purposes of the corporate rules because –

- C is a "controlling group company" while D is a "controlled group company"; and
- C satisfies the requirement that "the controlling group company" directly holds at least 70% of the equity shares in at least one "controlled group company".

**Example 2 – Interpretation of the definition in section 41(1)**

*Facts:*

Companies A, B, C and D are incorporated and effectively managed in South Africa.

A directly holds 100% of the equity shares in B and C. These shares are held on capital account and there are no contractual obligations, rights or options to purchase or sell the shares under particular circumstances.

C directly holds 100% of the equity shares in D. These shares are held as trading stock.

*Result:*

*Application of the definition in section 1(1) to A, B, C and D*

A, B, C and D meet the requirements of the definition in section 1(1) because A directly holds at least 70% of the equity shares in B and C. As such, B and C are "controlled group companies" as defined. A indirectly holds at least 70% of the equity shares in D through another controlled group company, namely, C.

C and D meet the requirements of the definition in section 1(1) because C holds at least 70% of the equity shares in D.

*Application of the proviso to the definition in section 41(1) to A, B, C and D*

Paragraph (ii)(*aa*) of the proviso deems all D's shares not to be equity shares because C holds them as trading stock. D cannot therefore be a "controlled group company" as defined in the definition in section 1(1) and is excluded from consideration as part of the group of companies in the definition in section 41(1).

None of the exclusions in paragraph (i) or deeming provisions in paragraph (ii) of the proviso apply to A, B or C.

The definition in section 1(1) must now be re-applied to A, B and C to determine if there is a group of companies for the purposes of the corporate rules, bearing in mind that D has been eliminated as part of the group.

*Application of the definition in section 1(1) to A, B and C*

A, B and C still meet the requirements of the definition in section 1(1) because A directly holds at least 70% of the shares in B and C. As such, B and C are "controlled group companies" as defined. Accordingly, A, B and C are a group of companies for purposes of the corporate rules.

### 4.2 Tax discrimination under tax treaties

Article 24(5) of the OECD Model Tax Convention on Income and on Capital[4] provides as follows:

> "5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the

[4] (July 2010) issued by the Organisation for Economic Co-operation and Development.

taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected."

In *HM Revenue and Customs v FCE Bank Plc*[5] a company resident in the United States of America (USA) owned and controlled two companies resident in the United Kingdom (UK). Under the UK's group taxation provisions the one subsidiary wished to "surrender" its assessed loss to the other subsidiary. The Commissioners for Her Majesty's Revenue and Customs (HMRC) refused to permit the transfer of the assessed loss on the grounds that the two subsidiaries did not form part of a group of companies because of the exclusion of their USA parent company from the group for group taxation purposes. The court held that HMRC's refusal to allow the transfer of the assessed loss amounted to discrimination under Article 24(5) of the Double Taxation Convention between the UK and the USA and dismissed HMRC's appeal. The court's reasoning was that had the two subsidiaries had a resident parent company they would have been entitled to transfer the assessed loss and accordingly there was discrimination.

The question arises whether this judgment could find application under the corporate rules, for example, when a foreign incorporated parent company, which is not effectively managed in South Africa, holds shares in two resident subsidiaries and the subsidiaries are denied roll-over relief on a transfer of assets between them under section 45 because of the operation of the proviso. The parent company in this example would be a non-resident for income tax purposes.[6]

In deciding this question it is necessary to determine whether two resident subsidiaries of a resident parent company which are in a similar position would be denied group relief.

The proviso does not discriminate against resident companies because they are wholly or partially owned or controlled, directly or indirectly, by one or more non-resident parent companies. Rather it does so because the parent companies are not liable to taxation in South Africa except on South African-source income and capital gains on South African immovable property and assets of a permanent establishment in South Africa. The relief is also denied to resident subsidiaries of a resident parent company when the parent company is exempt or partially exempt from normal tax. For example, subsidiaries of the following resident companies are excluded from a group of companies under paragraph (i) of the proviso:

- A co-operative [paragraph (i)(*aa*)].
- An association formed in South Africa to serve a specified purpose, beneficial to the public or a section of the public [paragraph (i)(*aa*)].
- A portfolio of a collective investment scheme in property that qualifies as a REIT [paragraph (i)(*aa*)].[7]
- A "non-profit company" as defined in section 1 of the Companies Act No. 71 of 2008 [paragraph (i)(*bb*)].



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5 [2012] EWCA Civ 1290 (17 October 2012).

6 The parent company would be a company contemplated in paragraph (i)(*ee*) of the proviso and would not form part of a group of companies with its South African subsidiaries.

7 The requirement that a collective investment scheme in property must qualify as a REIT was inserted by section 4(1)(*f*) of the Taxation Laws Amendment Act No. 31 of 2013 and applies to years of assessment commencing on or after 1 January 2015.

- A company whose receipts or accruals of whatever nature would be exempt from normal tax under section 10 [paragraph (i)(*cc*)].
- A company that is a public benefit organisation or recreational club that has been approved by the Commissioner under section 30 or 30A [paragraph (i)(*dd*)].

As a result, Article 24(5) will not apply when paragraph (i) of the proviso excludes a non-resident controlling company from a group of companies because resident companies who are similarly exempt from South African income tax are also excluded from relief under the corporate rules.

With effect from 1 January 2013 a company incorporated, established or formed in South Africa but which has its place of effective management outside South Africa is also excluded from a group of companies under paragraph (i)(*ff*)[8] of the proviso. Certain tax treaties[9] provide that when a person other than an individual is a resident of both contracting states, that person shall be deemed to be a resident solely of the state in which its place of effective management is situated.

## 5. Conclusion

It is not permissible to interpret the proviso as an independent enacting clause and its provisions must be read as if they formed part of the opening words of the definition in section 41(1). The exclusion by the proviso of, for example, a controlling company from a group of companies will accordingly impact on whether its controlled companies remain part of a group of companies under the corporate rules.

The exclusion of non-resident companies by the proviso does not constitute discrimination under South Africa's tax treaties.



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[8] Paragraph (i)(*ff*) of the proviso was inserted by section 90(1)(*e*) of the Taxation Laws Amendment Act No. 31 of 2013 and applies to transactions entered into on or after 1 January 2013.

[9] The term "tax treaty" means an agreement for the avoidance of double taxation entered into between two countries.

## Annexure – The law

### Definition of "group of companies" in section 1(1)

**"group of companies"** means two or more companies in which one company (hereinafter referred to as the **"controlling 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 percent of the equity shares in 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;

### Definition of "group of companies" in section 41(1)

**"group of companies"** means a group of companies as defined in section 1: Provided that for the purposes of this definition—

(i) any company that would, but for the provisions of this definition, form part of a group of companies shall not form part of that group of companies if—

(*aa*) that company is a company contemplated in paragraph (*c*), (*d*) or (*e*) of the definition of "company";

(*bb*) that company is a non-profit company as defined in section 1 of the Companies Act;

(*cc*) any amount constituting gross income of whatever nature would be exempt from tax in terms of section 10 were it to be received by or to accrue to that company;

(*dd*) that company is a public benefit organisation or recreational club that has been approved by the Commissioner in terms of section 30 or 30A;

(*ee*) that company is a company contemplated in paragraph (*b*) of the definition of "company", unless that company has its place of effective management in the Republic; or

(*ff*) that company has its place of effective management outside the Republic; and

(ii) any share that would, but for the provisions of this definition, be an equity share shall be deemed not to be an equity share if—

(*aa*) that share is held as trading stock; or

(*bb*) any person is under a contractual obligation to sell or purchase that share, or has an option to sell or purchase that share unless that obligation or option provides for the sale or purchase of that share at its market value at the time of that sale or purchase;

### Definition of "controlled group company" in section 1(1)

**"controlled group company"** means a controlled group company contemplated in the definition of "group of companies";

### Definition of "controlling group company" in section 1(1)

**"controlling group company"** means a controlling group company contemplated in the definition of "group of companies";