

BINDING PRIVATE RULING: BPR 233

DATE: 19 May 2016

ACT : INCOME TAX ACT NO. 58 OF 1962 (the Act)
SECTION : SECTIONS 1(1) – DEFINITION OF “GROSS INCOME”, 8(4)(a), 11(a) READ WITH 23(g); 24C AND 45(4B) OF THE ACT AND PARAGRAPHS 3(a), AND 4(a) AND (b)(ii)(aa) OF THE EIGHTH SCHEDULE TO THE ACT
SUBJECT : TRANSFER OF A PART OF A BUSINESS TO A FELLOW SUBSIDIARY

1. Summary

This ruling determines the tax consequences for the seller and the buyer upon the transfer of a part of the seller’s business, specifically –

- whether the settlement of the seller’s actual obligations by the buyer will result in a recoupment for the seller;
- whether an amount accrues to or is received by the buyer as gross income if the seller transfers an cash amount to the buyer in order to take over certain of the seller’s contingent liabilities; and
- whether, in that event, the buyer will be entitled to an allowance in respect of future expenditure on the relevant contracts.

2. Relevant tax laws

This is a binding private ruling issued in accordance with section 78(1) and published in accordance with section 87(2) of the Tax Administration Act No. 28 of 2011.

In this ruling references to sections and paragraphs are to sections of the Act and paragraphs of the Eighth Schedule thereto applicable as at 8 December 2015. Unless the context indicates otherwise, any word or expression in this ruling bears the meaning ascribed to it in the Act.

This is a ruling on the interpretation and application of the provisions of –

- section 1(1) – definition of “gross income”;
- section 8(4)(a);
- section 11(a) read with section 23(g);
- section 24C;
- section 45(4B);
- paragraph 3(a);
- paragraph 4(a); and

- paragraph 4(b)(ii)(aa).

3. Parties to the proposed transaction

The Applicant:	A company incorporated in and a resident of South Africa that will be disposing of a part of its business to the Co-Applicant
The Co-Applicant:	A new company incorporated in and a resident of South Africa that will acquire a part of the business from the Applicant
Newco:	A new company incorporated in and a resident of South Africa that will be the holding company of the Applicant and the Co-Applicant

4. Background

The Applicant provides business process services and software solutions to, amongst others, the automotive insurance industry in South Africa, which can be divided into two categories, financial services and non-financial services business. The non-financial services business includes, amongst others –

- a) the issuing of motor vehicle service plans and motor vehicle maintenance plans to customers (customer contracts). The Applicant bears the cost of the services and/or maintenance of the motor vehicles covered by the respective plans. It also provides related administrative services; and
- b) the administration and management of motor vehicle service plans and motor vehicle maintenance plans issued by, amongst others, the motor vehicle manufacturers and other third party corporate entities (corporate client contracts).

The customer contracts are entered into directly between the Applicant and the customer. The contracts provide cover for the duration of the relevant plan for the following items –

- i) all specified motor vehicle manufacturer services;
- ii) the replacement of certain maintenance items to motor vehicles;
- iii) labour charges for the services and maintenance rendered; and
- iv) consumables and sundry charges.

The Applicant's obligation under the customer contracts is to settle the costs of the motor vehicle service as covered by the plan and to provide the administration services necessary for the implementation of the plan. The obligations are conditional upon the customer taking his or her motor vehicle for a service. As consideration for the cover provided, the customer is required to pay either a premium in advance or monthly premiums.

The service plan terminates on the earlier of reaching either the stipulated contract kilometre limit or the stipulated contract period. In the event that a customer cancels the plan, and if a refund is due, all costs incurred will be deducted and the balance refunded to the customer on a *pro rata* basis within 30 days.

The corporate client contracts are entered into between the Applicant and various corporate clients. Similar administration services as in the case of the customer contracts are provided. The Applicant also provides additional administrative services to the corporate clients. Upon a corporate plan being issued by a corporate client to a motor vehicle owner the Applicant becomes obliged to perform policy loading, policy administration and premium collection and reconciliation services. Similar to the customer contracts described above, the obligations of the Applicant are conditional upon the owner taking his or her motor vehicle for a service. As consideration, the corporate client either pays a premium in advance or monthly premiums.

The Applicant will transfer the relevant contracts where the customers and clients have paid premiums in advance (hereafter referred to as prepaid customer contracts or the prepaid corporate client contracts, where applicable) to the Co-Applicant.

The Applicant has historically claimed the section 24C allowance relating to the administration services in respect of income received in advance.

5. Description of the proposed transaction

The proposed restructuring entails the incorporation of two new companies, a new South African holding company (Newco) and the Co-Applicant to whom the Applicant will sell a part of its business. The proposed series of transactions to achieve this restructuring is set out below:

5.1 Incorporation of Newco

The current holding company of the Applicant will transfer its shares in the Applicant to Newco in return for shares in Newco in the same proportion as its shareholding in the Applicant.

5.2 Sale of the shares of operating subsidiaries to Newco

The Applicant will sell its shares in its operating subsidiaries to Newco. Newco will function as the holding company for the South African operating subsidiaries. The sale will take place at book value and the Applicant will undertake a return of capital to Newco. The purchase price and return of capital distribution will be paid in cash.

5.3 Incorporation of the Co-Applicant and the sale of the Applicant's non-financial services business

The Co-Applicant will be incorporated with 100% of its shares being held by Newco. The Applicant will sell its non-financial services business (the business) and the group's common infrastructure to the Co-Applicant by way of a section 45 intra-group transaction. The agreement of sale will provide that the Applicant sells to the Co-Applicant the business, comprising of –

- a) the assets, being the movable assets identified, the accounts receivable, cash, inventories, intangible assets, intellectual property, prepaid expenses and deposits;
- b) the business contracts which consist of contracts between the Applicant and third parties (corporate client contracts) and the Applicant and customers (customer contracts), excluding the prepaid corporate client and the prepaid customer contracts;

- c) the rights pertaining to and vested in the business, including any transferable authorisations, if any; and
- d) the e-mail addresses and the telephone and fax numbers relating to the business as at the effective date,

but, excluding the “excluded assets”, as defined in the agreement of sale.

The purchase price for the sale of the business will be the book value of the assets comprising the business of the Applicant plus R1. Payment is to be made by the assumption by the Co-Applicant of certain liabilities of the Applicant plus a cash payment, if necessary. The liabilities to be delegated by the Applicant to the Co-Applicant, as the payment method of the purchase price, are defined as the amounts owing by the Applicant to its creditors in respect of –

- i) finance leases for desktop computers and monitors; and
- ii) accounts payable and sundry creditors.

The excluded liabilities which remain with the Applicant and are not part of the payment, include, amongst others, the contingent liabilities.

As part of the agreement of sale and as required by section 40 of the Basic Conditions of Employment Act No. 79 of 1997 read with section 197 of the Labour Relations Act No. 66 of 1995, the Co-Applicant will take-over the Applicant’s leave pay obligations to the employees who are to be transferred from the Applicant to the Co-Applicant. The Applicant will pay a cash amount equal to the value of those obligations to the Co-Applicant.

5.4 Dividend declaration

The Applicant will declare a cash dividend to Newco out of the sale proceeds referred to in **5.2**.

5.5 Service level agreement with respect to the group infrastructure

The Applicant and the Co-Applicant will enter into a service level agreement in terms of which the Co-Applicant will make the group infrastructure available to the Applicant. This agreement will stipulate that the parties provide each other with –

- a) the use of certain of their infrastructure and assets; and
- b) the services of certain of their employees.

5.6 Assumption of contingent liabilities

The Co-Applicant will assume the contingent liabilities of the Applicant.

The contingent liabilities of the Applicant relate to performing administrative services and paying the costs of motor vehicle services in terms of the prepaid customer contracts and prepaid corporate client contracts. These obligations may become actual liabilities on the happening of various uncertain future events.

The Applicant has indicated that the reason for not delegating the contingent liabilities as part of the purchase price for the sale of the business is a commercial necessity. The Applicant will make a cash payment to the Co-Applicant equal to the cash value of these obligations as reflected in the Applicant’s contingent obligation effective date management accounts.

5.7 Loan agreement

The Co-Applicant will lend part of the cash received from the Applicant to Newco on an interest free basis in terms of a loan agreement.

6. Conditions and assumptions

This binding private ruling is not subject to any additional conditions and assumptions.

7. Ruling

The ruling made in connection with the proposed transaction is as follows:

7.1 The Applicant

The settlement of the Applicant's actual obligations by the Co-Applicant will not result in a recoument for the Applicant under section 8(4)(a) or under any other provision of the Act, in respect of obligations for which deductions were allowed to the Applicant.

7.2 The Co-Applicant

The receipt by or accrual of an amount as consideration for the assumption of contingent obligations under the prepaid customer contracts and prepaid corporate client contracts will be included in the Co-Applicant's "gross income" as defined in section 1(1) in the year of receipt or accrual, whichever occurs first.

The Co-Applicant will be entitled to a section 24C allowance, calculated on the amount so included in its "gross income".

The Co-Applicant will be entitled to a deduction when the actual expenses relating to the performance of the prepaid customer contracts and prepaid corporate client contracts are incurred.

The amount to reimburse the Co-Applicant for assuming the leave pay obligations in respect of the Applicant's transferring employees as at the effective date of the sale of business will be a capital receipt or accrual by or in favour of the Co-Applicant.

The Co-Applicant will not be entitled to a deduction in respect of the incurral or payment of actual leave pay obligations, existing at the effective date and taken over from the Applicant in terms of the sale of business agreement.

The Co-Applicant will not realize a capital gain or loss in respect of the receipt of cash payments from the Applicant, relating to its assumption of the Applicant's actual leave pay obligations in respect of employees transferred to it.

7.3 Both the Applicant and the Co-Applicant

The loan to be provided by the Co-Applicant to Newco, using a portion of the cash payment received from the Applicant in terms of the sale of business agreement, will not trigger the deemed de-grouping provisions of section 45(4B).

8. Period for which this ruling is valid

This binding private ruling is valid for a period of 6 years from 8 December 2015.

**Legal and Policy Division: Advance Tax Rulings
SOUTH AFRICAN REVENUE SERVICE**