The introduction of the new Companies Act, 2008 had a significant impact on the commercial landscape. A number of significant changes were introduced in the way the business is done, and it is questionable whether or not the tax regime has adequately aligned itself with the legal implications of the new Companies Act. Below are some thoughts on certain Capital Gains Tax (CGT) issues. The issues discussed should not be considered an exhaustive list; we merely highlight a few concerns that bear consideration.

**Treatment of inconsistent Provisions**

It is clear that the purposes of the Companies Act and the Income Tax Act 1962 are completely different. The Companies Act is designed to regulate the affairs of corporate entities, and its stated purpose includes –

- Promoting the development of the South African economy, innovation and investment in South African markets and balancing the rights and obligations of shareholders and directors within companies; and
- Encouraging the efficient and responsible management of companies and providing for the efficient rescue and recovery of financially distressed companies in a manner that balances the rights and interests of all relevant stakeholders.

On the other hand, the ITA constitutes fiscal legislation which is designed to –

- Specify the taxation on income;
- Provide mechanisms for the collection of these taxes.
- The question of interest to the reader is: what would happen if the Companies Act and the Income Tax Act were to clash? Put differently, which piece of legislation would prevail if, for example, a CGT rule contained in the Eighth Schedule to the ITA clashes with a provision in the Companies Act, where both dealt with similar subject matter?

In terms of the Companies Act, in the case of inconsistency between acts –

- The provisions of both acts apply concurrently, to the extent that it is possible to apply one inconsistent provisions without contravening the other; and
- To the extent that it is impossible to apply or comply with one of the inconsistent provisions without contravening the second, the Companies Act will prevail over the ITA.

It is questionable whether a rule in one piece of legislation which seeks to establish its paramountcy over other statutes is competent. However, this provision should be borne in mind, particularly in light of some of the issues discussed where there may, indeed, be inconsistencies between the CGT rules in the ITA, and the Companies Act.

**Amalgamations**

An area of significant development relates to the rules surrounding mergers and amalgamations. The ITA has long allowed certain transactions to be undertaken without triggering any immediate CGT where those transactions fall within the so-called roll-over relief provisions.

By way of background, the roll-over relief provisions contained in sections 41 to 47 of the ITA allow parties that fall within their scope to transfer assets to each other.

Of particular interest for the present circumstances are amalgamation transactions which are regulated in terms of section 44, and intra-group transactions set out in section 45. An amalgamation transaction allows two companies that may or may
not form part of the same group of companies to ‘merge’ by way of one company transferring of its assets and liabilities to the other. The transferring company must be wound up.

Section 45 is a simpler provision and deals with intra-group transfers where assets can be moved within a group of companies free of any immediate tax charge.

Under the 1973 Companies Act regime, companies could only ‘merge’ by way of a sale of shares or business. Under the 2008 Act, however, new provisions specifically dealing with ‘mergers’ and ‘amalgamations’ have been included: the question is whether or not these provisions communicate efficiently with the roll-over relief rules, particularly the rules dealing with amalgamations and inter group transfers for tax purposes.

The Companies Act contains a long, detailed list of requirements for the conclusion of a merger transaction, including that each merged entity must comply with the solvency and liquidity tests after the implementation of the merger.

The merger and amalgamation procedures are set out in section 113 and 116 of the Companies Act. These provisions are new and unfamiliar and, in particular, the transfers of property is legislatively catered for, and thus happen by operation of law. Section 1 of the Companies Act defines ‘amalgamation and merger’ to mean –

‘A transaction, or series of transactions, pursuant to an agreement between two or more companies, resulting in –

(a) The formation of one or more new companies, which together hold all the assets and liabilities that were held by any of the amalgamating or merging companies immediately before the implementation of the agreement, and the dissolution of each of the amalgamating or merging companies; or

(b) The survival of at least one of the amalgamating or merging companies, with or without the formation of one or more new companies, and vesting in the surviving company or companies, together with any such new company or companies, of all the assets and liabilities that were held by any of the amalgamating or merging companies immediately before the implementation of the agreement.’

The Companies Act contains a long, detailed list of requirements for the conclusion of a merger transaction, including that each merged entity must comply with the solvency and liquidity tests after the implementation of the merger.

Upon implementation of a merger agreement, the property of each merging company becomes the property of the surviving company, which is liable for all the obligations of every amalgamating or merging company. Again, this happens by operation of law, and no documentation other than a merger agreement and certain regulatory filing, is required.

These provisions in the Companies Act and the ITA do not specifically refer to one another. However, in our view, there appears to be no inconsistency between the two. Put differently, the Companies Act now allows for a transfer of assets either by way of a sale of assets shares, or a ‘merger’. We are of the view that both can be undertaken in terms of the roll-over relief rules contained in the ITA. Contracting parties must be careful to ensure that the procedural and anti-avoidance requirements in the various sets of rules are complied with when undertaking a merger or amalgamation, if it is intended that both the Companies Act and the roll-over relief rules from the ITA should apply.

We are also of the view that parties seeking to ‘merge’ from a Companies Act perspective will be liable for CGT should they fail to ensure that their transaction falls within one of the roll-over relief rules.

Distributions

Another area of interest arises in respect to company distributions. The corporate law rules regulating distributions by a company have been significantly relaxed under the Companies Act. While certain commentators suggest that the changes are not particularly significant, in our view the new regime, which holds liquidity and solvency of a distributing company as the major criteria for consideration in making a distribution, is a significant departure from the past.

Of primary concern to National Treasury, the body responsible for drafting fiscal laws, was that strict distinctions between the origin of funds of a company are no longer relevant in terms of the new Companies Act. Put differently, when assessing whether a company is competent to make a distribution to a shareholder, the key question is whether or not the company will be liquid and solvent as contemplated in section 46 of the Companies Act after that distribution, and not the type of funds being distributed, i.e. reserves, share premiums, etc.

Because the ITA seeks to tax distributions of profits differently from distributions of capital, the Income Tax Act has assumed the
obligation of defining the types of funds a company is distributing and, even, when such distributions may be made.

As was always the case, in terms of recent amendments to the ITA under the Taxation Laws Amendment Act, 2011 (the TLAA), a ‘return of capital’ remains a CGT event for a shareholder. No longer is the CGT payable calculated with reference to paragraph 33 of the Eighth Schedule to the ITA, but rather new rules have been drafted to specifically assist in calculating the capital gain of the shareholders in a capital distribution. These rules are encapsulated in paragraphs 76 to 74B of the Eighth Schedule.

Of particular interest, however, is that a ‘return of capital’ is essentially defined to be a distribution which reduces the contributed tax capital (CTC) of the distributing company. The problem with this is that CTC, which was formerly known as the capital of a company (i.e. capital and share premiums), is now defined to mean the share premium of the company as at 1 January 2011 or the amounts received by the company upon a subscription for shares by shareholders. CTC is also class specific, in that it appears from the ITA, CTC of one class of shares should not be distributed to shareholders of a different class, but should always be distributed pro rata to shareholding with a class.

Accepting for present purposes that CTC must be distributed pro rata to shareholding in a class is competent (in our view it is not), interesting anomalies arise. Assume, for example, that a company has a foreign shareholder and a local BEE shareholder who cannot provide any funding to the company. It may well arise that all of the funding will be introduced by the foreign funder and, given that the foreign shareholder will be subject to thin capitalisation rules, a portion of the funding may need to be introduced as equity funding (i.e. CTC). Based on the rule enunciated above, that for the purpose of the ITA, CTC should be distributed prorata within a class, arguably a portion of the CTC contributed by the foreign shareholder must now be distributed only to the BEE shareholder. This would trigger an immediate capital gain for the BEE shareholder but one which the BEE shareholder will in all likelihood be happy to bear given that it is participating in funds that it did not introduce.

What the ITA is silent on, is what happens if the CTC prohibition is ignored? What will happen if all the funds are distributed to the foreign shareholder? Does the foreign shareholder realise the capital gain based on an excessive return of capital in terms of paragraphs 76 to 76B of the Eighth Schedule, or will the ‘excess portion’ constitute a dividend? All of these queries are yet to be answered and, hopefully, will shortly be dealt with by statutory amendments.