



DAUDS ADVISORY

Tax

Facilitation of Corporate Activity through Corporate Reorganisation Rules

Introduction

1. There is a recognition worldwide that corporate activity, which may economically be beneficial, should not be frustrated by tax rules. It is for this reason that policymakers have considered it appropriate to design their tax system in such a way as not to discourage corporate restructuring. Reorganisations may occur for the purpose of creating greater corporate efficiency, when ownership of companies changes hands or as part of the privatisation process. Business reorganisations typically lead to asset or share transfers which would, in the absence of special tax rules, be taxable. Where the transfers are taxable, the tax liabilities may be so large as to impede business reorganisations. In these circumstances, business reorganisations would not be economically efficient. In recognition of this, policymakers in many countries have designed rules that remove tax-related impediments to reorganisations.

Forms of Corporate Reorganisation

2. Some tax systems contain a definition of “reorganisation”, while others do not. South Africa is one country whose tax system does not have a definition of the word, merely examples, or instances, of reorganisation transactions. Nevertheless, a reorganisation tends to describe a transaction which involves a significant change in either the legal or economic structure of one or more business enterprises. Section 368 of the US Internal Revenue Code defines a “reorganisation” as a statutory merger or consolidation, the acquisition by one company of the shares of another company; the acquisition by one company of the assets of another company; the transfer by a company of its assets to another company; a recapitalisation; or a mere change in identity, form or place of organisation of a company.

3. Corporate reorganisations come in varied forms. One form, asset acquisition, involves a transfer of the assets and liabilities by one company, or more companies, to a newly established or pre-existing company in exchange for consideration which may take the form of shares, securities, cash, assets in kind or the transfer of liabilities. In an asset acquisition transaction, the transferor company may continue to exist after the transfer, or it may distribute the proceeds from the transfer to its shareholders in complete liquidation. A corporate reorganisation may also take the form of a share acquisition. This involves the transfer of shares by one company to a newly established or pre-existing company in exchange for consideration which may take the form of shares, securities, cash or assets. The South African tax system deals with these types of transaction under what is referred to as “asset-for-share transaction”. Incorporation transactions also fall in this category of transactions.

4. Another form of corporate reorganisation is a merger, called an amalgamation in the South African tax system. It involves two legal entities — one of them disappears as part of the reorganisation, while the other remains as the surviving entity. In this transaction,

the assets and liabilities of the one company are transferred to the other company usually in exchange for shares. A consolidation shares the characteristics of an amalgamation or merger, the only difference being that in a merger, the legal entity to which the assets and liabilities are transferred is a pre-existing company, while in a consolidation, the legal entity to which the assets and liabilities are transferred is typically a newly established company.

5. Yet another form of corporate reorganisation is a corporate division, or fission. It is the opposite of a merger or consolidation (also referred to as a fusion). In this transaction, the assets of one company are transferred to at least two newly established or pre-existing companies. The transfer is required to be made in exchange for shares. Corporate divisions, or fissions, come in three forms — spin-off, split-off and split-up. In a spin-off, the shares of a subsidiary are distributed to the shareholders of the parent company. In a split-off, the shares of the subsidiary are distributed in exchange for the surrender of shares of the parent company. In a split-up, the parent company distributes its shares in two or more subsidiaries in complete liquidation. A corporate division is known in the South African tax system as an unbundling transaction. Corporate divisions are also known as demergers.
6. The South African tax system recognises a liquidation distribution transaction as a form of corporate reorganisation. The tax system provides more detailed requirements for all the recognised forms of corporate reorganisations.

Tax Deferral Benefits for Corporate Reorganisations

7. The tax system of many countries, including South Africa's, contains rules which provide for what is commonly referred to as a "tax-free reorganisation". The description is not entirely correct. What is really meant is that the taxation of reorganisation transactions is deferred. So the more apt description should be "tax-deferred reorganisation". In

other words, the tax consequences of the transaction are postponed to a later date when some realisation event either actually occurs, or is deemed to occur. When taxation does occur, it happens on the basis of what the tax consequences would have been at the time of the reorganisation, if the transaction were taxable then.

8. The objective of the tax deferral rules is not to entirely exempt the companies or shareholders to a reorganisation, but rather to neutralise the tax effects so that there are no tax advantages or tax disadvantages to the reorganisation. The principle is thus one of deferral of tax on unrealised gains that exist at the time of the transaction. Under the deferral principle, no tax is levied on the gain realised by a company upon the transfer of its assets to another company in exchange for shares. Where consideration for the transfer is made up of a combination of shares and cash, i.e. partly in shares and partly in cash, partial tax deferral is commonly allowed by the rules. The treatment accorded to the transferor company is extended to the shareholders of the transferor company. Where, as part of the reorganisation, the shareholders receive consideration partly in shares and partly in cash, partial tax deferral follows.
9. Different tax systems lay down different requirements for the purpose of tax deferral in reorganisation transactions. But what is typically required, in addition to any other possible requirements, is a continuation of the business enterprise, and secondly, a continuity of shareholder interest. The detail of continuity is usually spelled out in the tax system, more specifically, the degree of such continuity. Shares which constitute voting shares, or ownership in the business enterprise (equity shares) are typically accepted as securing the continuity of shareholder interest. Debt securities, on the other hand, are usually not.
10. Typically, in a reorganisation, the tax attributes of the assets of the transferor company are carried over to the transferee company. The tax attributes include the base cost of

the assets. In other words, the base cost of the assets in the hands of the transferee company will be the same as the base cost of those assets in the hands of the transferor company before the reorganisation.