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SECTION 42 VS SECTION 45 TRANSACTIONS: CHOOSING THE CORRECT RESTRUCTURING MECHANISM

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Corporate restructures are common in modern business operations. Businesses may wish to consolidate assets, introduce new shareholders, separate divisions, or simplify existing structures. In doing so, they often seek tax-efficient ways to implement these changes.

The Income Tax Act, 58 of 1962 ("**ITA**") provides several corporate rollover relief mechanisms that allow qualifying restructures to occur without triggering immediate tax consequences. Two of the most commonly used provisions are Section 42 (asset-for-share transactions) and Section 45 (intra-group transactions). These provisions may appear similar at first glance, but they serve different purposes and operate under different requirements.

The purpose of rollover relief is to allow businesses to restructure without immediate tax liability where there has not been a true economic disposal outside the corporate environment. Without these provisions, internal restructures could trigger capital gains tax, transfer duty, securities transfer tax, and other tax consequences. SARS applies these provisions strictly, and transactions must be structured carefully to ensure compliance.

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Section 42 Transactions:

Section 42 transactions are commonly referred to as "asset-for-share transactions". A Section 42 transaction occurs where a person (individual or qualifying juristic person, e.g. a company) disposes of an asset to a company in exchange for (additional) equity shares issued by that company to the person as consideration.

A simple example would be:

- Individual A owns a business personally;
- Individual A transfers the business assets into NewCo (Pty) Ltd;
- NewCo issues shares to Individual A as consideration.

Provided the statutory requirements are met, the transaction may qualify for rollover relief under Section 42.

In practical terms, the transfer does not trigger immediate capital gains tax because the transferor has not truly "cashed out" of the asset. Instead, ownership changes from direct ownership of the asset to ownership of shares in the company holding the asset.

The asset is treated as being transferred at its original base cost, rather than at its current market value. The transferee company effectively steps into the shoes of the transferor by acquiring the asset at the same base cost, and the shares received by the transferor inherit that rolled-over base cost. This means that any built-up gain in the asset is not eliminated but merely deferred and carried over into the shares issued as consideration. The deferred gain will only be realised and taxed in the future when the shares or the underlying asset are ultimately disposed of in a fully taxable transaction.

An important requirement in Section 42 transactions is the "qualifying interest" requirement. The transferor must, as a result of the transaction, hold a qualifying equity interest of at least 10% in the transferee company immediately after the asset-for-share transaction. In addition, the ITA contains anti-avoidance provisions aimed at preventing short-term disposals following a rollover transaction. If the shares acquired under a Section 42 transaction, or the underlying assets, are disposed of within approximately 18 months after the transaction, the rollover relief may be reversed or adverse tax consequences may arise. Businesses should therefore carefully consider any intended post-transaction disposals before implementing a Section 42 restructure.

Section 42 serves as an important restructuring tool, allowing assets to be moved into corporate vehicles without an immediate tax burden, while ensuring that the tax liability is preserved for a later disposal.

Section 42 is commonly used when incorporating a business, introducing assets into a company, implementing new investment structures, or consolidating businesses into a new entity.

A key requirement is that the consideration must consist of equity shares.

Section 45 Transactions:

Section 45 applies to "intra-group transactions". Unlike Section 42, Section 45 only applies where companies form part of the same qualifying "group of companies" as defined in Section 41 of the ITA. This generally requires at least a 70% direct or indirect shareholding relationship.

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A simple example would be:

- HoldCo owns 100% of Subsidiary A and Subsidiary B;
- Subsidiary A transfers assets or business operations to Subsidiary B;
- The transfer occurs within the same group structure.

If the statutory requirements are met, the transfer may qualify for tax rollover relief under Section 45.

Section 45 is commonly used when transferring assets between subsidiaries, centralising operations within a group, moving intellectual property or property internally, or reorganising divisions within an existing group structure.

Key differences:

The key distinction between Sections 42 and 45 is the nature of the transaction:

Section 42	Section 45
Asset-for-share transaction	Intra-group transaction
Assets transferred in exchange for shares	Assets transferred within a group
Can involve individuals or companies	Applies between qualifying companies
Often used for incorporations and new structures	Often used for internal group reorganisations

Common mistakes:

Some of the most common mistakes made in relation to Sections 42 and 45 include:

- **Incorrectly assuming a “group of companies” exists.** Businesses often assume companies form part of the same group when they do not. This can occur where shareholding percentages are insufficient, trusts or individuals interrupt the group chain, or ownership structures are misunderstood. If the group requirements are not met, Section 45 relief may fail entirely.
- **Incorrect consideration structure.** For Section 42 transactions, the consideration must consist of equity shares. Incorrect structuring may disqualify the transaction.
- **Ignoring other tax and legal implications.** Even where rollover relief applies for income tax purposes, businesses must still consider VAT, securities transfer tax, transfer duty, employees’ tax, accounting implications, and corporate law requirements. A restructure should never be analysed purely from an income tax perspective.
- **Lack of commercial substance.** SARS increasingly scrutinises transactions that appear artificial or purely tax driven. Transactions should have a genuine commercial rationale and be properly implemented.

Anti-avoidance considerations:

Even where a transaction qualifies for rollover relief under Sections 42 or 45, businesses must remain mindful of the general anti-avoidance rules (GAAR) contained in the ITA. SARS closely scrutinises corporate restructures to ensure that they have genuine commercial substance and are not implemented primarily to obtain impermissible tax benefits.

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In the context of Section 42 transactions, Section 24BA (the value-for-value rule) may apply where assets are transferred in exchange for shares that do not properly reflect market value. In the context of Section 45 transactions, the ITA contains specific de-grouping and anti-avoidance provisions aimed at preventing the tax-free migration of assets outside a group shortly after an intra-group transfer. In addition, the general anti-avoidance rules may apply to artificial or tax-driven structures lacking commercial substance.

Proper structuring and professional advice are therefore essential to ensure that restructuring transactions achieve their intended tax-neutral outcome without triggering unintended tax consequences.

Conclusion:

There is no "one-size-fits-all" restructuring solution. Sections 42 and 45 remain valuable tools in South African corporate restructuring and, when used correctly, allow businesses to implement legitimate commercial restructures on a tax-neutral basis. However, these provisions are technical and strictly regulated, and incorrect implementation can result in significant tax exposure.

The appropriate restructuring mechanism will depend on the intended commercial outcome, the existing corporate structure, and various legal, tax, accounting, financing, and regulatory considerations. Businesses considering restructures should therefore ensure that the appropriate rollover relief provision is selected, all statutory requirements are satisfied, the transaction has genuine commercial substance, and the structure is properly documented and implemented.

Early professional legal and tax advice is essential, as correcting an incorrectly conceived or implemented structure after the fact can often be significantly more expensive than obtaining proper advice upfront.

It would accordingly be prudent for persons to ensure when concluding a contract, which could result in the other party as lien holder exercising their lien (and retaining possession of the property concerned), that they seek legal advice in order to procure, where competent, a waiver of lien.

By Candace Schoeman (Director) | Corporate and Commercial Department