

# Tax Alert

## Pre-Budget Tax Briefing 5: Change in Control

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### In brief

- The taxation of indirect disposals is a relatively new focus area of tax policy and the subject of evolving debate and best practice.
- In 2012 an amendment was made to the “change in control” provision to enable taxation of indirect disposals (where underlying ownership change is overseas).
- Although the amendment was well intentioned - namely to counter tax avoidance - its effect is much wider than originally intended, and consequently may deter investment (particularly for the extractive sector).
- Experience of recent legislative change in other jurisdictions, as well as recent policy papers, give some guidance as to appropriate boundaries for the scope of indirect disposal provisions.
- It is hoped that this Budget will see changes to delineate boundaries to the scope of this provision that will better align it with emerging best practice elsewhere.
- As regards scope, consideration could be given to an amendment to exclude extractive sector assets not yet at production stage

### Background

The Finance Act 2012 amended Section 56 of the Income Tax Act (ITA) 2004, the “change in control” provision, which applies where the ultimate (underlying) share ownership of a Tanzanian entity changes by more than 50%. A copy of the provision (with Finance Act 2012 amendments marked

in **strikeout and bold**) is set out as an Appendix to this newsletter. Following the 2012 amendment, where there is such a change all the assets and liabilities of the Tanzanian entity are automatically deemed to be realised (and reacquired) at market value and if this results in a gain, then such a gain is taxable.

The objective of the amendment was clearly stated in the 2012 Budget speech as follows: “*iv. Impose capital gain tax on sale of shares relating to local company by the parent/offshore company. This measure is intended to control tax avoidance malpractice.*” This preceding quotation in English is the official translation of the following Swahili narrative as read in the actual speech itself: “*Kuanzisha kodi itokanayo na uuzaji wa raslimali ya uwekezaji (capital gains tax) kwenye uuzaji wa hisa za kampuni za ndani unaofanywa na kampuni mama ya nje ya nchi.*”

The intention of the 2012 amendment was clearly articulated - namely, to prevent the deliberate avoidance of income tax on capital gains where the primary underlying value or a significant proportion of the transaction value related to an entity or asset located in Tanzania. The particular target of the amendment was transactions structured as a disposal of an indirect interest in Tanzania (for example, shares in an overseas intermediate holding company) instead of a disposal of the local business in Tanzania, or shares in the Tanzanian company.

However, although the purpose for the amendment was clearly articulated (namely to deal with share sales deliberately structured to be offshore so as to avoid tax), the provision as amended is much more wide ranging potentially capturing transactions that should not be within scope. The issue is of great importance as it potentially can act as a potential deterrent to investment.

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As part of the pre-Budget stakeholder engagement process, in February 2021 we sent a pre-Budget submission with certain suggestions on potential tax issues for consideration, including a separate submission specifically in relation to the change in control provision. This newsletter sets out some of the challenges with and potential changes to this provision. We have dedicated a newsletter on this particular issue given its importance in relation to inbound investment.

## Challenges with the Change in Control provision

- **Listed entities:** Transactions in shares of entities listed on stock exchanges clearly have no tax avoidance motive; however currently there is no exclusion for such shares. In addition, there is a practical challenge of continuous monitoring of changes in ownership (over a rolling three year period) bearing in mind that listed shares are by their nature freely transferable, and in practice transactions take place on a daily basis.
- **Proportion of value attributable to Tanzania:** There is no minimum threshold of underlying transaction value attributable to Tanzania so as to trigger the provision. Therefore even if there is a takeover of a multinational group, and the Tanzanian subsidiary is only 1% of the value of the group - in theory, the provisions are triggered.
- **Assets in scope:** In jurisdictions that do have provisions to deem disposals locally as a consequence of overseas transactions, the scope of such provisions is frequently limited to a specific category of asset (in particular, real property and extractive rights). However the Tanzania provisions do not have any such limitation.
- **Discouragement of new investment (especially in extractive sector):** As drafted, the provisions might be interpreted to deem a disposal when new investment is made into a company; one such scenario might be where ownership is diluted in return for funds being invested into a company - here, although the existing investor does not receive anything, the company is potentially deemed to have realised all its assets and liabilities. If so, the practical effect would be to tax the new investment funding - clearly such an approach would be a deterrent to investment, especially in the extractive sector.
- **Minority shareholders:** The provisions deem a sale of the whole business so long as underlying ownership changes by more than 50%. Therefore a challenge arises where there is a minority shareholding - for example, if the majority shareholder owns 55% and the minority 45%, but only the majority shareholder disposes of their stake, then despite the fact that the underlying interest only changes by 55% the local entity is deemed to dispose of 100% of its assets and liabilities.
- **Potential double taxation:**
  - » Disposal of shares in a Tanzanian company: There is potential double taxation on a disposal of shares in a Tanzanian company as despite the taxation of the disposal of the shares, simultaneously the company could be deemed to dispose of the business. Although in practice the Tanzania Revenue Authority take a pragmatic approach and accept that there cannot be "two bites of the cherry" (i.e. the provisions do not apply to deem a gain both on shares and on disposal of the business at the same time), nevertheless the current situation does cause potential uncertainty.
  - » Disposal of shares overseas: As noted above, the provision applies irrespective of whether there is a tax avoidance motive

- without such an override, the likelihood is that the transaction is effectively within a charge to tax twice (namely in the country where the transaction takes place, as well as in Tanzania)

Ultimately, these concerns (both in terms of equity / right to tax as well as practicality) are likely to act as a deterrent to investment and indeed could deflect investments to other countries assuming that all other factors are equal. Tax policy should be developed in terms of collecting an appropriate amount of tax (by appropriate boundaries on scope) and without creating legislation which is either too complex, impractical or cumbersome to apply such that it cannot be effectively and efficiently implemented. Otherwise the risk is that it creates a domestic tax landscape that is unattractive to international capital.

Given the above, there is a need to consider an appropriate amendment to section 56.

## Issues to address in considering an amendment

In considering the nature of the amendment reference should be made to:

- The stated purpose of the 2012 amendment (see narrative above)
- The challenges brought about by the 2012 amendment (see narrative above);
- Emerging international best practice on the tax treatment of indirect disposals (see narrative further below).

As part of such a review, the following issues would need to be addressed:

- Is the purpose only to deal with transactions that have a tax avoidance motive?
- If not, and the provisions are to apply irrespective of tax avoidance motive, what boundaries should be put in place as regards scope of application?



## With regard to the latter, issues to consider in relation to scope of application could include:

- Potential restriction to where an entity:
  - » Derives more than a set percentage of their value from a particular type of asset (immovable property / property with location specific rents); or
  - » Has a value that exceeds a set minimum proportion of the total transaction value; in other words, only applicable if more than a certain percentage of the overall transaction value is attributable to Tanzania
- Nature / purpose of the transaction (for example, exclusion if primary purpose is to raise funds for investment)
- Listing status of the security / share transferred (bearing in mind that the motive for listing on an international stock exchange is its efficiency as a market on which to raise funds and to transact in the securities once listed; the purpose is not tax avoidance).
- Transactions where the application of section 56 potentially could result in double taxation

## Way Forward - guidance from practice elsewhere

The taxation of gains of a capital nature / disposal of investments / capital gains is an area of some complexity from a tax policy perspective.

### Indirect transfers - recent international policy documents

There has been significant recent international policy discussion on this topic, particularly as regards indirect transfers, including the following documents:

- United Nation Note on Capital Gains Taxation and Taxation of Indirect Asset Transfers (“UN Note”) (issued on 15 October 2015)<sup>1</sup>
- The Platform for Collaboration on Tax, which on 16 July 2018 published for comment an updated “draft version 2” of its document “The Taxation of Offshore Indirect Transfers - a toolkit” (“PCT Toolkit”)<sup>2</sup>.

As highlighted in the PCT Toolkit, there are in essence two models for taxation of Offshore Indirect Transfers, namely:

- “Model 1”, Taxing the Local Resident Asset-Owning Entity under a Deemed Disposal Model (which is similar to the approach in our change in control provision)
- “Model 2”, Taxing the Non-Resident Seller (which is the approach adopted by India)

These publications, together with emerging practice in other jurisdictions in relation to indirect transfers (including China, India, Peru (as referred to in the UN and PCT publications)), can provide some guidance as to possible ways forward.



### China - “Reasonable Commercial Purpose”

One of the more detailed provisions in this regard is China’s Public Notice 7 issued in 2015<sup>3</sup>, with seven general criteria (plus other relevant criteria) for assessing whether there are reasonable commercial purposes for an offshore indirect transfer including:

- “Red Zone” criteria which if all satisfied then automatically result in not meeting the test including:
  - » Proportion of transaction value attributable to China (including tests by reference to proportion of value of taxable properties, and proportion of value of income), and
  - » Whether foreign income tax arising on the transaction is less than burden otherwise applicable on a direct transfer in China
- “Green Zone” criteria which if any are individually satisfied result in the test being met including:
  - » Shares acquired and sold through public stock exchanges
  - » Transactions which if effected in country would be exempt
  - » Certain internal group restructurings

The test in relation to proportion of value refers to a 75% threshold applied to the holding company if it derives its value directly or indirectly from China Taxable Properties; the test also incorporates a reference to share of asset value and of income – in both cases, the threshold is 90%.

### India<sup>4</sup> - “Substantial Value”

Income arising from the transfer of a share or interest in a company or entity incorporated or registered outside India (“Transferred Asset”), is taxable in India if such share or interest derives substantial value from assets located in India (such company or entity is referred to as “Foreign Company” and such transfer is referred to as “indirect transfer of assets”).

The Transferred Asset is considered to derive its value substantially from assets located in India if the FMV of the assets, of the Foreign Company, located in India exceeds Rs.100 Million (currently equivalent to approximately USD1.33m), and constitutes at least 50% of the FMV of the total assets of the Foreign Company.

### Peru

Indirect disposal rules apply in either of the following scenarios:

- In the twelve months prior to the change, the market value of the local entity is 50% or more of the market value of the foreign holding entity in which ownership changes, and the transaction represents a transfer of 10% or more of non-resident entity’s interest in Peru, or
- The value of the local interest transferred is more than 40,000 “tax units” (UIT) (equivalent to approximately USD 48m<sup>5</sup>)

## Our recommendations - leveraging guidance from practice elsewhere

Assuming that we continue with the current approach ("Model 1") using Section 56 ITA 2004 then potential amendments to consider could be to:

- Clearly delineate scope by either (i) specification of certain exclusions from scope, or (ii) limitation of scope to certain express inclusions; and
- Expressly remove the risk of double taxation

### Express exclusions from scope

In terms of scope delineation, if the approach is to specify certain exclusions from scope, then potential exclusions to consider could include:

- Transactions on a stock exchange
- Transactions where the percentage of the transaction value attributable to Tanzania is less than a certain percentage of total transaction value (e.g. 50%)
- Transactions by "small shareholders" i.e. members whose underlying ownership together with any associates is less than a specified percentage of the total underlying ownership (eg 10%)
- Disposals of a direct interest in Tanzanian shares (unless the purpose is to apply sub-section (2) of Section 56 so as to restrict the carry forward of certain tax attributes)
- Mergers
- An entity engaged in mining operations or petroleum operations, and that has not yet started commercial production of minerals or petroleum

### Express inclusions from scope

Alternatively, if the approach is to specification of certain specified inclusions, then potential inclusions to consider could be:

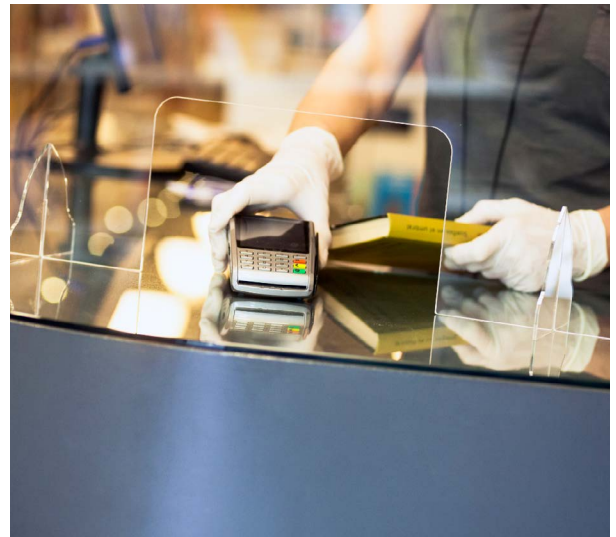
- Transactions where the primary underlying value in Tanzania relates to certain types of property (for example, immovable assets (including extractive sector interests but only once such operations have reached commercial production)
- Transactions where the motive for the structure of the transaction is to avoid tax

## Priority - extractive sector

Given the potential significant investment into the extractive sector, as a minimum certain amendments that target this sector should be a particular priority.

One characteristic of the extractive sector is that there tends to be a lot of transactional activity. This is for a variety of reasons, including factors such as (i) the need to raise additional financing (ii) a desire to spread risk with other parties (iii) a recognition by one party that it does not have the capacity to continue with the project - perhaps a junior explorer looking to pass an asset on to an entity in a better position to develop a project.

Transactions are therefore the lifeblood of a healthy extractive sector, and it is important that the tax regime does not deter such transactions from happening. However, the concern is that the change in control provisions do potentially deter such investment. Accordingly, consideration could be given to an amendment to exclude extractive sector assets not yet at production stage from the application of the change in control provisions.



## Section 56 ITA 2004 - Change in Control

### (Finance Act 2012 amendments highlighted in bold and strikeout)

- (1) ~~Subject to subsection (4),~~ at the moment the underlying ownership of an entity changes by more than fifty % as compared with that ownership at any time during the previous three years, the entity shall be treated as realising any assets owned and any liabilities owed by it immediately before the change.
- (2) Subject to the provisions of subsection (4), where there is a change in ownership of the type referred to in subsection (1), after the change the entity shall not be permitted to -
- ~~interest carried forward under section 12(3) that was incurred by the entity prior to the change;~~
  - deduct a loss under section 19(1) that was incurred by the entity prior to the change;
  - in a case where the entity has, prior to the change, included an amount in calculating income in terms of section 25(2) or (4), claim a deduction under those provisions after the change;
  - carry back a loss under section 26(3) that was incurred after the change to a year of income occurring before the change;
  - reduce under section 36(3) gains from the realisation of investment assets after the change by losses on the realisation of investment assets before the change; or
  - carry forward foreign income tax under section 77(3) that was originally paid with respect to foreign source income derived by the entity prior to the change.
- (3) Where there is a change in ownership of the type referred to in subsection (1) during a year of income of the entity, the parts of the year of income before and after the change shall be treated as separate years of income.
- (4) ~~This section~~ **The provisions of subsection (2)** shall not apply where for a period of two years after a change of the type mentioned in subsection (1), the entity -
- conducts the business or, where more than one business was conducted, all of the businesses that it conducted at anytime during the twelve month period before the change and conducts them in the same manner as during the twelve month period; and
  - conducts no business or investment other than those conducted at anytime during the twelve month period before the change.

## Footnotes

<sup>1</sup> [https://www.un.org/esa/ffd/wp-content/uploads/2015/10/11STM\\_Attachment2\\_Cgt.pdf](https://www.un.org/esa/ffd/wp-content/uploads/2015/10/11STM_Attachment2_Cgt.pdf)

<sup>2</sup> <http://documents.worldbank.org/curated/en/887741531422160105/a-toolkit-draft-version-2> this draft followed feedback received on the original draft issued in 2017

<sup>3</sup> For more detail, refer to the summary in a February 2015 PwC China newsletter - "A totally different tax landscape for offshore indirect transfer - wider, clearer & more challenging", and to pages 38 and 39 of the UN Note

<sup>4</sup> Further detail on the treatment in India is set out in a July 2016 PwC India newsletter - "Computation of Income attributable to Indirect Transfer of Assets and reporting thereon"

<sup>5</sup> Automatic application in cases exceeding USD48m following a change in law in September 2018