DLA CLIFFE DEKKER HOFMEYR

FINANCE
AND BANKING

ALERT
14 MAY 2014

IN THIS ISSUE

FOREIGN ACCOUNT TAX COMPLIANCE ACT (FATCA) – PRACTICAL IMPLICATIONS FOR SOUTH AFRICAN ENTITIES

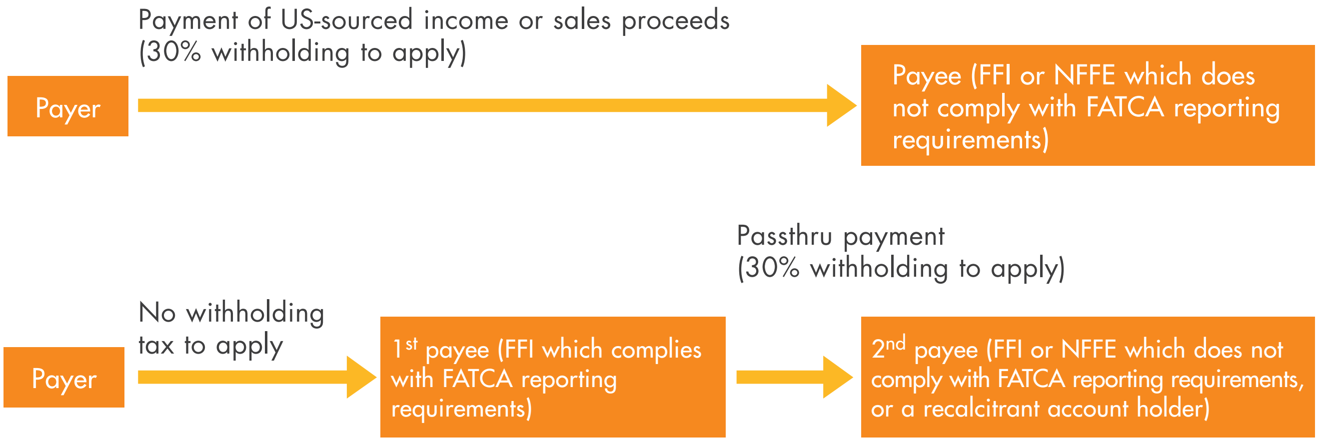
FATCA was enacted in 2010 by the United States (US) to improve tax compliance with regard to offshore accounts of US citizens. Generally speaking, FATCA imposes a 30% withholding tax on certain payments to foreign financial institutions (FFI's), unless the FFI has complied with FATCA's reporting requirements with regard to US accounts handled by it. The 30% withholding applies to US-sourced income and sales proceeds paid to a FFI for its own account or in respect of any financial account which it maintains for others.

In terms of FATCA, the term FFI has been given a wide definition, and includes (subject to exceptions) amongst others, financial institutions, brokers, dealers, custodians, hedge funds, private equity funds and pension funds. FATCA also extends to non-financial foreign entities (NFFE's) as payments to such entities may also be subject to a 30% withholding tax.

The 30% withholding tax imposed under FATCA shall not apply in the event that FFI's enter into an agreement with the US Internal Revenue Service (IRS), in terms of which the FFI agrees to obtain, verify and report on certain information regarding accounts held by it, and in terms of which it agrees to deduct and withhold a tax equal to 30% of any passthru payment which is made by such FFI to a recalcitrant account holder (being an account holder who fails to comply with requests for information required under FATCA).

continued

The following diagrams illustrate which payments will be subject to a 30% withholding tax under FATCA:

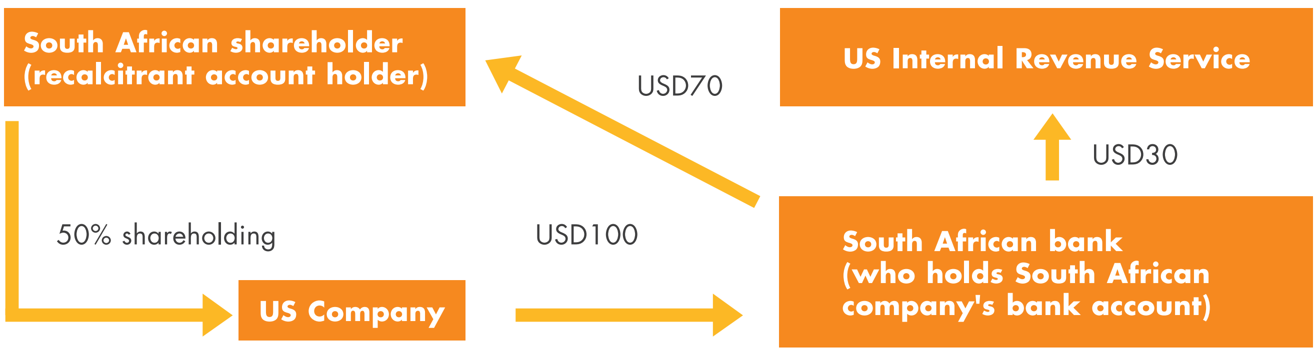


Example 1

A South African bank (which does not comply with the reporting requirements set out in FATCA) lends an amount of USD1 000 to a US company, which amount will accrue interest at a rate of 10% per annum. The amount of interest to be paid by the US company to the South African bank, being USD100 per annum, will be dealt with as follows:

Example 2

A US company which is 50% owned by a South African company, declares a dividend to its shareholders. The South African company, in its capacity as shareholder in the US company, becomes entitled to a dividend of USD100, which dividend is to be paid into such company's bank account held with a South African bank (the South African bank complies with the reporting requirements set out in FATCA whilst the account holder, being the SA company, has failed to comply with requests for information required under FATCA). The dividend to be paid by the US company to the South African company will be dealt with as follows:



continued

From the above, it is clear that FATCA has a worldwide reach and that the implementation thereof has far-reaching consequences for entities falling within its ambit. Such entities will have to consider the level of change which is required in order to comply with FATCA and consider whether the benefits of complying with such legislation outweighs the costs involved in undergoing the necessary changes, as well as any costs associated with non-compliance. The South African and US governments are in the process of developing an intergovernmental agreement which will regulate the implementation of FATCA. The sharing of information under such agreement may be on a reciprocal or nonreciprocal basis.

Deon Wilken and Hoffman Van Zyl

WHEN IS A COMPANY AN OPERATING COMPANY FOR TAX PURPOSES?

This is an important question in the context of preference share funding in renewable energy transactions, particularly in determining whether the funding is for a qualifying purpose and therefore exempt from the clutches of s8E and 8EA of the Income Tax Act, No 58 of 1962 (Income Tax Act).

From the beginning of the government's Renewable Energy Independent Power Producers Procurement Programme (IPP Programme), development funding institutions (DFI) have favoured preference share funding when they offer finance. This is because dividends from preference shares are normally exempt from income tax which makes it a cheaper form of funding. However the two sections mentioned above, s8E and 8EA of the Income Tax Act, do in certain circumstances render dividends from preference shares taxable.

S8E provides that dividends on shares that constitute hybrid equity instruments are deemed to be income and are therefore subject to income tax. A hybrid equity instrument is defined, *inter alia*, as "any preference share if that share is - (i) secured by a financial instrument; or (ii) subject to an arrangement in terms of which a financial instrument may not be disposed of unless that share was issued for a qualifying purpose." (our emphasis)

A financial instrument is defined, *inter alia*, as 'any interest bearing arrangement' (ie an interest bearing bank account). A common feature in such transactions is a requirement that a collections account be opened by the issuer wherein all dividends from the project company are paid into and from which the dividends to the DFI are to be paid. This is normally coupled with a negative pledge ie a condition that such account is to be kept open until all the preference shares have been redeemed. The negative pledge would therefore constitute an 'arrangement in terms of which a financial instrument may not be disposed of'. Accordingly, the preference shares will be deemed to be hybrid equity instruments unless the preference shares are issued for a 'qualifying purpose'.

S8EA provides that dividends on third-party backed shares are deemed income and are therefore subject to income tax. Third-party backed shares are preference shares in respect of which an enforcement right is exercisable by the holders of those preference shares or an enforcement obligation is enforceable by the holders as a result of any dividend or return of capital not being received by the persons entitled to them.

However, s8EA has 'saving provisions' to avoid its consequences. To qualify for the saving provisions, one of the requirements to be satisfied is that the funds derived from the issue of the relevant preference shares must have been applied for a qualifying purpose.

A 'qualifying purpose', in relation to the funds derived from the issue of a preference share, is, *inter alia*, the direct or indirect acquisition of equity shares in an 'operating company'. An operating company is defined as:

(i) a company that carries on business continuously, and in the course or furtherance of that business provides goods or services for consideration;

(ii) any company that is a controlling group company in relation to a company contemplated in item (i); or

(iii) any company that is a listed company.

continued

In most renewable energy transactions the funds derived from the preference shares are usually used to acquire equity in a project company which intends to construct and thereafter operate a plant that will provide and sell the renewable energy, be it solar power or wind generated power, etc. However and crucially, at the time of the acquisition of the equity in the project company, the project company is not carrying on business nor providing goods or services for consideration. It would typically be about to commence the construction of the plant. It is therefore not an operating company in the strict sense contemplated in the Income Tax Act. This means the funds derived from the issue of the preference shares do not have a qualifying purpose.

We would however argue that a purposive interpretation should be applied because it is clear that the intention of the project company is to become an operating company after the construction phase of the plant is completed. On this latter interpretation, the application of the funds would be for a qualifying purpose. The latter interpretation however is yet to be pronounced upon by our courts or the revenue authorities.

If it is determined that the funds derived from the issue of the preference shares are not issued for a 'qualifying purpose', s8E and 8EA apply and the dividends will be deemed to be income and the borrower will have to 'gross-up' ie pay the tax payable by the preference shareholder in order that the DFI receives the same return it would have received if dividends were tax free. This is clearly an onerous outcome especially in view of the fact that most of the entities requiring this type of funding from DFIs are black economic empowerment companies. Given the prevalence of these funding structures in the IPP Programme, this is a subject that should be clarified by the revenue authorities urgently.

Temba Kali and Bridgett Majola

DEMYSTIFYING ADEQUATE DELIVERY OF A SECTION 129 NOTICE

A few weeks ago the Constitutional Court (CC) handed down judgment in the case of Kubyana v Standard Bank of South Africa Ltd (CCT 65/13) (Kubyana) regarding the interpretation of s129(1) of the National Credit Act, No 34 of 2005 (Act). S129 of the Act deals with the required procedures to be followed by a credit provider before debt enforcement can take place. This section provides that if a consumer is in default under a credit agreement the credit provider:

(i) may draw the default to the attention of the consumer in writing and propose methods available to the consumer to resolve any dispute under the credit agreement or develop and agree on a plan to bring the payments under the agreement up to date; and

(ii) subject to s130(2) may not commence legal proceedings to enforce the credit agreement before adhering to the aforementioned, or meeting the further requirements set out in s130.

The contentious debate regarding the interpretation of this section centred on when delivery of the s129 notice actually takes place. In other words:

(i) what steps must a credit provider take to ensure that a notice of default has reached a consumer before the commencement of litigation; and

(ii) what must a credit provider prove to satisfy a court that it has discharged its obligation to effect proper delivery.

continued

In the past, courts held the view followed in *Rossouw v First Rand Bank Limited* that, since the consumer is entitled to elect the manner of delivery, the legislature intended to place the risk of non-receipt on the shoulders of the consumer. There was no duty on the credit provider to ensure that such notice was actually received by the consumer, or delivered to the correct post office. In *Sebola v Standard Bank of South Africa Limited* the CC imposed an additional burden on the credit provider that proof by way of a post office 'track and trace' report was required, showing that the notice reached the correct post office. This would constitute proper delivery of the s129 notice. The CC's judgment in Sebola attempted to provide clarity as to the interpretation of s129 of the Act. The wording of the judgement however led to greater confusion regarding whether notices must be brought under the subjective knowledge of the consumer or not.

As such the Sebola judgment led to conflicting decisions in different divisions of the high court. The problems encountered with the s129 notice emanate from the legislature not clearly defining the concept of 'delivery' as envisaged in s130 of the Act. This rendered s129 open to various interpretations, and this led to the disconnect. The issue as to the interpretation of Sebola arose where the credit provider had a track and trace report evidencing that the notice was sent to the correct post office, but the notification from the post office to the consumer to collect the registered post had not been brought to the subjective attention of the consumer and was subsequently returned to the credit provider. The debate on what is required to prove that the s129 notice has in fact been delivered has now been settled by Kubyana.

The facts are that Mr Kubyana had defaulted on his motor vehicle repayments on a number of occasions. After he consistently remained in arrears, Standard Bank sent him a notice in terms of s129(1) of the Act by way of registered mail to his elected registered address. Mr Kubyana failed to collect the notice from the post office, after the post office notified him twice that he had documents for collection. The post office returned the unclaimed s129 notice to Standard Bank, which then issued summons. Mr Kubyana argued that Standard Bank did not comply with its obligations in terms of s129, as he did not receive the notice as was evident by the return of the notice to Standard Bank by the post office.

The CC held that there was no obligation on Standard Bank to use additional measures to ensure that the notice reached Mr Kubyana, as there was no requirement to bring the notice under the subjective knowledge of the consumer. Beyond ensuring that the notice was sent to the correct post office, there was no further expectation on Standard Bank as the placement of additional requirements on the credit provider would impose an excessively onerous standard of performance and afford consumers the advantage of being able to ignore valid notices. There is accordingly an onus on consumers to receive notices and not deliberately fail to collect and rely on this failure to attempt to avoid legal action.

Adriaan Van Der Merwe and Vusiwe Ngcobo.
Overseen by Jennifer Stolp.

DLA CLIFFE DEKKER HOFMEYR

CONTACT US

For more information about our Finance and Banking practice and services, please contact:

Deon Wilken
National Practice Head
Director
T +27 (0)11 562 1096
E deon.wilken@dlacdh.com

Biddy Faber
Director
T +27 (0)11 562 1439
E biddy.faber@dlacdh.com

Stephen Gie
Director
T +27 (0)21 405 6051
E stephen.gie@dlacdh.com

Temba Kali
Director
T +27 (0)11 562 1482
E temba.kali@dlacdh.com

Adnaan Kariem
Director
T +27 (0)21 405 6102
E adnaan.kariem@dlacdh.com

Jacqueline King
Director
T +27 (0)11 562 1554
E jacqueline.king@dlacdh.com

Izak Lessing
Director
T +27 (0)21 405 6013
E izak.lessing@dlacdh.com

Mashudu Mphafudi
Director
T +27 (0)11 562 1093
E mashudu.mphafudi@dlacdh.com

Jackie Pennington
Director
T +27 (0)11 562 1131
E jackie.pennington@dlacdh.com

Ludwig Smith
Director
T +27 (0)11 562 1103
E ludwig.smith@dlacdh.com

Jennifer Stolp
Director
T +27 (0)11 562 1409
E jennifer.stolp@dlacdh.com

Muhammed Ahmed Bobat
Senior Associate
T +27 (0)11 562 1341
E muhammed.bobat@dlacdh.com

Kerry-Lee Carew
Senior Associate
T +27 (0)11 562 1193
E kerry-lee.carew@dlacdh.com

Jenni Darling
Senior Associate
T +27 (0)11 562 1188
E jenni.darling@dlacdh.com

Preshan Singh Dhulam
Senior Associate
T +27 (0)11 562 1192
E preshan.singh@dlacdh.com

Bridgett Majola
Senior Associate
T +27 (0)11 562 1622
E bridgett.majola@dlacdh.com

Dayne Muller
Senior Associate
T +27 (0)11 562 1215
E dayne.muller@dlacdh.com

Tamryn Blackbeard
Associate
T +27 (0)11 562 1625
E tamryn.blackbeard@dlacdh.com

Pride Jani
Associate
T +27 (0)21 405 6103
E pride.jani@dlacdh.com

Mbali Kubeka
Associate
T +27 (0)11 562 1373
E mbali.kubeka@dlacdh.com

Hoffman van Zyl
Associate
T +27 (0)11 562 1255
E hoffman.vanzyl@dlacdh.com

BBBEE STATUS: LEVEL THREE CONTRIBUTOR

JOHANNESBURG
1 Protea Place Sandton Johannesburg 2196, Private Bag X40 Benmore 2010
South Africa Dx 154 Randburg and Dx 42 Johannesburg
T +27 (0)11 562 1000 **F** +27 (0)11 562 1111 **E** jhb@dlacdh.com

CAPE TOWN
11 Buitengracht Street Cape Town 8001, PO Box 695 Cape Town
8000 South Africa Dx 5 Cape Town
T +27 (0)21 481 6300 **F** +27 (0)21 481 6388 **E** ctn@dlacdh.com