DLA CLIFFE DEKKER HOFMEYR

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FINANCE AND BANKING MATTERS

INCOME TAX LIMITATIONS ON EXCESSIVE DEBT

On 29 April 2013, the National Treasury released a media statement indicating their concern over debt based tax schemes that were leading to the erosion of the tax base. Initially their concern had been founded on structures which utilised the corporate restructuring rules in the Income Tax Act, No 58 of 1962 (Act).

Certainly, the Minister of Finance's budget speech on 27 February 2013 reflected that Treasury is concerned with capping interest deductions on what might be regarded as excessive debt or over gearing. In their media release of 29 April, they described this as acquisition debt and raised the concern that interest on the debt often eliminates taxable profits for years to come. Their real concern is with mezzanine and subordinated debt which often contains a number of equity features. Treasury is also concerned that excessive debt exposes problems in corporate governance because it creates excessive risk in the underlying company.

Together with the media release, the Government released draft legislation for the amendment of s8F of the Act dealing with hybrid debt instruments, and a new s8FA where what they define as hybrid interest would be deemed to be a dividend. Here we deal with Treasury's concern about excessive debt. Firstly, they are concerned that where debts are owed between entities of the same economic group, there is not a true arm's length relationship between the parties because the substance of the instrument can be amended by the two entities acting in concert to change the terms of the instrument as group economic necessity dictates. Accordingly, they are looking to limit the aggregate deductions for interest associated with debt between certain entities of the same group, regardless of the terms attached to that debt. That is if a company pays interest to another entity within the same group for IFRS accounting purposes, and the interest is untaxed or taxed at a lower rate when received or accrued by the other entity, the interest will be subject to an interest limitation. This would apply even if a group entity guarantees or provides other security in respect of the debt owed by the debtor company (financial assistance). The limitation imposed on the debt would be 40% of the debtor's taxable income (disregarding interest received, accrued, paid or incurred) plus interest received or accrued; reduced by the interest paid or incurred in respect of debt falling outside the limitation. To the extent that interest paid or incurred on debt between IFRS group entities exceeds the limitation, the excess will be capable of being carried forward for up to five years.

As part of the media statement, because of the relatively new legislation on transfer pricing, and more particularly the draft Interpretation Note on this topic, Treasury said they would look to have issued a safe harbour to be added to the transfer pricing rules by way of a binding general ruling. They see this as being related to the limitations on debt because the general

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restrictions on debt would reduce the need for the transfer pricing legislation to address excessive debt and hybrid debt. So the proposal would be that the potential safe harbour for cross-border debt between connected persons would be that the interest on the debt may not exceed 30% of the taxable income; and that the interest rate would depend on the currency denomination of the loan. The interest on the debt may not exceed the foreign equivalent of the South African prime rate if denominated in foreign currency. The interest rate on the debt may not exceed the South African prime rate if denominated in Rand.

Previously the South African Revenue Services (SARS) had introduced s23K to act as a regulator on the amount of interest bearing debt which may be accessed through an acquisition transaction using the corporate restructuring rules. In 2012, mindful that companies could do an indirect s45 acquisition, they introduced a new s24O to permit a direct acquisition of equity with tax deductible debt. The essence of the media statement was that it would now look to set out a rule, that if an acquirer acquires the assets of a target company through the use of s45, the deduction for interest paid or incurred in respect of the debt would be limited to 40% of the debtor's taxable income (before taking into account interest received or accrued and interest paid or incurred); plus interest received or accrued; less interest paid or incurred in respect of debt falling outside the limitation. The provision to carry forward any excess for five years would apply here equally.

In the case of a s24O acquisition, there would be a similar limit to 40% of the taxable income of the target company. But if the acquirer only acquired 80% of the shares of the target company, then the limit would be 80% of the 40% of the target company's taxable income. There was specific recognition in the media statement that if the target assets or the assets of the target company consisted of sizable amounts of immovable property generating rental income, rental income would be subject to a notional 50% uplift of the threshold for the purposes of determining the impact of the limitation in respect of the acquisition debt.

Alastair Morphet

JUST HOW MUCH IS YOUR ELECTRONIC SIGNATURE WORTH?

Advancements in technology have modernised the traditional and familiar ways of doing business. Parties no longer have to be in one room or in the same country to conclude transactions. This also relates to the execution and signature of documents, particularly where the signatories are in different locations or countries.

The standard practice, where parties are in different locations, has been to print a document, sign it in ink, scan it and send it to the other parties with a view to collating all the counterparts containing each signatory's original signature at a later date. However, the advent of 'electronic signatures' means one can sign a document 'electronically' without having to print it and with no lag time between the signature and collation of documents.

In a recent finance transaction several signatories opted to sign the relevant agreements and documents by having their scanned signatures placed on the documents through, presumably, a cut and paste exercise. The Electronic Communications and Transactions Act No. 25 of 2002 (ECT Act) allows for the signature of documents by way of an 'electronic signature' and distinguishes between 'electronic signatures' and 'advanced electronic signatures'. The ECT Act defines an 'electronic signature' as "data attached to, incorporated in, or logically associated with other data and which is intended by the user to serve as a signature" and 'data' is defined as being "electronic representations of information in any form". On the other hand, an 'advanced electronic signature' is defined as "an electronic signature which results from a process which has been accredited" in accordance with the ECT Act through an accreditation authority. When one uses an advanced electronic signature, the document is signed with an encrypted data signature.

Section 13(1) of the ECT Act provides that where a signature of a person is required by law and such law does not specify the type of signature, that requirement will be met only if an advanced electronic signature is used. Section 13(2) provides that (subject to the provisions of s13(1)) an electronic signature is not without legal force and effect merely on the grounds that it is in electronic form. In terms of the ECT Act, a normal electronic signature (ie a scanned image of a written signature) will be regarded as a data message. In this regard, s11 of the ECT Act legally recognises data messages and provides that information is not without legal force and effect merely on the grounds that it is wholly or partly in the form of a data message.

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Parties are, therefore, not only entitled to provide for electronic signature, but are, in terms of the ECT Act (and provided s13(1) is not applicable), also entitled to determine the type of electronic signature they wish to use for the agreement to be properly executed. Section 13(3), however, dictates that where the parties have provided for the use of an electronic signature but have not agreed on the type of electronic signature to be used, the requirements for a valid electronic signature will only be met if:

- a method is used to identify the person signing the documentand to indicate the person's approval of the information being communicated; and
- the method was chosen and used in light of relevant circumstances at the time and was appropriately reliable for the purposes for which the information was communicated.

(It must be noted, however, that documents governed by the Wills Act, No 7 of 1953, the Alienation of Land Act, No 68 of 1981 and the Bills of Exchange Act, No 34 of 1964 (that is wills, contracts for the sale of immovable property and bills of exchange, respectively) will be invalid if signed electronically regardless of the type of electronic signature used).

In the event that parties agree on the use of an electronic signature, an advanced electronic signature would be advantageous from an onus perspective as s13(4) of the ECT Act contains a presumption that where an advanced electronic signature has been used, such signature is regarded as being a valid electronic signature, applied properly, unless the contrary is proved. Thus the burden of proof is placed on the party disputing the validity of the signature. Therefore, where, in a finance transaction, a lender seeks to enforce repayment against a borrower or to foreclose under any security and the borrower and/or the security provider seek to escape liability on the basis that the document was not validly executed, the onus will be on the borrower or security provider to prove that the signature is not valid.

Agreements concluded electronically are therefore in principle valid and enforceable. The type of electronic signature used will be dependent upon the nature of the contract to be executed and whether the parties are obliged to use an advanced electronic signature pursuant to legislation (as envisaged in s13(1)). Where a contract is not subject to legislation requiring the parties to use advanced electronic signatures, the parties should agree on the form of electronic signature to be used. In the event that parties agree to the electronic signature of a document but do not agree on the particular type of electronic signature to be used, the requirement for an electronic signature will be met if the signature enables the identification of the signatory and the signatory's intention to be bound by the document, requirements normally applied to handwritten signatures. Also, the electronic signature used must be appropriate to the specific circumstances in which it is used. Similarly, where an agreement is silent on the mode of signature and is signed using an electronic signature, the effect of s13(2) of the ECT Act is that such signature is not without legal force merely on the grounds that it is in electronic form. Something more would be required to render it invalid, ie that it does not enable the identification of the signatory and does not show the signatory's willingness to be bound to the terms of the document and that it was not appropriate for the specific circumstances.

Written signatures conventionally served as acknowledgement of acceptance of the content of a document. From an evidentiary perspective, handwritten signatures also served, and still do, as proof of acknowledgement. The use and authenticity of digital images of a written signature in agreements may be problematic from an evidentiary perspective due to the ease with which scanned signatures can be copied from one electronic document to another, opening the door for fraud and disputes when it comes to the enforcement of an agreement. As such, one should err on the side of caution when using an electronic signature, as it is not without risks. In finance transactions, for example, lenders require assurance and certainty that they would be able to obtain repayment, by the borrower and/or any security providers, of any monies advanced, in the normal course or by foreclosing under any security held. As such it is important that there is no room for any dispute as to the execution (and therefore enforceability) of the applicable documents.

In light of the potential for future disputes associated with electronic signatures, lenders, in particular, still require that documents be executed the old fashioned way, by hand and in ink. This can be achieved by inserting a clause in the agreement excluding electronic signatures. In the event of future disputes as to the authenticity of handwritten signatures, it would be easier to determine the authenticity of any disputed handwritten signatures than having to prove the authenticity of an electronic signature.

Izak Lessing and Pride Jani

NON-COMPLIANCE WITH S44, S45 AND S46 OF THE COMPANIES ACT, NO 71 OF 2008

In the previous publication of Finance and Banking Matters, I dealt with the applicability of s44, 45 and 46 of the Companies Act, No 71 of 2008 (Companies Act) with reference to a specific example. This article deals with the consequences of non-compliance with those sections.

Each of s 44 and 45 provides that both a resolution/decision to provide financial assistance and the financial assistance itself is void to the extent that the provision of that assistance would be inconsistent with either the applicable section or any restriction in the company's memorandum of incorporation (MOI). In addition, those sections contain language to the effect that if a resolution or agreement is void in terms of the section; and a director was present at the meeting at which the board approved the resolution or agreement, and the director failed to vote against that resolution or agreement, despite knowing that the provision of financial assistance was inconsistent with the section or any prohibition, condition or requirement contained in the company's MOI, the director is liable to the extent set out in s77(3)(e). Section 46, however, contains no provision to the effect that a distribution made contrary to that section is void, and provides that if a director attends a meeting at which the board approves a distribution, and fails to vote against that distribution despite knowing that the distribution is 'contrary' to the section, the director is liable.

Section 77(3)(e) is to the effect that a director is liable to the company (of which he is a director), if he was present at a meeting or participated in the making of a decision and failed to vote against the provision of financial assistance to a person envisaged in s44, despite knowing that the provision of that financial assistance was inconsistent with s44 or the company's MOI; the provision of financial assistance 'to a director for a purpose contemplated in section 45', despite knowing that the provision of financial assistance was inconsistent with that section or the company's MOI; and a resolution approving a distribution, despite knowing that the distribution was contrary to s46 (the director's liability is, however, subject to s77(4)).

Section 218 of the Companies Act provides that unless another provision specifically provides otherwise, no provision 'renders void any other agreement, resolution or provision of an agreement, memorandum of incorporation or rules of a company that is prohibited, voidable or that may be declared unlawful in terms of this Act, unless a court has made a declaration to that effect regarding that agreement, resolution or provision'. In relation to s46, therefore, since the section does not say that a distribution made contrary to s46 is void, the effect of s218 is that the distribution is valid except if a court declares it void under any applicable provision of the Companies Act; and s77(5) deals with a situation where a company has made a decision in a manner that contravened the Companies Act in any manner envisaged in s77(3)(e), and provides that the company or any director who has been held liable in terms of s77(3) may apply to a court for an order setting aside the decision of the board. Section 77(5) further provides that the court may make 'an order setting aside the decision in whole or in part, absolutely or conditionally', or 'any further order that is just and equitable in the circumstances'.

I think it is clear that if a company provides financial assistance (as envisaged in s44 and 45) without obtaining the required special resolution and without the required solvency and liquidity determination by its board and/or in contravention of its MOI, (together the 'formal requirements'), the financial assistance is void. Section 46 does not contain any language to the effect that a distribution made contrary thereto is void and, instead, s77(5) (read with s218) empowers a court to declare that the distribution is void. Since s77(5) requires the court to make a decision that is just and equitable, it is likely that a court will hold, if a distribution is made in the absence of compliance with the formal requirements, that such distribution is void in its totality.

What then are the consequences if a company complies with the formal requirements, but the board of a company makes a solvency and liquidity determination which is wrong? There are three possible answers, namely that, for the purposes of s44 and 45, the financial assistance is completely void and unenforceable; valid and enforceable in its entirety; or void to the extent to which it causes the company to fail the test and valid to the extent to which the company will pass the test.

Neither complete voidness nor validity and enforceability in its entirety, can be right. Sections 44 and 45 provide for voidness of the financial assistance only to the extent to which it is inconsistent with the sections. It is strongly arguable, in my view, that if a company provides financial assistance, and the board of the relevant company complies with the formal requirements, and it appears subsequently that, at the time of the provision of the financial assistance, the company did not in fact comply with the solvency and liquidity test, the following position will arise:

- the financial assistance is potentially void (at least to the extent to which it caused the company to fail the test) under s44 and 45; and

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- if the financial assistance also constitutes a distribution, it is contrary to s46, but is not void under s46 until the court declares it to be void under section 77(5).

By virtue of the overlap between s44, 45 and 46, it is unlikely that the legislature have intended that, if a solvency and liquidity determination is wrong, the financial assistance in question is completely valid and enforceable since if a court, acting under s77(5), then declares that a portion of the distribution is void, s44 and 45 would have a result which differs from the result of the application of s46; or completely void, for the same reason (in such a case the court, acting under s77(5), may hold that a portion of the distribution is valid whereas the effect of s44 and 45 would be that the entire financial assistance/distribution is void).

The question then is what order a court should make under s77(5). In this regard the following are relevant:

- an order to the effect that a distribution made contrary to s46 is completely void would be commercially unrealistic as s46 deals with distributions, and there can be no basis in my view to prohibit a distribution which does not result in the company's insolvency or illiquidity;

- the just and equitable order that a court should make is that the distribution is valid to the extent to which the company will not fail the test and void to the extent to which it causes the company to fail the test;

- this approach is supported by s77(4) which limits a director's liability for a distribution made contrary to s46, to the irrecoverable amount in excess of 'the amount by which the value of the distribution exceeded the amount that could have been distributed without causing the company to fail to satisfy the solvency and liquidity test'.

It therefore seems that the only reasonable interpretation is that if a solvency and liquidity determination is wrong, the financial assistance is void only to the extent to which it causes the company to fail the solvency and liquidity test. If such financial assistance also constitutes a distribution, a court could then, under s46, declare such distribution partially void (to the extent that the distribution causes the company to fail the solvency and liquidity test). This would then result in an interpretation of s44, 45 and 46 which is consistent. As regards s46, it is probable that a court may also order the person who receives the distribution to refund the amount of that distribution to the extent to which it exceeds the amount which the company could have distributed without failing the solvency and liquidity test.

Izak Lessing

WHY USE A SECURITY SPECIAL PURPOSE VEHICLE (SPV)?

Security SPV structures are used in most 'club deals' where financing is obtained from multiple lenders due to lender capital adequacy constraints when financing a single individual.

An example of a security SPV structure entails the following:

Three lenders, banks A, B and C each provide R100 to the borrower for the purchase and development of immovable property. For security, a SPV is established (security SPV) independent from the borrower. The security SPV grants a guarantee to the lenders for the obligations of the borrower under the loan agreement. The borrower, in turn, provides an indemnity to the security SPV and the borrower secures its obligations under the indemnity by granting security to the security SPV.

As an alternative to establishing a security SPV, the borrower could register a mortgage bond in favour of the lenders over the immovable property to provide adequate security. Such an arrangement would make the registration and management of a company, the security SPV, superfluous.

However, the Deeds Registry Act, No 47 of 1937 (Deeds Act) dismisses such an arrangement. Section 50(5) of the Deeds Act prohibits the securing of debts or obligations owing to more than one creditor, arising from different causes, with a single mortgage bond. In addition, s54 prohibits the registration of a single bond

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in favour of an agent of the principal. Therefore, the practice of registering the mortgage bond in favour of a single fiduciary trustee acting as agent to the lenders is also not possible in terms of South African law.

The logical solution would then be to register a first mortgage bond in favour of bank A, a second mortgage bond in favour of bank B and a third mortgage bond in favour of bank C. The individual banks will naturally request a security sharing arrangement amongst themselves ranking them *pari passu*. This is more problematic than it sounds. Besides the restraints on dealing with a mortgage bond in cases of any variations in lenders, especially in terms of possible refinancing in the future, a lender exposes itself to a far greater risk than was initially contemplated in the event that the borrower becomes insolvent.

Take for example the event of the borrower's insolvency, where the mortgaged property only realises an aggregate of R210. Bank A and bank B will each receive R100 with bank C receiving the remaining R10. In terms of the security sharing arrangement bank C will then have a claim against bank A and bank B for its *pari passu* share. If bank A becomes insolvent in the interim, its insolvency will cause the security sharing arrangement between the lenders to reduce to an executory contract. This will result in bank C's claim being reduced to a concurrent claim together with the other unsecured creditors of bank A. In effect, each lender with a lower ranking bond takes a credit view over higher ranking lenders.

The lenders are therefore much more prudentially exposed than might initially appear from the arrangement. The security SPV structure evades this exposure because it creates only one *causa* (the borrower's indemnity) and requires only one mortgage bond to be registered or various other security instruments to be executed in favour of only one creditor (the security SPV).

Previously one could argue that the risk of a bank going insolvent is slender. However, as witnessed globally recently, banks are as much susceptible to insolvency as any other corporate entity. It is thus of paramount importance to advise your client on the risks involved in mortgaged security when dealing with multiple lenders as an alternative to a security SPV structure.

Ludwig Smith and Standre Bezuidenhout

LEVERAGING CASH COLLATERAL

Providers of liquidity into the securities lending market are increasingly taking cash collateral for securities loans on the basis of the outright transfer of title model. The outright transfer model is commonplace in international jurisdictions but for various reasons is not always adopted by local lenders. Increasingly local lenders of securities are agreeing to the outright transfer of cash model given its international acceptance and the protection afforded to borrowers under s35B of the Insolvency Act, No 24 of 1936.

There is however a tax implication for a lender into a transaction structured on this basis. An outright transfer of title to cash will be a taxable receipt in the hands of the lender for income tax purposes. A timing mismatch arises in respect of the deductible expense if the equivalent collateral is only returned in a subsequent tax year of the lender.

Given that the lender is in no worse off position should it take a cession in *securitatem debiti* of the cash collateral, as opposed to an outright transfer, the risks associated with the outright transfer model should be fully understood prior to the model being adopted. It is trite that cash collateral placed in a ring-fenced account and ceded in *securitatem debiti* to the lender bank may be dealt with as if it is the cash of the bank and the common law principles of deposit apply. Accordingly the question is whether the enhanced protection that the outright transfer of cash collateral provides to borrowers is justifiable given the potential tax implications for lenders.

Deon Wilken

CONTACT US

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

Ludwig Smith
National Practice Head
Director
T +27 (0)11 562 1103
E ludwig.smith@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

Alastair Morphet
Director
T +27 (0)11 562 1391
E alastair.morphet@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

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

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

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

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

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

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

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

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

DLA CLIFFE DEKKER HOFMEYR

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

www.cliffedekkerhofmeyr.com

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