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TAX AND EXCHANGE CONTROL ALERT

IN THIS **ISSUE**

INVESTMENT BY A VENTURE CAPITAL COMPANY

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CUSTOMS HIGHLIGHTS

This week's selected highlights in the Customs and Excise environment since our last instalment.

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INVESTMENT BY A VENTURE CAPITAL COMPANY

The VCC tax regime was introduced into the Income Tax Act, No 58 of 1962 in 2009 to encourage investment into small and medium-sized enterprises and junior mining companies.

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The South African Revenue Service (SARS) released Binding Private Ruling 274 (BPR 274) on 6 June 2017, which deals with the investment by a venture capital company (VCC) in a company providing and expanding plants for the generation of solar electricity.

By way of background, the VCC tax regime was introduced into the Income Tax Act, No 58 of 1962 (Act) in 2009 to encourage investment into small and medium-sized enterprises and junior mining companies. The relevant legislation, which is found in s12J of the Act, provides for the formation of an investment holding company, described as a VCC. Investors subscribe for shares in the VCC and claim an income tax deduction for the subscription price incurred. The VCC, in turn, invests in "qualifying companies" (ie investee companies).

Recent legislative amendments to s12J have given rise to an increased participation in the asset class and use of the investment vehicle, evidenced by the increasing number of binding private rulings that have been issued by SARS in relation thereto. BPR 274, which is discussed in more detail below, is the latest of these rulings.

Background to the proposed transaction

An operating company incorporated in South Africa and a tax resident of the country (OpCo) has a number of shareholders which are South African individuals (Individuals). The Individuals subscribed for their shares ('A' shares) in OpCo and paid nominal subscription prices. The applicant, a South African company that has been approved as a VCC (Applicant), intends to invest in the OpCo, as follows:

- The Applicant will subscribe for 'B' class shares ('B' shares), which will constitute 20% of the equity shares in OpCo. The 'B' shares will entitle the Applicant to:
  - receive an aggregate amount of distributions that will result in the Applicant receiving an aggregate amount equal to the subscription amount, plus a cumulative nominal monthly return; and

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The sale agreement between OpCo and the Partnership provides that OpCo will acquire the business of conducting a solar facility at specific sites of its customer.

- dividends which must be paid regularly out of excess or free cash. In this regard, the Individuals will not, unless otherwise determined unanimously by the board of directors of OpCo, be entitled to receive any dividends or distributions until the Applicant has received the total return as described above.

- It is important to note that the terms of the 'B' shares also provide that, notwithstanding the number of 'A' and 'B' shares in issue, such shares will carry 50% of the total voting rights, until the Applicant has received the full return. Following this, the 'A' and 'B' shares will rank *pari passu* in all respects and carry a single vote each.

As part of its business operations, OpCo will acquire an existing solar services agreement (SSA) from a partnership (Partnership) which has the Individuals as limited partners and a South African company as the general partner (Company A). The SSA enables the "provision, maintenance, and expansion of solar electricity at the sites of its customer".

The sale agreement between OpCo and the Partnership provides that OpCo will acquire the business of conducting a solar facility at specific sites of its customer. In addition, OpCo will enter into an installation development contract with Company A as the developer, for the purpose of extending the existing photovoltaic plants.

Company A built and supplied the solar panels. As a result, OpCo's business operations will continue to be supplied by Company A. OpCo will, however, own the assets relating to the supply of solar electricity, including solar panels, transmission cables and other related facilities, which will be supplied to the customer in terms of an operating lease as stipulated in the SSA.

Neither Company A nor the Individuals are directly or indirectly responsible for the financing needs of OpCo.

Issues for consideration

The parties to the proposed transaction required SARS to consider, among other things, the following issues:

- **The meaning of "controlled group company" for purposes of the definition of "qualifying company"**

  Section 12J(5)(b) of the Act requires that the sole object of a VCC must be the management of investments in "qualifying companies". Paragraph (b) of the definition of "qualifying company" in s12J(1) excludes a company that is not a controlled group company in relation to a group of companies. A controlled group company in relation to a group of companies is a company where at least 70% of its shares are held by a controlling group company or by other controlled group companies within the group of companies.

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It is important to have regard to the rights and limitations attached to the shares in the qualifying company in order to ascertain whether such shares constitute "equity shares" and thereby "qualifying shares".

In this regard, SARS ruled that for purposes of the definition of "qualifying company" in s12J(1), OpCo will not constitute a "controlled group company" for as long as the number of equity shares which the Applicant holds constitutes less than 70% of the total number of equity shares in issue, irrespective of the fact that the Applicant would have invested more than 70% of the aggregate share capital in monetary terms.

- **The meaning of "equity share" for purposes of the definition of "qualifying share" with reference to the issue of different classes of shares**

  A "qualifying share" is defined in s12J(1) as an equity share held by a VCC which is issued to that VCC by a qualifying company and which does not include a "hybrid equity instrument" as defined in s8E(1) of the Act (but for the three year period requirement), nor a "third-party backed share" as defined in s8EA(1) of the Act. Whereas, "equity share" is defined in s1 of the Act as "any share in a company, excluding any share that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution".

  It is therefore important to have regard to the rights and limitations attached to the shares in the qualifying company in order to ascertain whether such shares constitute "equity shares" and thereby "qualifying shares".

  Based on the facts and the terms of the 'B' shares discussed above, SARS ruled that the shares held by the Applicant will be "equity shares" as defined in s1.

- **Whether OpCo will be regarded as carrying on an "impermissible trade" in immovable property as contemplated in paragraph (a) of the definition of that terms in s12J(1)**

  As mentioned above, s12J(5)(b) of the Act requires that the sole object of a VCC must be the management of investments in "qualifying companies". The definition of a "qualifying company" in s12J(1) of the Act encompasses, among other things, a company that does not carry on an "impermissible trade". An impermissible trade is defined, among other things, as any trade carried on in respect of immovable property, other than a trade carried on as a hotel keeper.

  SARS ruled that OpCo's trade is carried on in respect of solar panels, which are movable assets. Therefore OpCo will not be carrying on an impermissible trade as contemplated in paragraph (a) of the definition of "impermissible trade" in s12J(1).

- **Whether rental income derived by OpCo will be "investment income" as defined in s12E(4)(c) and contemplated in paragraph (f) of the definition of "qualifying company" in s12J(1)**

  Paragraph (f) of the definition of "qualifying company" in s12J(1) includes any company if the sum of

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SARS ruled that the income derived by OpCo in terms of its contracts with its customers will not constitute rental derived in respect of immovable property.

investment income, as defined in s12E(4)(c), derived by that company during any year of assessment does not exceed an amount equal to 20% of the gross income of that company for that year. Section 12E(4)(c) of the Act defines "investment income" to include rental derived in respect of immovable property.

In this regard, SARS ruled that the income derived by OpCo in terms of its contracts with its customers will not constitute rental derived in respect of immovable property and this amount will not be taken into account in determining the investment income for the purposes of paragraph (f) of the definition of "qualifying company" in s12J(1).

Conclusion

It is important to note that binding private rulings are issued to taxpayers to provide guidance on how SARS interprets and applies the tax law to specific transactions. It is therefore important for taxpayers to be cautious when relying on rulings issued by SARS as persons not party to the ruling cannot bind SARS thereto.

BPR 274 is valid until 28 February 2022.

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CUSTOMS AND EXCISE HIGHLIGHTS

Please note that this is not intended to be a comprehensive study or list of the amendments, changes and the like in the Customs and Excise environment, but merely selected highlights which may be of interest.

In the event that specific advice is required, kindly contact our Customs and Excise specialist, Director, Petr Erasmus.

This week's selected highlights in the Customs and Excise environment since our last instalment:

1 Schedule 1 Part 1 to the Customs & Excise Act, No 91 of 1964 (Act) is amended by the substitution of tariff subheadings 1001.91 and 1001.99 as well as 1101.00.10 and 1101.00.90 to reduce the rate of customs duty on wheat and wheaten flour from 119.02c/kg to 94,72c/kg and 178.53c/kg to 142,18c/kg, respectively.

2 Draft amendments to Schedules to the Act:

2.1 Schedule 1 Part 1:

2.1.1 To insert eight-digit tariff subheadings to differentiate between antimicrobials for human use and those for veterinary use in tariff headings 29.41, 30.03 and 30.04;

2.1.2 To make provision for "other" under tariff heading 3920.20.9;

2.1.3 To substitute the statistical unit of tariff subheading 9506.99.20; and

2.1.4 To amend the structure of fowls of the species *Gallus domesticus* under tariff headings 0207.12 and 0207.14.2.

2.2 Schedule 2 to be amended as a consequence of the restructuring in Schedule 1 Part 1 to amend the structure of fowls of the species *Gallus domesticus*.

2.3 Schedule 4 to be amended as a consequence of the restructuring in Schedule 1 Part 1 to amend the structure of fowls of the species *Gallus domesticus*.

2.4 Schedule 6:

2.4.1 To be amended to insert refund item 624.14 on distillate fuel received in a licensed customs and excise manufacturing warehouse for the express purpose of blending with heavy fuel oil classifiable in tariff subheading 2710.12.35 at a ratio not exceeding 30% of distillate fuel used in the manufacture of intermediate fuel oil; and

2.4.2 To be amended to insert refund item 670.13/000.00/01.00 on distillate fuel received in a licensed customs and excise manufacturing warehouse for the express purpose of blending with heavy fuel oil classifiable in tariff subheading 2710.12.35 at a ratio not exceeding 30% of distillate fuel used in the manufacture of intermediate fuel oil.

Comments may be submitted to AMpanza@sars.gov.za or MMaphosa@sars.gov.za by 6 July 2017.

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