

TAX & EXCHANGE CONTROL ALERT

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WHAT IS THE VALUE OF A CONVERTIBLE PREFERENCE SHARE FOR PURPOSES OF DETERMINING A CAPITAL GAIN AND THE PAYMENT OF CAPITAL GAINS TAX? THE SCA CONSIDERS THE ISSUE

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The Tax Court found in favour of the Executors and held that the Deceased was not entitled to convert the preference shares into ordinary shares at the time of his death.



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Facts

The issued preference shares were held by the late Sidney Ellerine (Deceased) and formed part of the share capital of Sidney Ellerine Trust (Pty) Ltd (Company), which, in total, consisted of 600 ordinary shares of R1 each and 112,000 7% redeemable non-cumulative preference shares of R1 each. The Deceased held all of the redeemable preference shares issued by the Company. The beneficial owners of the ordinary shares were four separate trusts. The Company held 40% of the issued share capital in another company, Ellerines Brothers (Pty) Ltd (EB) and the remaining 60% of the shares in EB were held by Eric Ellerine Trust (Pty) Ltd (EET).

The preference and ordinary shares of the Company enjoyed one vote for each share in general meetings of shareholders so that the Deceased held the overwhelming majority of the voting rights in the Company. The South African Revenue Service (SARS) assessed the Deceased estate's liability for capital gains

tax and determined that the Deceased was entitled, by using his voting power, to convert his preference shares to ordinary shares. SARS assessed the value of the preference shares in the amount of R563,376,418 on the basis that the shares represented 99.47% of the share capital of the Company and thus should be valued at 99.47% of the value of the Company.

Before the Tax Court, the executors of the deceased estate (Executors) argued that the preference shares were worth only R1 each as the Deceased could only convert the preference shares to ordinary shares with the voting support of at least 75% of the ordinary shareholders. This was required by the Memorandum and Articles of Association of the Company. The Tax Court found in favour of the Executors and held that the Deceased was not entitled to convert the preference shares into ordinary shares at the time of his death and therefore the shares were not worth R563,376,418, as alleged by SARS. SARS appealed the Tax Court's decision to the SCA.

Who's Who Legal

Emil Brincker has been named a leading lawyer by Who's Who Legal: Corporate Tax – Advisory and Who's Who Legal: Corporate Tax – Controversy for 2017.

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In terms of paragraph 40(1) of the Eighth Schedule to the Income Tax Act, No 58 of 1962 (Eighth Schedule), a deceased person is treated as having disposed of his or her assets at the time of death, for an amount received or accrued equal to the market value of those assets at the date of the person's death.



Legal framework

The SCA had to consider the following legal provisions in deciding the matter:

- In terms of paragraph 40(1) of the Eighth Schedule to the Income Tax Act, No 58 of 1962 (Eighth Schedule), a deceased person is treated as having disposed of his or her assets at the time of death, for an amount received or accrued equal to the market value of those assets at the date of the person's death.
- Paragraph 31(3) of the Eighth Schedule states that the market value of any shares not listed on a recognised exchange must be determined at a value equal to the price which would have been obtained upon a sale of the share between a willing buyer and a willing seller dealing at arm's length in an open market. This is subject to, among other things, the fact that no regard must be had to any provision that restricts the transferability of the company's shares and it shall be assumed that the shares were freely transferable.

Judgment

The SCA stated that this matter turned on the answer to the following two questions:

- Could the holder of the Deceased's preference shares convert these shares into ordinary shares without an amendment to article 34 of the Articles of Association, which, when read with special condition 5.8, required the written approval of 75% of the holders of each class of shares in the issued share capital of the Company?

- Whether, in terms of article 4.2 of the Articles of Association, conversion of the Deceased's preference shares to ordinary shares could take place without the approval of 75% of the holders of the ordinary shares.

In terms of special condition 5.8, article 34 of the Articles of Association could only be amended with the prior written approval of the holders of each class of shares in the issued share capital of the Company and EET, for as long as EET held any shares in EB, or EB's successor in title. Article 34 of the Articles of Association dealt with the rights of shareholders of the Company's redeemable non-cumulative preference shares.

SARS, in essence, argued that the nominal value of the 112,000 preference shares does not reflect the market value of the shares. This is because the voting rights attached to the preference shares entitled the Deceased to convert his preference shares into ordinary shares at any stage after 9 May 2006, in terms of article 7.1.10 of the new Articles of Association adopted on 9 May 2006 by the Company, and notwithstanding the provisions of special condition 5.8.

The Executors argued that the value of the preference shares must be determined on the basis that the holder was precluded from converting these shares to ordinary shares without obtaining prior written approval of at least 75% of the Company's ordinary shareholders and at least 75% of the holders of each class of shares in EET.

The first leg of this argument is based upon special condition 5.8 read with article 34 of the Articles of Association

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The SCA upheld SARS's appeal and concluded that the Deceased was entitled, on the date of his death, to convert the preference shares to ordinary shares.



and in this regard, the Executors argued that a conversion of the preference shares to ordinary shares would alter the rights, privileges and conditions of the Deceased's preference shares, as provided for in article 34, and that it would have to be amended. The SCA rejected this argument and found that the entire article 34 is concerned with the rights attached to the preference shares as opposed to the rights of a particular holder thereof. It relied on article 34.6 of the Articles of Association, which states, amongst other things, that further shares ranking equally with the preference shares may only be created with the consent or sanction of the preference shareholders and held that one must consider the language used in light of the ordinary rules of grammar and syntax, in interpreting the meaning of special condition 5.8 and the Articles of Association.

The second leg of the Executors' argument was based on article 4.2 of the Articles of Association. This provision stated, in summary, that the rights, privileges or conditions attached to any class of the Company's shares, may be varied with the written consent of 75% of the shareholders of that class of shares, or in terms of a resolution passed in the same manner as a special resolution of the Company at a separate general meeting of the holders of that class of shares. The Executor argued that if the Deceased's preference shares

were converted to ordinary shares, the rights attaching to the existing ordinary shares would be varied and the conversion would therefore require approval of 75% of the ordinary shareholders.

The SCA rejected the second leg of the Executor's argument as the Deceased had sufficient voting power to ensure a conversion of the preference shares to ordinary shares and therefore the balance of the voting power or alter the rights, privileges and conditions attaching to ordinary shares. Furthermore, article 7.1.10 of the Articles of Association expressly states that any class of shares can be converted to shares of a different class, by special resolution. Therefore, as the Deceased held the overwhelming majority of the voting rights in the Company, he could have converted the preference shares into ordinary shares at the time of his death. For these reasons, the leg of the argument based on article 4.2 had to fail.

The SCA upheld SARS's appeal and concluded that the Deceased was entitled, on the date of his death, to convert the preference shares to ordinary shares. Therefore the preference shares had to be valued, for the purposes of paragraph 40 read with paragraph 31 of the Eighth Schedule, on this basis.

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