DLA CLIFFE DEKKER HOFMEYR

TAX

ALERT

13 JUNE 2014

IN THIS ISSUE

INVITATION TO SEMINAR: TO PREF OR NOT TO PREF

The tax consequences of preference shares have been the subject matter of much debate over the last few months, and various parties have expressed different views on the issue. In the Budget Speech earlier this year, the National Treasury indicated that certain amendments would be made to the provisions of the Income Tax Act regarding preference shares. The question, however, is whether such amendments would go far enough so as to provide comfort to both the issuers and the holders of preference shares.

Cliffe Dekker Hofmeyr Inc hereby invites you to a seminar on the tax issues relating to preference shares.

Some of the issues that will be discussed include:

- the concept of a 'qualifying purpose';
- what is an 'operating company';
- the use of proceeds to defray costs;
- the extension of preference share terms;
- the refinancing of preference share funding; and
- early redemptions.

The details of the seminar are as follows:

Date: 2 July 2014

Time: 16:30

Place: Cliffe Dekker Hofmeyr Inc, 8th Floor, 1 Protea Place, Sandton

Please respond soonest to ***celeste.olckers@dlacdh.com*** as availability is limited.

continued

THE TAXATION OF RISK POLICIES – THROW AWAY EXISTING PRINCIPLES

The National Treasury released the first batch of fiscal amendments on 10 June 2014. One of the most significant amendments relates to the way in which risk policies will be taxed in the hands of long-term insurance companies ("**Insurers**").

By way of background, the business of an insurer has to date been divided into four separate funds for tax purposes, being –

- the individual policyholder fund relating to policies owned by individuals;
- the company policyholder fund relating to policies owned by corporates;
- the untaxed policyholder fund relating to policies owned by untaxed entities and annuity contracts; and
- the corporate fund which reflected the remaining assets of the insurer.

To date both risk polices as well as investment policies were categorised within the relevant policyholder funds concerned. However, the proposals will have the effect that risk policies will have to be accounted for by an insurer in the corporate fund and no longer in any of the policyholder funds. In other words, it will only be risk policies that are accounted for in the policyholder funds concerned.

The proposals are to the effect that any policy issued by an insurer during any year of assessment commencing on or after 1 January 2016 in respect of a risk policy must be accounted for in the corporate fund. A risk policy is defined as a policy in terms of which any benefits payable under the policy is dependent on any future event, the happening of which is uncertain, or in terms of which any amount payable under the policy is only payable by reason of death. It includes any reinsurance policy in respect of these issues. Importantly, however, to the extent that the policy contains both investment and risk elements, the policy will be deemed to be a risk policy even if only a small portion of the policy benefits may be attributed to risk and/or investment. This categorisation may well give rise to manipulation as it would be relatively easy to decide in which fund a policy must be accounted for. To the extent that a decision is taken to reflect the policy in the corporate fund, one can merely attach a small element of risk to the policy. In cases where it is more advisable to account for the policy in the policyholder fund, one can split the policy so that only investment risk is accounted for in one policy and the risk element in another policy.

It is noteworthy that no reference is made to existing losses that may have been derived in a policyholder fund and how that is to be dealt with going forward. The only reference is that the insurer must place assets having a market value equal to the liabilities in respect of the relevant policies in the fund concerned.

Once the policy is reflected in the corporate fund, however, a number of new principles are introduced. Firstly, the corporate fund is only entitled to claim a deduction equal to the amount of the insurance liabilities as reduced by reinsurance assets in respect of the risk policies as determined in accordance with accounting principles. The amount of insurance liabilities reduced by reinsurance assets relating to risk policies that have been claimed in a preceding year of assessment must be added back. The problem, however, is that the corporate fund now contains a mix of both risk business as well as the surplus assets of the insurer.

In order to overcome this difficulty, premiums will now be included in the income of the corporate fund on the basis that claims actually incurred will be allowed as a deduction. This is similar to the treatment of the short-term insurance industry. However, the proposal goes much further in the sense that –

continued

- dividends going forward will become taxable;
- reinsurance claims received will become taxable, whereas reinsurance premiums paid are deductible;
- capital gains will now be subject to normal tax at the rate of 28% and not the normal corporate rate.

There are a number of fundamental changes in the normal taxation principles that apply to corporate taxpayers. The fact that dividends will become taxable and capital gains are subject to normal tax at the rate of 28% is far-reaching. This should be seen against the background that insurers are to be taxed on an annual basis in respect of unrealised capital gains. It is appreciated that not all of the dividends and capital gains will be taxed, but only a percentage thereof, calculated with reference to the premiums received compared to the total value of assets in the corporate fund. Even on this basis, however, it seems inconsistent with existing tax principles and the previous amendments that have been made to the taxation of the long-term insurance industry. If anything, one should rather consider the use of a fifth fund in which the risk policies must be reflected. This will have a much more equitable effect than throwing these polices into a corporate fund where a number of inconsistencies will arise.

Emil Brincker

THE FINE LINE BETWEEN A RESTRICTED AND UNRESTRICTED EQUITY INSTRUMENT

The complex tax legislation applicable to share incentive schemes has resulted in a number of taxpayers requesting advance tax rulings from the South African Revenue Service (SARS).

On 30 May 2014, Binding Private Ruling No. 170 (Ruling) was released by SARS, which dealt with the question of whether the conditions imposed on an employee in respect of an employee share scheme would result in the shares constituting 'restricted equity instruments' for purposes of s8C of the Income Tax Act, No. 58 of 1962 (Act). It is clear from the Ruling that there is often a fine line between whether or not one is dealing with a 'restricted equity instrument'.

In terms of s8C of the Act, an employee will be subject to income tax on any gain (or loss) determined on the date of vesting of a 'restricted equity instrument'. With reference to the Ruling, if the employee held a 'restricted equity instrument', he would be subject to s8C of the Act on the date of vesting, which would have income tax consequences (as opposed to capital gains tax consequences) for the employee concerned.

A 'restricted equity instrument' is defined in s8C(7) of the Act, and includes a share:

- which is subject to any restriction (other than a restriction imposed by legislation) that prevents the taxpayer from freely disposing of that equity instrument at market value;
- which is subject to any restriction that could result in the taxpayer:
    - forfeiting ownership or the right to acquire ownership of that equity instrument otherwise than at market value; or
    - being penalised financially in any other manner for not complying with the terms of the agreement for the acquisition of that equity instrument.

continued

Against this legislative background, SARS had to consider in the Ruling whether, in the following circumstances, the shares held by the employee constituted 'restricted equity instruments':

- The employee was not a resident of South Africa. At all material times, the employee resided in Country X and rendered services in Country X.
- As part of an employee share scheme, the employee acquired shares in his employer company, which was also resident in Country X.
- The employee was the beneficial owner of the shares, which could be sold at any time subject to the approval of the management of the board of his employer. However, the employee was required to sell the shares if he ceased to be employed by the employer group.
- In terms of a put and call option agreement (Agreement):
  - the shares could, at any time, either be sold by the employee to his employer company (or another company in the group) (Company) or acquired by the Company at market value;
  - all the shares could not be disposed of immediately. The sale had to be spread over a period of four years and the market value for the shares was fixed for the four-year period.
- The employee's employment with his employer had terminated and some of the shares were sold in terms of the Agreement. The remaining shares would therefore be sold over the next four years at the predetermined price.

The employee was contemplating relocating to South Africa with his family, and would most likely become a resident of South Africa before the remaining shares were sold to the Company.

If the employee became a resident of South Africa, he would in future be subject to tax in South Africa on his worldwide income and no longer only South African sourced income. It follows that, if the shares were 'restricted equity instruments' for purposes of s8C of the Act, the employee was presumably concerned that any gain on the subsequent disposal of the shares could be subject to income tax in South Africa in terms of s8C of the Act. If, however, the shares were 'unrestricted equity instruments', the employee would establish a base cost for those remaining shares equal to their market value when he became a resident.

Having regard to the definition of a 'restricted equity instrument' above, the important consideration was whether the restrictions on the disposal of the remaining shares over a four-year period at a predetermined price 'prevents the taxpayer from freely disposing of that equity instrument at market value'.

Despite the employee being forced to sell the shares over a four-year period at the market value determined and fixed at the time of termination of his employment, SARS ruled that these remaining shares constituted 'unrestricted equity instruments' as defined in s8C(7) of the Act. On this basis, s8C of the Act would not be applicable to the subsequent disposal of the shares by the employee once he became a resident of South Africa.

If s8C of the Act had been applicable to the subsequent disposal of the remaining shares by the employee, it would have been interesting to see whether SARS would consider any s8C gain as being exempt from normal tax in terms of s10(1)(o) of the Act.

continued

S10(1)(o) of the Act provides an exemption from normal tax for remuneration earned by an employee for services rendered outside of South Africa for a designated period of time. If the employee in the Ruling is entitled to apply the s10(1)(o) exemption over the period that the services were rendered to his employer (without regard to any subsequent periods of time spent in South Africa), the employee would be exempt from normal tax on any s8C gain realised on the disposal of the remaining shares, as he was outside South Africa for the entire time the services were rendered. In other words, if s10(1)(o) of the Act is applicable, it may be irrelevant whether the shares constituted 'restricted equity instruments'.

However, if one has regard to SARS's Income Tax Interpretation Note 16 and Binding Class Ruling No. 25, it is not clear whether SARS would adopt this interpretation and application of s10(1)(o) of the Act.

The Ruling illustrates the fine line between those situations where taxpayers would be regarded as holding a 'restricted equity instrument' and an 'unrestricted equity instrument', which could have a material impact on the tax consequences triggered on the subsequent disposal/vesting of the equity instruments concerned.

Andrew Lewis

DLA CLIFFE DEKKER HOFMEYR

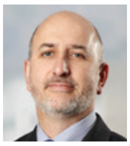
CONTACT US

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

Emil Brincker
National Practice Head
Director
T +27 (0)11 562 1063
E emil.brincker@dlacdh.com

Andrew Lewis
Director
T + 27 (0)11 562 1500
E andrew.lewis@dlacdh.com

Danielle Botha
Associate
T + 27 (0)11 562 1380
E danielle.botha@dlacdh.com



Ben Strauss
Director
T +27 (0)21 405 6063
E ben.strauss@dlacdh.com

Tessmerica Moodley
Associate
T +27 (0)21 481 6397
E tessmerica.moodley@dlacdh.com

Ruaan van Eeden
Director
T +27 (0)11 562 1086
E ruaan.vaneeden@dlacdh.com

Carmen Moss-Holdstock
Associate
T + 27 (0)11 562 1614
E carmen.moss-holdstock@dlacdh.com

Lisa Brunton
Senior Associate
T + 27 (0)21 481 6390
E lisa.brunton@dlacdh.com

Nicole Paulsen
Associate
T + 27 (0)11 562 1386
E nicole.paulsen@dlacdh.com

Heinrich Louw
Senior Associate
T +27 (0)11 562 1187
E heinrich.louw@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

Cliffe Dekker Hofmeyr is a member of DLA Piper Group,
an alliance of legal practices