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SARS RULING ON PREFERENCE SHARE TRANSACTION

Binding Private Ruling No 191 (Ruling) was released by the South African Revenue Service (SARS) on 26 March 2015. The Ruling relates to the refinancing of debt through means of preference share funding.

Having regard to the terms and conditions of the preference shares and the proposed cash-flows of the transaction, the applicant sought a ruling confirming that:

- the preference shares to be issued would not constitute 'hybrid-equity instruments' and 'third-party backed shares', as respectively defined in s8E(1) and s8EA(1) of the Income Tax Act, No 58 of 1962 (Act);
- the issue of the preference shares would fall within the definition of a 'qualifying purpose' as defined in s8EA(1), read together with s8E of the Act;
- the voluntary redemption of the preference shares by the issuer, whether partially or in full, would not create a new date of issue as defined; and
- the provisions of s19 and paragraph 12A would not be applicable to the repayment of the existing loans.

For purposes of this article, we focus on the last two issues, which have caused (and will most likely continue to cause) some debate amongst tax practitioners.

New date of issue

When analysing whether preference shares constitute 'hybrid-equity instruments' for purposes of s8E of the Act, it is important to have regard to the definition of 'date of issue', as it does not only include the date on which the preference shares were issued to the holder. In particular, the 'date of issue' includes the date on which:

"(b) the company [issuer] at any time after the share has been issued undertakes the obligation to redeem that share in whole or in part;

(c) the holder of the share at any time after the share has been issued obtains the right to require that share to be redeemed in whole or in part, otherwise than as a result of the acquisition of that share by that holder".

To the extent that a new 'date of issue' arises (eg the issuer, after the issue of the shares, undertakes the obligation to redeem that share), it could result in the preference shares becoming 'hybrid-equity instruments', which would result in any dividends received by or accrued to the holder during that year of assessment in respect of those shares being deemed to be income in the hands of the recipient.

In the Ruling, the salient features of the preference shares included the following:

- the issuer may redeem the preference shares in part or in full at any time after the date of issue;
- the exercise by the issuer of its option to redeem the preference shares (or part thereof) would not create an obligation on the issuer to do so, nor would it give the holder the right to call on the issuer for the redemption; and
- the exercise of the option to partially redeem would not alter any of the remaining preference share terms.

Having regard to the issuer's rights to voluntarily redeem the preference shares at any time and the wording in paragraphs (b) and (c) of the 'date of issue' definition, the applicant in the Ruling would have been concerned that once the issuer decides to voluntarily redeem the preference shares, either the issuer undertakes the obligation to redeem that share (in whole or in part) or the holder thereof acquires the right to call on the issuer for the redemption, thereby triggering a new 'date of issue'. If one attributes an ordinary meaning to the wording in the 'date of issue' definition, it appears that the voluntary redemption by the issuer could well create a new 'date of issue'.

However, the interpretation of the wording in the 'date of issue' definition, which has generally been preferred by tax practitioners, is that no new 'date of issue' should arise on the voluntary redemption of the preference shares on basis that the undertaking to redeem the preference share should be seen to arise whenever the enforceable obligation arises, irrespective of the fact that the obligation can only be enforced at a later stage. If an issuer undertakes to redeem the preference share after, say, four years, the date of issue will be the date upon which the undertaking is given, ie on day one and no new revised date of issue will arise (see paragraph 4.1 of Chapter N of *Taxation Principles of Interest and other Financing Transactions* by Prof TE Brincker).

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It appears that the Ruling may support this view where it was specifically indicated that "the voluntary redemption of the preference shares by the Co-Applicant, whether partially or in full, will not create a new 'date of issue' as defined in section 8E(1)". The Ruling does, to some extent, clarify the uncertainty surrounding the interpretation of the wording in the definition of 'date of issue' in s8E of the Act in the context of a voluntarily redeemable preference share.

Failure to discharge the debt

Subject to certain exemptions, the provisions of s19 of the Act and paragraph 12A of the Eighth Schedule to the Act can find application to the extent that there is a reduction of debt owed by a person. To the extent that there is a reduction of debt, these provisions could trigger income tax and/or capital gains tax consequences for the debtor being relieved of its debt obligations.

If we consider the application of these provisions in the context of the Ruling, we note that:

- The issuer held 26% of the ordinary shares in a private company, incorporated in and a tax resident of South Africa. The issuer had subscribed for these shares in the Company on loan account (Subscription Loan).
- As a result of the issuer's subscription for shares in the Company, the holder's interest in the Company had been diluted to 74%. To compensate the holder, the Company had declared a dividend equal to the Subscription Loan to the issuer, which remained outstanding on loan account (Subscription Dividend).
- The issuer and holder wished to refinance the respective loans, which would be implemented on the following basis:
  - the holder would utilise cash to subscribe for the preferences in the issuer, which cash proceeds would be utilised by the issuer to fully settle the Subscription Loan owing to the Company; and
  - the Company would utilise the funds received from the issuer to fully settle the outstanding balance on the Subscription Dividend.

If one has regard to the flow of funds in the proposed transaction in the Ruling, there would be a circular flow of funds between the holder, issuer and the Company. The question that often arises in these circumstances is whether there must be an actual flow of funds or whether an alternative payment mechanism can be implemented to alleviate the need to use cash? For example, could the proposed transaction have been implemented on the basis that, firstly, the holder discharges its obligation to the issuer by discharging the issuer's obligation to the Company (referred to as a payment *solutionis adiectus gratia*)? Thereafter, the holder and the Company could set off their respective obligations, negating the need for there to be a flow of funds.

It is assumed that it was this potential set-off of the parties' obligations which caused the applicants to seek the Ruling and implement the proposed transaction through means of an actual flow of funds. Pursuant to *C:SARS V Labat 2011 ZASCA 157*, concerns have been raised that a mere set-off does not necessarily constitute a valid discharge of a debt. If one adopts this interpretation of the *Labat* case and the proposed transaction in the Ruling had been implemented through means of set-off, there would not necessarily have been a valid discharge of a debt, which would triggered the debt reduction provisions contained in s19 and paragraph 12A of the Eighth Schedule to the Act.

On the basis that the proposed transaction in the Ruling was implemented through means of an actual flow of funds, SARS ruled that "the provisions of s19 and paragraph 12A will not be applicable to the repayment of the subscription loan and subscription dividend loan".

When implementing preference share transactions taxpayers must give careful consideration to the provisions of s8E and s8EA of the Act as the wording of these provisions is often unclear, which can lead to disputes with SARS. Furthermore, taxpayers must give careful consideration to their particular circumstances before deciding to set off their respective obligations as it may have unintended tax consequences.

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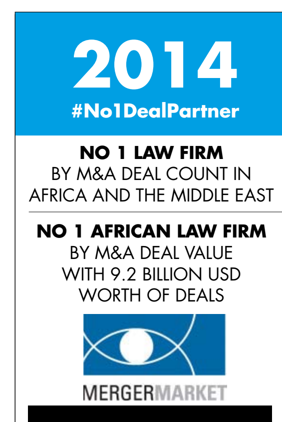

REPORTABLE ARRANGEMENTS SPECIFICALLY EXTENDED TO FOREIGN TRUST STRUCTURES

On 16 March 2015, the Commissioner for the South African Revenue Service (SARS) published Government Notice No. 212 in terms of s35(2) and s36(4) of the Tax Administration Act No, 28 of 2011 (TAA) specifically listing certain arrangements as so-called reportable arrangements (Notice). These listed arrangements are in addition to the arrangements that are already listed in s35(1) of the TAA.

The effect of an arrangement being regarded as a reportable arrangement for purposes of s35 of the TAA read with the Notice is that, in terms of s37 of the TAA, a participant must disclose certain information to SARS within 45 business days of any arrangement qualifying as a reportable arrangement for purposes of the TAA or, disclose the information within 45 days from the date of becoming a participant to that reportable arrangement. In terms of s37(3) of the TAA, a participant does not need to disclose the listed information if the participant obtains a written statement from any other participant that the other participant has disclosed the reportable arrangement.

One of the problematic arrangements listed in the Notice is:

"*Any arrangement in terms of which –*

(a) a person that is a resident makes any contribution or payment on or after the date of publication of this notice to a trust that is not a resident and has or acquires a beneficial interest in that trust; and

(b) the amount of all contributions or payments, whether made before or after the date of publication of this notice, or the value of that interest exceeds or is reasonably expected to exceed R10 million, excluding any contributions or payments made to or beneficial interest acquired in any –

(i) portfolio comprised in any investment scheme contemplated in paragraph (e)(ii) of the definition of "company" in section 1(1) of the Income Tax Act, 1962; or

(ii) foreign investment entity as defined in section 1(1) of the Income Tax Act, 1962".

One of the requirements for an arrangement relating to a foreign trust structure to fall within the ambit of the Notice is that a South African tax resident must have or acquire a 'beneficial interest' in the trust. The difficulty with determining whether one meets this requirement is that it is not clear what exactly is meant by the words 'beneficial interest', as this term is not defined in the TAA or the Income Tax Act, No 58 of 1962. These words are therefore open to interpretation.

This is particularly relevant in the instance of a discretionary trust where the trustees are afforded a discretion whether to vest any income or capital in a beneficiary of the offshore trust. In instances where the offshore trust is a discretionary trust, it is arguable that a beneficiary of the trust may not have a beneficial interest in the offshore trust, as any interest which that beneficiary may or may not receive is completely within the discretion of the trustees and therefore not certain until such time as the discretion is exercised. Therefore, a specific beneficiary may never gain a 'beneficial interest' in the offshore trust to the extent that the trustees exercise their discretion by never vesting any capital or income in such beneficiary. This appears to be in line with the decision of *Commissioner for Inland Revenue v Estate Merensky (1959) 2 All SA 501 (A)*, although the point was not specifically argued in that case.

The SARS Comprehensive Guide to Capital Gains Tax (Issue 5) appears to provide some support for the argument that a beneficiary to a discretionary trust has a contingent right, but that this right is no more than a *spes* (hope or an expectation) until the trustees have exercised their discretion and the assets are vested in the beneficiary. It appears to be SARS' understanding that, as the beneficiaries of a discretionary trust hold no more than a spes until the exercise of the discretion by the trustees and the vesting of assets in the beneficiaries, the beneficiaries have no beneficial interest in the trust as the value of their rights cannot be quantified until the assets are vested in them.

However, there is also a counter-argument, namely that it may be SARS' intention to include any beneficial interest in a discretionary trust in the term 'beneficial interest,' otherwise SARS would have expressly excluded this scenario in the Notice.

The impact and application of the Notice in respect of offshore trusts therefore appears to be somewhat uncertain and open to interpretation. At this stage it certainly seems possible to argue the matter either way.

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