TAX

IN THIS ISSUE

INNOCUOUS BINDING PRIVATE RULING OR PERHAPS NOT

THIRD PARTY RETURNS – EXCHANGE OF INFORMATION IN ACCORDANCE WITH INTERNATIONAL TAX STANDARDS

INNOCUOUS BINDING PRIVATE RULING OR PERHAPS NOT

We often comment that the tax legislation applicable to share incentive schemes is complex and, as a result, a number of advance tax rulings have been published by the South African Revenue Service (SARS) dealing with the issues.

Another Binding Private Ruling, No 199 (Ruling), was released by SARS this week which dealt with the questions of whether:

- the participation rights held by beneficiaries of a share incentive trust constituted "restricted equity instruments" for purposes of s8C(7) of the Income Tax Act, No 58 of 1962 (Act); and
- the dividends received by the beneficiaries by virtue of these participation rights will be tax as income or exempt from normal tax in terms of s10(1)(k)(i) of the Act.

The Ruling once again illustrates the difficulty that taxpayers face in determining whether the particular equity instruments concerned constitute "restricted equity instruments" and whether any dividends received by them will be exempt from normal tax. In particular, recent amendments to subparagraphs (dd) and (ii) of s10(1)(k)(i) of the Act have created some uncertainty whether dividends received in respect of the relevant equity instruments will be exempt from normal tax.

The facts of the Ruling are common in a number of share incentive schemes where:

- An incentive trust (Applicant) is established for the directors / employees of a private company.
- The Applicant acquires ordinary shares in the private company, which are held for the benefit of the directors and designated employees (Beneficiaries).
- The Beneficiaries are awarded participation units (Units) which entitle them to, amongst others things, a portion of the dividends received by the Applicant. However, in this particular scheme, the Units do not entitle the Beneficiaries to receive any shares held by the Applicant.

Importantly, for purposes of analysing the attendant tax consequences arising from the scheme, the Units in the Ruling were subject to the following restrictions:

- if a Beneficiary ceases to be a Beneficiary, the Beneficiary will be deemed to have offered their Units for sale to parties (Offerees) specified in the trust deed who shall be entitled (but not obliged) to purchase the Units;

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- the purchase price payable for the Units is an amount equal to the fair market value which will either be determined (i) in terms of the trust deed or (ii) with reference to the ultimate underlying investments in which the shares, held by the Applicant, are invested;
- the Offerees are not obliged to purchase the Units; and
- no Beneficiary may dispose of a Unit without permission of the board of directors of the company, who may not unreasonably withhold its permission.

It is difficult to analyse the Ruling without all of the detailed facts and circumstances of the scheme. However, it is anticipated that the uncertainty has been created as a result of the recent amendments to s10(1)(k)(i) of the Act. The provisions of s10(1)(k)(i) of the Act are subject to differences of interpretation. However, it appears that the generally accepted interpretation of these provisions is that:

- if one is dealing with a "restricted equity instrument", the dividends will be exempt provided one complies with the provisions of s10(1)(k)(i)(dd) of the Act. In this case, all of the shares held by the Applicant had to be equity shares to qualify for the exemption; and
- if one is dealing with an "unrestricted equity instrument" or other arrangement, one has to carefully consider whether "any dividend received by or accrued to a person in respect of services rendered or to be rendered, or in respect of or by virtue of employment or the holding of any office", otherwise it may not be exempt in terms of s10(1)(k)(i)(ii) of the Act. The provisions of subparagraph (ii) are certainly less clear than the provisions of subparagraph (dd).

In the context of the Ruling it is likely that the Applicant and the Beneficiaries were concerned that if the Units were "unrestricted equity instruments", any dividends received by the Beneficiaries would be "in respect of services rendered or to be rendered, or in respect of or by virtue of employment or the holding of any office" and therefore no longer exempt in terms of the new s10(1)(k)(i)(ii) of the Act.

However, SARS confirmed in the Ruling that the Units constituted "restricted equity instruments" and, presumably on the basis that all the shares held by the Applicant were equity shares, any dividends received by the Beneficiaries would be exempt from normal tax in terms of s10(1)(k)(i)(dd) of the Act.

The Beneficiaries in the Ruling will take comfort from the certainty that any dividend distributions received by them will be exempt from normal tax, although any dividend distributions will be subject to the dividend withholding tax imposed at a rate of 15%.

However, the Ruling may give other taxpayers some cause for concern as to whether their particular equity instruments may be regarded as "restricted equity instruments" for the purposes of s8C of the Act. In particular, we note that:

- It is not clear from the Ruling, which of the restrictions imposed on the Units resulted in the Units constituting "restricted equity instruments" or whether it was the restrictions viewed collectively. For example:
  - Is the fact that the Beneficiaries may not dispose of the Unit without prior approval from the board of the company alone sufficient for the Units to constitute a "restricted equity instrument", bearing in mind that the approval may not be unreasonably withheld?
  - Do the other restrictions result in the Units becoming "restricted equity instruments" in circumstances where the Units can be disposed of at fair market value?
- Many of the restrictions referred to in the Ruling are common in a private company scenario where there is not a readily available market for the sale of the shares in the company and the board or other shareholders need to pre-approve the transfer of shares to any other person. If in a private company scenario, the shareholders of the company who also happen to be employees of the company are required, upon ceasing to be an employee, to offer their shares to designated transferees at fair mark value and/or obtain prior approval from the board to dispose of their shares (at fair value value), does this mean that these shares will be regarded as "restricted equity instruments"?

On first reading, the Ruling appears innocuous without much cause for concern. However, on closer analysis it does raise interesting, and often difficult, questions on when an equity instrument will be a "restricted equity instrument" and an "unrestricted equity instrument".

Andrew Lewis

THIRD PARTY RETURNS – EXCHANGE OF INFORMATION IN ACCORDANCE WITH INTERNATIONAL TAX STANDARDS

In order to provide the necessary legislative amendments required to implement the tax proposals that were announced in the 2015 National Budget on 25 February 2015, the National Treasury (Treasury) published the 2015 Draft Tax Administration Laws Amendment Bill (TALAB) on 22 July 2015 for public comment.

One of the important proposals relates to greater tax transparency and the automatic exchange of information between tax administrations in various jurisdictions in order to counter cross-border tax evasion and aggressive tax avoidance. To this effect, s32 of the TALAB proposes the insertion of a definition of "international tax standard" in s1 of the Tax Administration Act, No 28 of 2011 (TAA), to mean "an international standard as specified by the Commissioner by public notice for the exchange of tax-related information between countries".

Treasury indicated that this definition was inserted to implement a scheme under which the South African Revenue Service (SARS) may require South African financial institutions to collect information under an international tax standard such as the Organisation for Economic Cooperation and Development Standard for Automatic Exchange of Financial Account Information in Tax Matters.

The aforementioned standard encompasses the Common Reporting Standard (CRS) that was endorsed by the G20 Finance Ministers in 2014. In order to ensure the consistency and efficiency of this standard, certain financial institutions must report on all account holders and controlling persons, irrespective of whether there is an international tax agreement between South Africa and their jurisdiction of residence or whether such jurisdiction is currently a CRS participating jurisdiction.

This reporting requirement will ease the compliance burden on reporting financial institutions as they would otherwise have to effect changes to their systems and collect historical information each time South Africa concludes a new international tax agreement or a jurisdiction is added to the CRS. Pursuant to the proposed amendment, all reporting financial institutions are obliged by statute to obtain the information and provide it to SARS. In addition, the financial institutions must ensure compliance with the relevant data protection laws.

In order to give effect to the proposed implementation of the international tax standard, s37 of the TALAB proposes the amendment of s26 of the TAA. Currently, s26 enables the Commissioner of SARS, by public notice, to require third parties to submit returns for a person with whom that party transacts, ie employers, banks and asset managers of the taxpayer.

The TALAB proposes the insertion of subsection 3 to s26 of the TAA, which provides as follows:

> The Commissioner may require a person to register as a person required to submit a return under this section, an international tax agreement or an international standard for exchange of information.

The intention of the proposed amendment is to ensure that the relevant financial institutions register with SARS in order to comply with international tax standards. In turn, the registration will assist SARS in the administration and the enforcement of international tax standards.

Public comments on the proposed amendments are due by close of business on 24 August 2015.

Gigi Nyanin and Nicole Paulsen

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

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

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

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

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

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

Mareli Treurnicht
Senior Associate
T + 27 (0)11 562 1103
E mareli.treurnicht@dlacdh.com

Gigi Nyanin
Associate
T + 27 (0)11 562 1120
E gigi.nyanin@dlacdh.com

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

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BBBEE STATUS: LEVEL TWO 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

cliffedekkerhofmeyr.com

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