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TAX ALERT

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RULING ON THIRD-PARTY BACKED SHARES

Section 8EA of the Income Tax Act, No 58 of 1962 (Act) constitutes an anti-avoidance provision which, if applicable, has the effect that the amount of any dividend or foreign dividend received or accrued to the holder of a preference share, is deemed to be an amount of income as opposed to exempt income for tax purposes. In order for the provisions of s8EA of the Act to apply, the preference share in question must be regarded as a 'third-party backed share'.

PRESERVATION ORDERS - THE COURT SETS A HIGH BAR FOR SARS

In The Commissioner for the South African Revenue Service v Sunflower Distributors CC and Others (66077/2015) [2015] ZAGPPHC 896 (17 November 2015), the court had to decide whether a provisional preservation order granted in favour of the South African Revenue Service (SARS) should be made final.

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RULING ON THIRD-PARTY BACKED SHARES

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A third-party backed share means any preference share in respect of which an enforcement right is exercisable by the holder of that preference share or an enforcement obligation is enforceable as a result of any amount of any specified dividend, foreign dividend, return of capital or foreign return of capital attributable to that share not being received by, or accruing to the person entitled thereto.

It should however be noted that one of the important requirements that must be satisfied in order for the preference share in question to be regarded as a third-party backed share, is that the funds derived on the issue of the preference share must be applied for a purpose other than a 'qualifying purpose', as defined in s8EA(1) of the Act. Accordingly, where the funds derived from the issue of the preference share are applied for a 'qualifying purpose', the provisions of s8EA of the Act will not apply, provided that the enforcement rights or obligations are only exercisable or enforceable against certain persons listed in s8EA(3)(b) of the Act.

Accordingly, where the funds derived from the issue of the preference share are applied for a 'qualifying purpose', the provisions of s8EA of the Act will not apply, provided that the enforcement rights or obligations are only exercisable or enforceable against certain persons listed in s8EA(3)(b) of the Act.

For purposes of this article, subparagraph b(i)(aa) of the definition of 'qualifying purpose' in s8EA(1) of the Act states that a qualifying purpose in relation to the application of the funds derived from the issue of a preference share, means the partial or the full settlement by any person of any debt incurred for the direct or indirect acquisition of an equity share by any person in an operating company. However, this excludes a direct or indirect acquisition of any equity share from a company that, immediately before that acquisition, formed part of the same group of companies as the person acquiring that equity share.

It is therefore not enough to merely have applied the funds derived from the issue of the preference share for a 'qualifying purpose', to escape the application of the aforementioned provisions to the preference share.

On 22 December 2015, the South African Revenue Service (SARS) issued Binding Private Ruling 214 (BPR 214), which deals with the interpretation and application of the provisions of s8EA of the Act. In particular, BPR 214 determines whether, in terms of the proposed transaction, cumulative redeemable preference shares constitute 'third-party backed shares'.

The parties to the proposed transaction is the Applicant, a company incorporated in and a resident of South Africa, which is a wholly owned subsidiary of a private company incorporated in and resident of South Africa (Company B). Company B in turn is a wholly owned subsidiary of a listed company incorporated in and resident of South Africa (Company A). A private company incorporated in and resident of South Africa (Company C), is a wholly owned subsidiary of the Applicant.

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In terms of the proposed transaction, Company C borrowed an amount from Company B with the sole purpose of acquiring shares in a special purpose, non-operating company (Company D). Company D was created solely to hold equity shares in an operating company (Company E). The loan was subsequently delegated by Company C to the Applicant, resulting in the Applicant being indebted to Company B.

In terms of the proposed transaction, Company C borrowed an amount from Company B with the sole purpose of acquiring shares in a special purpose, non-operating company (Company D). Company D was created solely to hold equity shares in an operating company (Company E). The loan was subsequently delegated by Company C to the Applicant, resulting in the Applicant being indebted to Company B. The Applicant required funds to partially settle the loan and accordingly issued cumulative redeemable preference shares (shares) to a resident listed company, acting through its Corporate and Investment Banking Division (Company F).

In addition to the share subscription, the respective parties agreed that the following arrangements will apply:

- the Applicant will, *inter alia*, indemnify Company F in the event of non-payment relating to the shares and will enter into a pledge and cession agreement with Company F, in respect of certain rights it holds;
- company B will subordinate all of its claims against the Applicant, in favour of Company F;
- company A will extend a guarantee to Company F for all the post redemption obligations of the Applicant; and
- either Company A or Company B, or both of them, may extend guarantees to Company F in respect of the non-payments of the shares.

Further, in accordance with the calculation in terms of the share subscription agreement, three classes of dividends are to be payable in respect of the shares.

SARS made the following ruling in connection with the proposed transaction:

- by virtue of the shares being issued for the indirect acquisition of an equity share in an operating company, the shares were applied for a 'qualifying purpose', as contemplated in s8EA(3), read with subparagraph (b)(i)(aa) of the definition of 'qualifying purpose' in s8EA(1) of the Act. Accordingly, the shares do not constitute 'third-party backed shares', as defined in s8EA(1) of the Act; and
- by virtue of Company A and Company B forming part of the same group of companies as the Applicant, no regard must be had to the enforcement right exercisable by Company F, where the security provider is Company A or Company B.

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PRESERVATION ORDERS - THE COURT SETS A HIGH BAR FOR SARS

The author of the SARS founding affidavit stated that the preservation order was applied for as an interim measure to preserve realisable assets until the final winding-up order is granted and until final liquidators have been appointed by the Master of the High Court, and them taking charge of the assets.

In The Commissioner for the South African Revenue Service v Sunflower Distributors CC and Others (66077/2015) [2015] ZAGPPHC 896 (17 November 2015), the court had to decide whether a provisional preservation order granted in favour of the South African Revenue Service (SARS) should be made final.

The key issue in this case was whether the evidence presented by SARS justified the granting of the final preservation order.

In this case, the 'First Respondent', Sunflower Distributors CC, was placed under a final winding-up order on 15 September 2015, after the provisional order was granted on 28 July 2015. The author of the SARS founding affidavit stated that the preservation order was applied for as an interim measure to preserve realisable assets until the final winding-up order is granted and until final liquidators have been appointed by the Master of the High Court, and them taking charge of the assets. The provisional preservation order was granted on 8 September 2015.

The provisional preservation order was obtained in terms of s163 of the Tax Administration Act (TAA), after an *ex parte* application was brought by SARS in the High Court. The basis for the *ex parte* application and the granting of the provisional preservation order is that the Respondents were involved in an elaborate VAT scheme.

The key issue in this case was whether the evidence presented by SARS justified the granting of the final preservation order. The 'Second Respondent' objected that the SARS' founding affidavit relied on hearsay evidence and that a letter written to SARS by the First Respondent's auditor, a certain Van der Linde, was material to SARS' application and had not been annexed to the affidavit. The Second Respondent argued that the failure to annex this letter and the reliance on hearsay evidence in the founding affidavit were material omissions meaning that SARS' application could not be granted.

SARS' founding affidavit made reference to the findings of a certain Swanepoel, a SARS official who had conducted a value-tax audit of the First Respondent. Van der Linde was an auditor at an auditing firm, which had been appointed by the First Respondent. Van der Linde assisted the First Respondent with the value-tax audit. In applying for the final preservation order, SARS made reference to the audit, which Swanepoel conducted by randomly choosing 10 examples of transactions which were conducted during the tax period in issue, namely July 2011. A letter of findings was subsequently sent to Van der Linde on 8 November 2011. Van der Linde responded to the letter of findings in a letter dated 22 November 2011. This response dealt extensively with the alleged administrative failures of the First Respondent to claim certain input tax, identified in the letter of findings of 8 November 2011. The thrust of Van der Linde's detailed letter was that the First Respondent was perfectly entitled to deduct the input tax that it paid to its suppliers from the output tax which the client that it supplied paid to it and that it was not operating a scheme.

The court held that as the application for a provisional preservation order is an ex parte application, SARS had a duty to act in the utmost good faith. The court

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Section 163 of the TAA is a far-reaching provision which can have a significant impact on the business and/or livelihood of a taxpayer as it deprives such a taxpayer, temporarily at least, from dealing with its assets.

stated that it will not hold itself bound by any order obtained where there was a misapprehension of the true facts.

Where an applicant obtained relief, but did not disclose all the necessary facts in its application, the court will consider the following factors in deciding whether to grant final relief:

- the extent to which the rule of disclosure has been breached;
- the reasons for the non-disclosure;
- the extent to which the first Court might have been influenced by proper disclosure;
- the consequences from the point of doing justice between the parties.

The effect of this failure to annex this letter or deal with it in the founding affidavit meant that the duty to act with the utmost faith had not been complied with by SARS. Coupled with the significant hearsay evidence relied on by SARS in its founding affidavit, the court decided not to confirm the provisional order.

Section 163 of the TAA is a far-reaching provision which can have a significant impact on the business and/or livelihood of a taxpayer as it deprives such a taxpayer, temporarily at least, from dealing with its assets. This judgment protects the taxpayer when faced with opposing such an application by SARS. It shows that the court will not easily grant such an order in favour of SARS and that taxpayers, in defending such applications, can know that SARS must provide full disclosure of all the relevant facts in order to succeed with such an application.

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