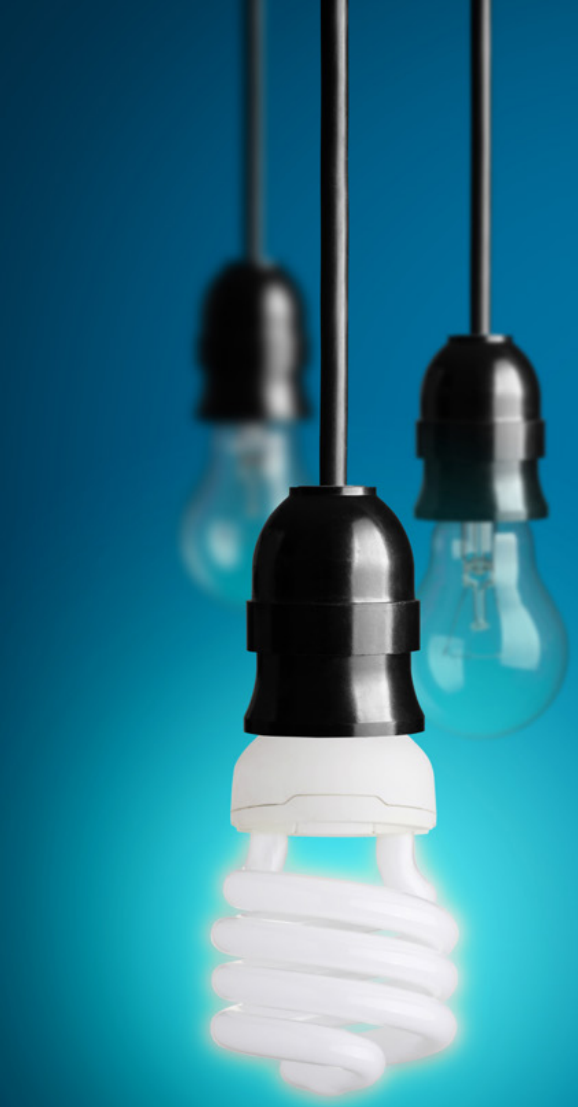

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CORPORATE & COMMERCIAL ALERT

IN THIS **ISSUE**

PREFERENCE SHARE FUNDING STRUCTURES: AN OVERVIEW OF THE APPLICATION OF THE RELEVANT COMPANIES ACT AND INCOME TAX ACT PROVISIONS

Preference share funding structures contemplate the subscription by a funder for preference shares in the share capital of a company with a pre-agreed dividend rate (often linked to a prevailing interest rate) and capital redemption profile. These types of funding structures are often preferred by banks and other financial institutions because dividends received by certain holders, including banks and other juristic persons, are exempt from income tax.

FILING YOUR ANNUAL FINANCIAL STATEMENTS THE XBRL WAY

As of 1 July 2018, the Companies and Intellectual Property Commission (CIPC) sanctioned the submission of annual financial statements for companies through eXtensible Business Reporting Language (XBRL), in line with its legislative mandate contained in regulation 30 of the Regulations to the Companies Act, No 71 of 2008, as amended, 2011 (Regulations) (Companies Act).

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PREFERENCE SHARE FUNDING STRUCTURES: AN OVERVIEW OF THE APPLICATION OF THE RELEVANT COMPANIES ACT AND INCOME TAX ACT PROVISIONS

The provisions of the Companies Act and Income Tax Act need to be considered in the context of the outcome which the company wishes to achieve before a company settles the terms of a preference share funding structure.

Preference share funding structures contemplate the subscription by a funder for preference shares in the share capital of a company with a pre-agreed dividend rate (often linked to a prevailing interest rate) and capital redemption profile. These types of funding structures are often preferred by banks and other financial institutions because dividends received by certain holders, including banks and other juristic persons, are exempt from income tax. Interest on loans, on the other hand, is taxable in the hands of the recipient and often cannot be deducted from the income of the borrower.

The types of preference shares available to companies wishing to establish a preference share funding structure can be categorised according to the different obligations, rights and entitlements attaching to them.

The provisions of the Companies Act and Income Tax Act need to be considered in the context of the outcome which the company wishes to achieve before a company settles the terms of a preference share funding structure. What follows is a brief overview of, and practical guide to, the application of the Companies Act and Income Tax Act provisions relevant to preference share funding structures.

1. Share Capital

1.1 The existing share capital structure and memorandum of incorporation (MOI) of the company should be reviewed at the start of the preference share structuring process to determine whether it is necessary to increase the authorised share capital of the company in order to create the class of preference shares required for purposes of the funding venture and whether the MOI prescribes compliance with certain formalities prior to such increase being undertaken.

1.2 A share capital increase amounts to an amendment of the company's MOI and needs to be authorised by the directors and shareholders of the company in accordance with s36(1)(d), read with s16(1)(c)(i), of the Companies Act. The amendment needs to be registered with the Companies and Intellectual Property Commission, which process can take between two to four weeks and in some instances, even longer.

1.3 It is recommended that this process be undertaken at the start of the structuring process to ensure that the shares are in existence by the time the preference share subscription agreement, preference share terms and related security documents have been negotiated and signed.

1.4 It is therefore best to create a class of unspecified shares, the preference, rights, limitations and other terms of which are to be specified by the board of directors, and approved by the shareholders if required by the company's MOI, once the preference share terms have been agreed.

2. Type of Preference Shares

The types of preference shares available to companies wishing to establish a preference share funding structure can be categorised according to the different obligations, rights and entitlements attaching to them.

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Section 8E(2) of the Income Tax Act provides that dividends received in respect of a preference share will be deemed to be income in the hands of the recipient if the preference share constitutes a "hybrid equity instrument".

The nature of the obligations, rights and entitlements will depend on the type of funding structure that the company wishes to establish. Preference shares can therefore be categorised into the following main types:

2.1 Participating vs Non-Participating: participating preference shares entitle the holder thereof to the surplus assets and profits of the company once all shareholders have been paid their dues while non-participating preference shares do not.

2.2 Cumulative vs Non-Cumulative: preference shares usually entitle the holder thereof to a preferential dividend payable on a specified dividend payment date. If the company does not declare a preferential dividend on the dividend payment date, a cumulative preference share will entitle the holder thereof to an accrued dividend which will be carried over to the next dividend payment date. The cumulative dividend must usually be settled before any further dividends, whether ordinary or preferential, are paid. The holder of a non-cumulative dividend will not be entitled to such an accrual and will lose the right to receive a dividend if the company does not declare a dividend on that dividend payment date.

2.3 Convertible vs Non-Convertible: convertible preference shares entitle the holder thereof to the right to convert the preference shares to ordinary shares in the share capital of the company on predetermined terms while non-convertible preference shares do not. Upon conversion, the preference shareholder will lose its preferential rights and will have the same rights as the holders of the class of shares into which the preference shares have been converted.

2.4 Redeemable vs Non-Redeemable: redeemable preference shares can be redeemed by the company either on a specified date or over a period of time. Upon redemption, the company will be required to pay all distributions which have accrued to the holder thereof and all other amounts owed to such holder. Such redemption will be undertaken in accordance with s46 of the Companies Act.

3. Purpose

3.1 Section 8E(2) of the Income Tax Act provides that dividends received in respect of a preference share will be deemed to be income in the hands of the recipient, ie the holder of the preference share, if the preference share constitutes a "hybrid equity instrument".

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Section 8E(1) defines a "hybrid equity instrument" as, among other things, a preference share which is secured by a financial instrument or is subject to a financial instrument which cannot be disposed of, unless the preference share was issued for a "qualifying purpose".

3.2 Section 8E(1) defines a "hybrid equity instrument" as, among other things, a preference share which is secured by a financial instrument or is subject to a financial instrument which cannot be disposed of, unless the preference share was issued for a "qualifying purpose". This means that the subscription proceeds which are received by or accrued to the issuer of the preference shares must be applied for one or more "qualifying purpose(s)", as defined in s8EA of the Income Tax Act.

3.3 Section 8EA of the Income Tax Act provides that subscription proceeds received by or accrued to the issuer of the preference shares will be deemed to have been used for a "qualifying purpose" if it is used for:

3.3.1 the direct or indirect acquisition of an equity share in a company which is an "operating company" at the time of receipt or accrual of the dividend, provided that it cannot be used to acquire shares in an operating company which, immediately prior to such acquisition, formed part of the same group of companies as the person acquiring the equity shares;

3.3.2 the direct or indirect acquisition or redemption of other preference shares (Original Preference Shares) if:

3.3.2.1 the Original Preference Shares were originally issued for a "qualifying purpose"; and

3.3.2.2 the amount received by or accrued to the issuer does not exceed the amount which remains outstanding in respect of the Original Preference Shares;

3.3.3 the payment of dividends in respect of the Original Preference Shares; and

3.3.4 the partial or full settlement of debt incurred in respect of any one of the above.

3.4 An "operating company" is defined in s8EA of the Income Tax Act as:

3.4.1 a company that carries on business continuously and, in the course of operating such business, provides goods and/or services for consideration or carries on exploration of natural resources;

3.4.2 a company that is a controlling group company in relation to the aforementioned operating company; and

3.4.3 any company that is a listed company.

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The preference share terms may however provide that the issuer has the right, at any time, to voluntarily redeem the preference shares before such date without the resultant adverse consequences of s8E.

4. Redemption Profile

4.1 Section 8E(1) of the Income Tax Act also defines a "hybrid equity instrument" as, among other things, a preference share in respect of which:

4.1.1 the issuer thereof is obliged to redeem the preference share in whole or in part within a period of three years from the date of issue of that preference share;

4.1.2 the holder thereof has the option to redeem the preference share in whole or in part within a period of three years from the date of issue of that preference share; or

4.1.3 the existence of the company issuing such preference share will be, or is likely to be, terminated within a period of three years from the date of issue of that preference share.

4.2 It follows that the preference share terms should always set the scheduled redemption date for any preference share on a date which is at least three years and one day after the issue date of such preference share.

4.3 The preference share terms may however provide that the issuer has the right, at any time, to voluntarily redeem the preference shares before such date without the resultant adverse consequences of s8E.

5. Security

5.1 Since preference share funding amounts to an obligation on the issuer to pay certain amounts to the holder thereof at a future date(s), holders often require that the obligations of the issuer be secured.

5.2 This can be achieved through a number of security arrangements using the assets of the issuer. It can also be achieved by using the assets of a third party. However, s8EA(2) of the Income Tax Act provides that dividends received in respect of a preference share will be deemed to be income in the hands of the holder of the preference share if the preference share constitutes a "third-party backed share".

5.3 Section 8EA of the Income Tax Act defines a "third-party backed share" as a preference share in respect of which an enforcement right is exercisable by the holder of that preference share or an enforcement obligation becomes enforceable as a result of any specified dividend or return of capital attributable to that share not being received by or accruing to the person entitled thereto.

5.4 Section 8EA(3) of the Income Tax Act does, however, provide that a preference share which is secured by the assets of a third party will not constitute a "third-party backed share" if the obligations of the issuer of that preference share is secured by one of the following persons:

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Section 8E and 8EA of the Income Tax Act and the resultant tax consequence of the application of these provisions often requires a delicate interpretation on a case by case basis.

5.4.1 the operating company in respect of which the preference share funds will be applied, provided the funds were applied for a qualifying purpose;

5.4.2 the issuer of the preference shares, provided it was issued for a qualifying purpose;

5.4.3 any person that directly or indirectly holds at least 20% of the equity shares in the relevant operating company or issuer;

5.4.4 any company that forms part of the same group of companies as the relevant operating company, issuer or 20% equity holder;

5.4.5 any natural person;

5.4.6 any non-profit company, trust or association of persons, provided that none of the activities of that organisation are directed at promoting the economic self-interest, other than the payment of reasonable remuneration, of any employee or fiduciary of that organisation; and

5.4.7 any person who holds equity shares in the issuer of the preference shares, provided that the enforcement right or obligation exercisable against that person is limited to any rights in and claims against that issuer that are held by that person.

Section 8E and 8EA of the Income Tax Act and the resultant tax consequence of the application of these provisions often requires a delicate interpretation on a case by case basis. It is therefore advisable to always obtain tax and structuring advice in respect of each preference share funding transaction which a company wishes to undertake, since each transaction will often have its own peculiarities.

Dominique van der Westhuizen and Chante du Plessis overseen by Roelf Horn

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FILING YOUR ANNUAL FINANCIAL STATEMENTS THE XBRL WAY

Where a company is required to audit its annual financial statements (AFSs) in terms of the Companies Act, it must file a copy of its latest approved AFSs on the date it files its annual returns.

The automated nature of XBRL now allows companies to submit AFSs with the confidence that their AFSs will be analysed thoroughly by a digitally programmed system.

As of 1 July 2018, the Companies and Intellectual Property Commission (CIPC) sanctioned the submission of annual financial statements for companies through eXtensible Business Reporting Language (XBRL), in line with its legislative mandate contained in regulation 30 of the Regulations to the Companies Act, No 71 of 2008, as amended, 2011 (Regulations)(Companies Act).

In terms of s33 of the Companies Act, every company is required to file an annual return within 30 days after the anniversary of its date of incorporation and, where a company is required to audit its annual financial statements (AFSs) in terms of the Companies Act, it must file a copy of its latest approved AFSs on the date it files its annual returns.

Regulation 30(5)(a) of the Regulations specifically prescribes for the CIPC to establish a system to review AFSs with the objective of monitoring compliance with the financial record keeping and financial reporting provisions of the Companies Act.

Previously, companies were required to submit AFSs in PDF format, which meant that AFSs were to be analysed, processed and calculated one-by-one; by walking, talking and breathing analysts.

As of 1 July 2018, the submission of AFSs for companies are to be done through XBRL, a form of digital financial reporting which aims to define and exchange financial information in a structured, less administratively burdensome manner. The automated nature of XBRL now allows companies to submit AFSs with the confidence that their AFSs will be analysed thoroughly by a digitally programmed system.

What is XBRL?

For the successful deployment of XBRL, the CIPC created a taxonomy based on the applicable requirements contemplated in the Companies Act and international financial reporting standards (commonly known as a dictionary of "financial facts") which applies to all companies and which is consistent from one financial statement to another (Taxonomy).

In order to produce AFSs in XBRL format, all companies will require software that will be able to "tag", validate and/or interpret the required data elements based on the Taxonomy. Accordingly, each individual element of data will be "tagged". These tags contain information about the element of data as it appears on the AFSs. For example, "accounts receivable", being an individual element of data, has its own unique tag which is understandable to computers and includes specific information about the element of data such as its value, currency and whether the relevant amount is a debit

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Since the roll-out of the new XBRL format, the big question being asked on repeat is: "does our company need to file the XBRL way?"

or credit. Tagging requirements may differ from one company to another depending on whether such company is a Small or Medium Enterprise. However, the minimum tagging requirements apply to all entities and can be accessed on the CIPC website. Pursuant to the new XBRL roll-out, the CIPC created a web portal specifically for the submission of AFSs in XBRL format, which can be accessed via the CIPC website.

The CIPC's current e-Services functionality (Portal) will allow companies to upload AFSs in XBRL format:

- When users log in, the Portal will authenticate such user who will subsequently be permitted to upload AFSs. The Portal will either validate or reject the upload of the AFSs once automatically compared to the Taxonomy.
- The user will then receive an e-mail notification informing him/her of whether the upload of the AFSs has been validated or rejected. When an upload of AFSs has been rejected, companies will be required to rectify their data, through their own software, before re-submitting the AFSs to the CIPC. For assistance with the rectification of data, users may contact the CIPC by transmitting an e-mail to XBRL@cipc.co.za.
- After the successful upload of AFSs, the CIPC will perform an analysis on a sample of an AFS, including functions which cannot be automated through a digital financial system such as XBRL.

Does our company need to file the XBRL way?

Since the roll-out of the new XBRL format, the big question being asked on repeat is: "does our company need to file the XBRL way?"

In terms of regulation 28 of the Regulations, the following specific categories of companies are required to submit AFSs, on the same day that they file their annual returns, through the new XBRL system:

- all public companies and state-owned companies;
- companies with a public interest score (PIS) of more than 350, or if the PIS of a company is at least 100 and its AFSs for a particular year were internally compiled;
- companies with a memorandum of incorporation which prescribes that the company undergo an audit;

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Regulation 26(2) of the Regulations provides that companies are required to calculate their public interest score at the end of each financial year.

- any non-profit company if such company was incorporated:
  - directly or indirectly by the state, an organ of state, a state-owned company, an international entity, a foreign state entity or a foreign company; or
  - primarily to perform a statutory or regulatory function in terms of any legislation, or to carry out a public function, or for a purpose connected to any such function; and/or
  - any profit or non-profit company, if in the ordinary course of its primary activities, the company holds assets in a fiduciary capacity for unrelated persons and the aggregate value of such assets held at any time during the financial year exceeds R5 million.

How to determine the PIS of a company?

This notion of quantifying the public interest score (PIS) of a company has at the heart of its inception the ideal of social and ethical corporate responsibility. Regulation 26(2) of the Regulations provides that companies are required to calculate their PIS at the end of each financial year. The PIS calculation comprises the sum of the following elements:

- a number of points equal to the average number of employees of the company during the financial year;
- one point for every R1 million (or portion thereof) in third party liability of the company at the financial year end;
- one point for every R1 million (or a portion thereof) in turnover during the financial year; and
- one point for every individual who, at the end of the financial year, is known by the company:
  - in the case of the profit company, to directly or indirectly have a beneficial interest in any of the company's issued securities; or
  - in the case of a non-profit company, to be a member of the company, or a member of an association that is a member of the company.

Regulation 30(3) of the Regulations provides that if a company is not required, in terms of either the Companies Act, Regulations, and/or its memorandum of incorporation, to have its AFSs audited, such company may file a copy of its audited or reviewed statements together with its annual return. Additionally, if a company is not required to file AFSs or does not elect to file a copy of its AFSs, such company is required to file a financial accountability supplement to its annual return in the required CoR 30.2 form as contemplated in regulation 30(4) of the Regulations, and not in the XBRL format. In the event that the company has a zero turnover or is dormant, a CoR 30.2 form must still be completed and returned to the CIPC.

By mandating the use of XBRL, the CIPC has enabled companies to submit AFSs in accordance with a streamlined approach which is effective, efficient and allows for rapid and focused responses to companies submitting AFSs, all in line with international best practices.

Farren Eckleton, Andrea Trueman and Tessmerica Moodley

CDH
CLIFFE DEKKER HOFMEYR

OUR TEAM

For more information about our Corporate & Commercial practice and services, please contact:

Willem Jacobs
National Practice Head
Director
Corporate & Commercial
T +27 (0)11 562 1555
M +27 (0)83 326 8971
E willem.jacobs@cdhlegal.com

David Thompson
Regional Practice Head
Director
Corporate & Commercial
T +27 (0)21 481 6335
M +27 (0)82 882 5655
E david.thompson@cdhlegal.com

Mmatiki Aphiri
Director
T +27 (0)11 562 1087
M +27 (0)83 497 3718
E mmatiki.aphiri@cdhlegal.com

Roelof Bonnet
Director
T +27 (0)11 562 1226
M +27 (0)83 325 2185
E roelof.bonnet@cdhlegal.com

Tessa Brewis
Director
T +27 (0)21 481 6324
M +27 (0)83 717 9360
E tessa.brewis@cdhlegal.com

Etta Chang
Director
T +27 (0)11 562 1432
M +27 (0)72 879 1281
E etta.chang@cdhlegal.com

Clem Daniel
Director
T +27 (0)11 562 1073
M +27 (0)82 418 5924
E clem.daniel@cdhlegal.com

Jenni Darling
Director
T +27 (0)11 562 1878
M +27 (0)82 826 9055
E jenni.darling@cdhlegal.com

André de Lange
Director
T +27 (0)21 405 6165
M +27 (0)82 781 5858
E andre.delange@cdhlegal.com

Werner de Waal
Director
T +27 (0)21 481 6435
M +27 (0)82 466 4443
E werner.dewaal@cdhlegal.com

Lilia Franca
Director
T +27 (0)11 562 1148
M +27 (0)82 564 1407
E lilia.franca@cdhlegal.com

John Gillmer
Director
T +27 (0)21 405 6004
M +27 (0)82 330 4902
E john.gillmer@cdhlegal.com

Sandra Gore
Director
T +27 (0)11 562 1433
M +27 (0)71 678 9990
E sandra.gore@cdhlegal.com

Johan Green
Director
T +27 (0)21 405 6200
M +27 (0)73 304 6663
E johan.green@cdhlegal.com

Allan Hannie
Director
T +27 (0)21 405 6010
M +27 (0)82 373 2895
E allan.hannie@cdhlegal.com

Peter Hesseling
Director
T +27 (0)21 405 6009
M +27 (0)82 883 3131
E peter.hesseling@cdhlegal.com

Quintin Honey
Director
T +27 (0)11 562 1166
M +27 (0)83 652 0151
E quintin.honey@cdhlegal.com

Roelf Horn
Director
T +27 (0)21 405 6036
M +27 (0)82 458 3293
E roelf.horn@cdhlegal.com

Yaniv Kleitman
Director
T +27 (0)11 562 1219
M +27 (0)72 279 1260
E yaniv.kleitman@cdhlegal.com

Justine Krige
Director
T +27 (0)21 481 6379
M +27 (0)82 479 8552
E justine.krige@cdhlegal.com

Johan Latsky
Executive Consultant
T +27 (0)11 562 1149
M +27 (0)82 554 1003
E johan.latsky@cdhlegal.com

Giada Masina
Director
T +27 (0)11 562 1221
M +27 (0)72 573 1909
E giada.masina@cdhlegal.com

Nkcubeko Mbambisa
Director
T +27 (0)21 481 6352
M +27 (0)82 058 4268
E nkcubeko.mbambisa@cdhlegal.com

Nonhla Mchunu
Director
T +27 (0)11 562 1228
M +27 (0)82 314 4297
E nonhla.mchunu@cdhlegal.com

Ayanda Mhlongo
Director
T +27 (0)21 481 6436
M +27 (0)82 787 9543
E ayanda.mhlongo@cdhlegal.com

William Midgley
Director
T +27 (0)11 562 1390
M +27 (0)82 904 1772
E william.midgley@cdhlegal.com

Tessmerica Moodley
Director
T +27 (0)21 481 6397
M +27 (0)73 401 2488
E tessmerica.moodley@cdhlegal.com

Anita Moolman
Director
T +27 (0)11 562 1376
M +27 (0)72 252 1079
E anita.moolman@cdhlegal.com

Jo Neser
Director
T +27 (0)21 481 6329
M +27 (0)82 577 3199
E jo.neser@cdhlegal.com

Francis Newham
Director
T +27 (0)21 481 6326
M +27 (0)82 458 7728
E francis.newham@cdhlegal.com

Gasant Orrie
Cape Managing Partner
Director
T +27 (0)21 405 6044
M +27 (0)83 282 4550
E gasant.orrie@cdhlegal.com

Verushca Pillay
Director
T +27 (0)11 562 1800
M +27 (0)82 579 5678
E verushca.pillay@cdhlegal.com

David Pinnock
Director
T +27 (0)11 562 1400
M +27 (0)83 675 2110
E david.pinnock@cdhlegal.com

Allan Reid
Director
T +27 (0)11 562 1222
M +27 (0)82 854 9687
E allan.reid@cdhlegal.com

Ludwig Smith
Director
T +27 (0)11 562 1500
M +27 (0)79 877 2891
E ludwig.smith@cdhlegal.com

Ben Strauss
Director
T +27 (0)21 405 6063
M +27 (0)72 190 9071
E ben.strauss@cdhlegal.com

Tamarin Tosen
Director
T +27 (0)11 562 1310
M +27 (0)72 026 3806
E tamarin.tosen@cdhlegal.com

Roxanna Valayathum
Director
T +27 (0)11 562 1122
M +27 (0)72 464 0515
E roxanna.valayathum@cdhlegal.com

Deepa Vallabh
Head: Cross-border M&A,
Africa and Asia
Director
T +27 (0)11 562 1188
M +27 (0)82 571 0707
E deepa.vallabh@cdhlegal.com

Roux van der Merwe
Director
T +27 (0)11 562 1199
M +27 (0)82 559 6406
E roux.vandermerwe@cdhlegal.com

Charl Williams
Director
T +27 (0)21 405 6037
M +27 (0)82 829 4175
E charl.williams@cdhlegal.com

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@cdhlegal.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@cdhlegal.com