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TAX & EXCHANGE CONTROL **ALERT**

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Sharing is caring - ruling on disposal and acquisition of shares by a PBO

The Income Tax Act, No 58 of 1962 (Act) states that where a non-profit company, trust or association of persons meets certain requirements in the Act, it can be approved by SARS as a public benefit organisation (PBO), which enjoys certain tax benefits. To obtain approval a PBO is required, amongst other things, to carry on public benefit activities (PBAs) with a philanthropic intent and in a non-profit manner. However, it may happen that a PBO has excess funds that it would like to invest to earn interest, for example, which interest it would then also use to carry on public benefit activities.

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Sharing is caring - ruling on disposal and acquisition of shares by a PBO

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The Income Tax Act, No 58 of 1962 (Act) states that where a non-profit company, trust or association of persons meets certain requirements in the Act, it can be approved by SARS as a public benefit organisation (PBO), which enjoys certain tax benefits. To obtain approval a PBO is required, amongst other things, to carry on public benefit activities (PBAs) with a philanthropic intent and in a non-profit manner. However, it may happen that a PBO has excess funds that it would like to invest to earn interest, for example, which interest it would then also use to carry on public benefit activities.

Section 10(1)(cN) of the Act states that approved PBOs are exempt from paying income tax on any of their receipts and accruals to the extent that the receipts and accruals are derived otherwise than from any business undertaking or trading activity. The section further states that where the income is derived from a business undertaking or trading activity, it will be exempt only in certain circumstances. One instance in which receipts and accruals from a business undertaking or trading activity will be exempt is where the receipts and accruals are derived from a business undertaking or activity that is integral and directly related to the sole or principal object of the PBO. The Act also states that a PBO can be exempt from paying capital gains tax (CGT), in certain circumstances.

On 20 August 2019, the South African Revenue Service (SARS) released Binding Private Ruling 324, dealing with the disposal and acquisition of shares by a PBO (Ruling), including the application of s10(1)(cN) to certain aspects of the transaction. We discuss the Ruling below.

Facts

The applicant in the Ruling is a resident trust (Applicant), which is approved as a PBO in accordance with s30(3) of the Act. It holds ordinary shares in company A, a resident company listed on the JSE. The Applicant received dividends in respect of the shares held which it used to make donations to other PBOs as provided for in paragraph 10(a) of Part I of the Ninth Schedule to the Act.

The Applicant intends to replace the shares it originally had in company A with BEE shares in the same company. This is because the BEE shares are considered to be a better investment as they were ranked on equal footing (*pari passu*) as the ordinary shares with respect to dividends, but would be traded at a discounted price and yield a higher dividend in comparison to the ordinary shares. The disposal of the ordinary shares will extend over several years due to market conditions.

Furthermore, the Applicant is a beneficiary of four resident trusts (Trusts). The Trusts will be dissolved and upon dissolution will make cash contributions to the Applicant out of dividends received, retained and capitalised by the Trusts during previous years of assessment, as well as the interest accrued on the cash balances held by the Trusts.

The Applicant will use these cash distributions received from the Trusts, the proceeds received from the disposal of the ordinary shares held in company A and dividends received from company A, to purchase the BEE shares in company A.

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The proposed disposals of the ordinary shares over the extended period in order to purchase BEE shares, shall not in itself constitute a 'business undertaking' or 'trading activity' deemed to be conducted by the Applicant.

Ruling

In having consideration for the above, together with the applicable sections that will be discussed below in more detail, SARS ruled as follows:

- The proposed disposals of the ordinary shares over the extended period in order to purchase BEE shares, shall not in itself constitute a 'business undertaking' or 'trading activity' deemed to be conducted by the Applicant. Furthermore, paragraph 63A of the Eighth Schedule to the Act would apply to the disposals to ensure that in the event that there is any capital gain derived from the transaction, that such would be disregarded;
- The disposals would not adversely affect the Applicant's status as an approved PBO for purposes of s30(3) of the Act;
- Any dividends received by the Applicant in respect of both the ordinary and BEE shares in company A shall be exempt from normal tax under s10(1)(cN) as well as dividends tax under s64F(1)(c);
- The interest distributed by the Trusts to the Applicant in the same year of assessment will retain its character as interest in terms of s25B(2) of the Act and will therefore also be exempt in the Applicant's hands in accordance with s10(1)(cN);
- Any capital gain derived from the distributions of trust capital by the Trusts to the Applicant in accordance with the Trusts' dissolution processes will be disregarded in accordance with paragraph 63A of the Eighth Schedule;
- The base cost of each of the BEE shares that the Applicant sought to acquire will be equal to the subscription price paid by the Applicant for each share as provided for in paragraph 20(1)(a) of the Eighth Schedule to the Act; and
- Nothing in the Ruling prevents SARS from exercising its powers under s30(5) of the Act, or any amendment or substitution of that provision.

Observations and comment

The Ruling raises several interesting questions as to how SARS appears to have applied the various provisions of the Act applicable to PBOs, in the context of the proposed transaction.

The first interesting issue is the application of paragraph 63A of the Eighth Schedule to the Act. Among other things, the provision states that a PBO must disregard any capital gain or capital loss arising from the disposal of an asset, if the PBO did not use that asset in carrying on any business undertaking or trading activity. While one does not have all the facts of the matter, regarding the shares held in company A, it appears that the ordinary

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SARS may still in future revoke the Applicant's PBO status if it does not continue to comply with s30 of the Act.

shares in company A may have been held by the Applicant as capital assets, from which it received dividends and used those dividends to make distributions to other PBOs. However, considering that the Ruling states that the Applicant intends to dispose of the ordinary shares over several years due to market conditions, it appears the Applicant may have been concerned that the disposal in this manner could be perceived as a business undertaking or trading activity, if it was done to receive the highest possible return. SARS ruled that the exemption in paragraph 63A of the Eighth Schedule to the Act will apply to these disposals. Had SARS deemed this disposal and acquisition of shares to constitute a business undertaking or trading activity, the exemption would not have applied.

At the same time, it is also interesting to note that SARS was satisfied that disposal of ordinary shares and the acquisition of BEE shares to earn a higher dividend will not render the additional dividends received to be taxable in the Applicant's hands. The full dividend received in respect of the BEE shares will still be exempt in terms of s10(1)(cN) and s64F(1)(c) of the Act.

Regarding the mention of s30(3) of the Act, it appears that SARS was also of the view that the transaction would not be inconsistent with any provisions of s30(3) of the Act. Section 30(3) of the Act contains a number of provisions that must be complied with, including the requirement in s30(3)(c) that a PBO may not knowingly be a party to a transaction, or knowingly permit itself to be used in a transaction, that has the aim of avoiding, postponing or reducing any tax, which would be payable but for such transaction. This could suggest that SARS was therefore also satisfied that the transaction in the Ruling was not aimed at tax avoidance.

Despite all of the above and what is stated regarding compliance with s30(3) of the Act, SARS still mentioned that it can exercise its rights under s30(5) of the Act, which provision allows SARS to revoke an entity's PBO status, if SARS believes that there has been, among other things, material non-compliance with s30. In other words, SARS may still in future revoke the Applicant's PBO status if it does not continue to comply with s30 of the Act.

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