

# CORPORATE & COMMERCIAL ALERT

9 FEBRUARY 2022



INCORPORATING  
**KIETI LAW LLP, KENYA**

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### Contributed Tax Capital and Preference Shares

On 14 January 2022, President Cyril Ramaphosa assented to the Taxation Laws Amendment Bill, B22 of 2021 (TLAB), which introduced a host of amendments to the Income Tax Act 58 of 1962 (ITA). One such amendment is that, with effect from 1 January 2023, the definition of 'contributed tax capital' (CTC) in section 1 of the ITA will be amended. This article will describe the impact of the amendment to the definition of CTC on preference share funding.



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## Contributed Tax Capital and Preference Shares

On 14 January 2022, President Cyril Ramaphosa assented to the Taxation Laws Amendment Bill, B22 of 2021 (TLAB), which introduced a host of amendments to the Income Tax Act 58 of 1962 (ITA). One such amendment is that, with effect from 1 January 2023, the definition of 'contributed tax capital' (CTC) in section 1 of the ITA will be amended. This article will describe the impact of the amendment to the definition of CTC on preference share funding.

As an overview, where preference shares are redeemed, different tax consequences would apply if the amount paid on redemption constitutes a 'return of capital' or a 'dividend' for the purposes of the ITA. Where the holder of the preference shares is not exempt from dividends tax, it is favourable from a tax point of view if the redemption of preference shares takes the form of a 'return of capital' rather than a 'dividend'. Before unpacking why this is the case, it is important to keep in mind that a 'return of capital' is a concept defined in Section 1 of the ITA to include any amount transferred by a company by way of distribution which results in a reduction of CTC.

For the ease of reference, we will refer to a 'return of capital' as the return of CTC. The redemption of preference shares is a 'disposal' for capital gains tax purposes and what accrues as a result of that disposal is the redemption price. For the purposes of capital gains tax (as regulated in the 8th schedule of the ITA), the 'proceeds' from the disposal of the

preference shares will be equal to the redemption price, and the redemption price is usually equal to the issue price of the preference shares. Importantly, by virtue of paragraph 35(3) of the 8th schedule of the ITA, any portion of the proceeds that is included in the gross income of the taxpayer is disregarded in determining the 'proceeds'. Dividends, in terms of paragraph (k) of the definition of 'gross income' in section 1 of the ITA, are included in 'gross income' and are therefore disregarded from the proceeds for the purposes capital gains tax. The 'base cost' of the preference shares is also usually equal to the issue price. As such, if the holder of the preference share(s) originally subscribed for the preference shares and if the whole redemption price reduces CTC, there should be no tax consequences flowing from the redemption for purposes of the ITA. This is because, the holder's 'proceeds' from the disposal will be equal to the 'base cost' and there will be no capital gain or capital loss on the 'disposal'. If, however, the whole or any portion

of the redemption price constitutes a 'dividend' and the holder is not exempt from dividends tax, the redemption will be a dividend and (unless an exclusion applies) subject to dividends tax in terms of the ITA. The key takeaway is that where the redemption of preference shares takes the form of a return of CTC, it may result in a better tax position for the holder of the preference shares.

The ITA, however, regulates what CTC constitutes and also how the return of CTC is to be facilitated. Prior to the TLAB, the return of CTC:

- had to be pursuant to the board of directors of the company having resolved (i) to return CTC and (ii) the amount of CTC that was to be returned; and
- had to be proportional to the holders of the specific class of shares on a per share basis. What this latter concept contemplates is best illustrated with an example. Assume the CTC was R100 and 100 shares were in issue. Where 5 shares were to be redeemed

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and the board of directors of the company had appropriately resolved to return CTC, the amount of CTC that could be returned with the redemption of the 5 shares was 5. A company could not return CTC in an amount of 10, the return had to be proportional to the amount of CTC and the number of shares in issue prior to the return.

The TLAB introduces an additional requirement which provides that it cannot constitute a return of CTC *"unless all holders of shares in that class participate in the transfer in the same manner and are actually allocated an amount of contributed tax capital based on their proportional shareholding within that class of shares"* (own emphasis). In simplest form, the TLAB now also requires that (i) all of the shareholders of that class of shares must participate in the return of CTC; and (ii) that all of the shareholders of that share must be allocated an amount of the return of CTC based on their proportionate shareholding.

The amendments proposed by the TLAB have practical consequences for preference share funding deals. The practical consequences are three-fold.

### CLUB DEALS AND EARLY EXITING PREFERENCE SHAREHOLDERS

The first practical consequence of the amendment relates to club preference share deals (which, simply put, entail that there are numerous holders). Should one of the holders (we shall refer to them as the Exiting Holder) wish to exit the funding deal early and the issuer redeems (notwithstanding that the balance of the holders do not redeem) the preference shares that are held by it, the amendment to the definition of CTC creates practical difficulties.

Prior to the amendment, (i) provided that the board of directors of the issuer resolved that the redemption shall in part constitute a return of CTC and set out the amount of the CTC to be a return of CTC; and (ii) provided that the return of CTC did not exceed the Exiting Holder's proportionate CTC, it was permissible

for the Exiting Holder's redemption to in part constitute a return of CTC and any accrued dividends (if applicable). Given that the Exiting Holder is participating alone in the redemption, not all of the holders of the shares are participating in the return of CTC and not all the holders participate in the return of CTC in the same manner and have not been allocated an amount of CTC based on their proportionate shareholding. In such a scenario, the Exiting Holder's

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redemption will have to constitute a dividend and not a return of CTC. Whereas, when the balance of the holders redeem their shareholding, assuming they do so in a scenario which complies with the new proviso to the definition of CTC, their redemption may constitute a return of CTC and a dividend.

### TRANCHES OF PREFERENCE SHARES

The second practical consequence of the amendment is on preference shares which are issued, and subsequently redeemed, in tranches. The amendments introduced by the TLAB require all holders of the shares in that class to participate in the return of CTC in the same manner. There is a practical consequence of the amendment on preference shares which are issued in tranches, particularly when such tranches are to be redeemed at different points in time. This is because a tranche of shares still forms part of the same class of shares. What the new amendment introduces is an added layer of complexity in the redemption of tranches of preference shares

because a company cannot return CTC in respect of a share unless all the holders of the shares participate in the return in the same manner and are actually allocated an amount of CTC which is proportional to their shareholding. A practical example may illustrate this more clearly.

Where a class of funding preference shares, the A1 Preference Shares, are issued in two tranches, Tranche A and Tranche B, with such tranches being held by different groups of holders. Should all the holders of Tranche A wish to redeem the preference shares prior to the holders of Tranche B redeeming the preference shares, the amendment to the definition of CTC creates an implementation difficulty. The difficulty is that unless all of the holders of the A1 Preference Shares, constituting both the holders of Tranche A and Tranche B, participate in the return of CTC, the ITA prohibits the company from returning CTC to the holders. As such, where the Tranche A holders wish to redeem and the Tranche B holders remain in

place, the entire redemption price will have to constitute a dividend in the hands of the Tranche A holders. This is because the amendment to the definition of CTC prohibits the company from returning CTC unless all of the holders of the shares participate in the return of CTC in the same manner.

In its essence, what the amendment to the definition of CTC results in, as is highlighted in the scenarios contemplated above, forcing a company to, in effect, treat shareholders differently. This begs the question, considering the new amendment, how does one square the obligation of the company to treat all shareholders equally with the prohibitive conditions set out in the amendment to the definition of CTC?

### SUBSCRIPTION PRICES AND REDEMPTION PROFILE

It is common in South African funding preference share deals for, after the initial three year restricted period contemplated in section 8E of the ITA, for the holders to have the right to

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require the redemption of preference shares. The amount to be redeemed is often determined by virtue of the amount standing in the issuer's bank account after accumulated dividends and other costs have been settled. The practical problem which the amendment introduced is that, should the initial subscription price be too high, it is conceivable that there is a mismatch in the amount available to be redeemed and the amount of CTC capable of being returned. This is again best illustrated with a practical illustration:

Assume the issuer has R101,000 available for the redemption of preference shares after it has settled all accumulated dividends. Assume further that the subscription price and CTC in respect of each preference share was R1,000 and that 200 preference shares were issued to 2 holders (**Holder A** and **Holder B**) in equal proportions at a subscription price of R100. As such, assume the CTC available for return is R200,000 and that no shares have been redeemed. At the point in time

when the issuer wants to redeem, the following applies:

- CTC available for distribution is R200,000.
- Holder A holds 100 preference shares issued at R1,000 per share.
- Holder B holds 100 preference shares issued at R1,000 per share.
- Amount available for redemption is R101,000.

Given the amendment to the definition of CTC, at redemption, the company can only redeem 100 shares for R100,000 and not 101 preference shares in an amount of R101,000. This is because, if the Company redeems 101 preference shares it will result in the holders of the preference shares not participating equally in the return of CTC because:

- Holder A will have 51 preference shares redeemed.
- Holder B will have 50 preference shares redeemed.

A possible workaround to minimise the effects of the amendment in the above scenario, bearing all applicable competition law considerations in mind, is that the issue price in respect of the preference shares be set as low as possible and as many preference shares as possible should be issued to the holders. As such, assume the facts are now:

- CTC available for distribution is R200,000.
- Amount available for redemption is R101,000.
- Number of preference shares in issue is 2,000,000 at an issue price of R0,1 and split equally between Holder A and Holder B such that Holder A holds 1,000,000 preference shares and Holder B holds 1,000,000 preference shares.

Where the subscription price is lower, the constraints introduced by the TLAB are minimised in that the company can redeem all R101,000 available for redemption by redeeming 1,010,000 preference

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shares split equally between 505,000 preference shares held by each of Holder A and Holder B.

Although previous iterations of the TLAB set the commencement date of the operation of the amendments discussed herein as 1 January 2022, the TLAB assented to set the effective date of the TLAB as 1 January 2023. As such, with effect from 1 January 2023, the amendment to the definition of CTC will have an impact of the redemption of funding preference shares in South Africa. Funders, and issuers, will be best

placed to structure their preference share deals, in particular the redemption thereof, with appropriate consideration to the effects that the amendment to the definition of CTC will have on them. After all, funding preference share deals necessarily contemplate redemption, so it is fundamental to factor in how to best facilitate redemption at deal conception and to ensure the funding documents properly cater for this.

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Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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