

Banking, Finance & Projects

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SOUTH AFRICA

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The legal nature of preference share funding

On 16 August 2025 National Treasury and the South African Revenue Service published a Draft Taxation Laws Amendment Bill (TLAB), which proposed to amend section 8E of the Income Tax Act 58 of 1962 (ITA), by providing that any share treated as a “*financial asset*” under International Accounting Standard 32 would in the future be regarded as a hybrid equity instrument. The effect of that proposal, had it been adopted, was that dividends that became payable in respect of various instruments, including “*funding*” preference shares, would be treated as income and would accordingly be taxable.

“*Funding*” preference shares are very commonly used in the context of funding provided for the acquisition of shares in a company. A “*funding*” preference share is a share for which a funder subscribes at an agreed subscription price, which is entitled to preference dividends calculated at an agreed rate on that subscription price and which is redeemable after a number of years at a redemption price equal to its subscription price.

Retraction by National Treasury

On 3 September 2025 National Treasury issued a media release in which it retracted the proposals relating to section 8E as contained in the TLAB. The media release noted that the proposals had caused uncertainty and that the Minister of Finance decided to retract them to avoid a negative impact on funding transactions.

In the media release, National Treasury explains the aim of the proposal contained in the TLAB as:

“The proposal’s aim is to shift to a principle based approach that classifies a financial instrument based on its substance rather than its legal form, as is the case in several other countries. For example, if a preference share is redeemable on a specific date and/or has a fixed mandatory dividend, it should be treated as a loan (debt) for tax purposes. This ensures that financial instruments that are economically similar to debt are treated as such for tax purposes, thereby preventing the misuse of dividend exemptions to reduce tax liabilities.”

Critical differences

Although funding preference shares are similar to debt, they are equity instruments and create risks for a funder that differ from the risks faced by a debt funder. The critical difference arises out of section 46 of the Companies Act 71 of 2008 (2008 Companies Act) which provides that a company may not make a distribution except if it appears reasonably that the company will pass the solvency and liquidity test (contained in section 4 of the 2008 Companies Act) immediately after the making of that distribution and the directors of the company have adopted a resolution in which they acknowledge that they have applied the solvency and liquidity test and concluded that the company will comply with it immediately after the making of a distribution.



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Since the definition of a "*distribution*", as contained in section 1 of the 2008 Companies Act, is wide enough to encompass both a dividend paid in respect of a funding preference share and the redemption of such a share, the consequence of the rule contained in section 46 is that the holder of a preference share has no claim of any nature against the issuer of that share if the issuer fails to comply with the solvency and liquidity test (in other words if the issuer is either insolvent or illiquid). If the issuer is liquidated, the right of a funding preference share on liquidation is typically to participate in excess assets after creditors have been paid (so that the holder of the preference share has no claim whatsoever until all the creditors have been paid).

If a funder has made a loan to a borrower and if the borrower becomes insolvent, the funder will have a claim against the borrower, which will be either a secured claim (if the lender holds security for the claim) or a concurrent claim (if the lender holds no security). A preference share funder, on the other hand, will have no claim of any nature at all until all the debts have been paid. Despite the economic similarity of a preference share and a debt, the two have markedly different legal consequences and from the funder's point of view the risk that it assumes under a funding preference share is greater than the risk under a loan.

Holders of preference shares often obtain security for the issuer's contingent obligations under the instrument, for example in the form of a pledge of assets. Paragraph (c) of the definition of a "*hybrid equity instrument*" as contained in section 8E of the ITA, is currently to the effect that a

preference share (as defined in section 8EA) is a hybrid equity instrument (and the dividends in respect thereof are accordingly taxable) if it is secured by a financial instrument. Despite the legislative recognition of security provided by an issuer in respect of a preference share, the value of such security is highly debatable. If an issuer is prevented by law (particularly section 46 of the 2008 Companies Act) from paying a distribution, the fact that the holder of the applicable instrument holds security would seem to be irrelevant and there seems to be a strong argument to the effect that the security in fact purports to secure an obligation that does not exist.

Obligation to pay dividends or redeem shares

Under the Companies Act 61 of 1973 (1973 Companies Act) the position was that a preference share could be redeemed only out of profits or out of a fresh issue of shares. Although that restriction has now been replaced by section 46, which has regard to solvency and liquidity rather than to profits and fresh issues of shares, the nature of a preference share under the 1973 Companies Act is identical to the nature of such a share under the 2008 Companies Act. Under both sets of legislation the issuer of a preference share does not have an absolute obligation to pay dividends or to redeem the shares and the rights of the holder to demand dividends and/or redemption are dependent on conditions which are not within its control (under the 1973 Companies Act, the availability of profits and/or fresh issue of shares and under the 2008 Companies Act, the solvency and liquidity of the issuer).

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Supreme Court of Appeal judgment

The difference between a preference share (under the 1973 Companies Act) and a loan was considered by the Supreme Court of Appeal (SCA) in *Commissioner for Inland Revenue v Datacor Engineering Proprietary Limited* [1998] (4) SA 1050. Factually the matter concerned the carrying forward of assessed tax losses under section 20 of the ITA. In terms of a scheme of arrangement implemented under section 311 of the 1973 Companies Act, debts owing by the taxpayer were settled out of preference shares issued by it. At the time, section 20(1)(ii) of the ITA provided that the amount of an assessed loss that could be carried forward had to be reduced by any benefit received by the taxpayer from a compromise made with its creditor if, as a result of that compromise, its liabilities to its creditor had been "reduced or extinguished". The taxpayer, in seeking to carry forward its assessed tax loss without reduction, argued that the replacement of debt claims with preference shares did not create a benefit. The SCA, in paragraph 11 of the judgment, rejected that contention, saying:

"The mere substitution of a creditor's claim with a share, even a redeemable preference share, amounts to a concession. An enforceable obligation is replaced with something of a completely different nature. In the case of debts, all the assets of the company are available to satisfy the claims of creditors whereas, in the case of redeemable preference shares, only profits available for dividends or the proceeds of a fresh issue of shares may be used to redeem the shares."

In paragraph 13 of the judgment, the SCA also dealt with an argument advanced by the taxpayer to the effect that, "conversion of a debt into redeemable preference shares is merely a change in the form of the company's liability because the extent of the obligation, and the obligation to repay, remain as before". The court refused to accept that proposition and in paragraph 14 of its judgment approved the following passages extracted from paragraph 103 of *The Law of South Africa Vol 4*:

"Although there are similarities with debt, the redeemable preference share is not debt ... where the redeemable preference shareholder has a right that the company redeem his shares and the company does not have available profits or is in fact unable to issue fresh shares to cover the obligations, the redeemable preference shareholder will not be able to enforce his right, and his only remedy is an order for the winding-up of the company."

The difference between preference shares and debt is accordingly not merely a matter of form and there are, instead, significant legal differences between the two.

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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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