

BINDING PRIVATE RULING: BPR 385

DATE: 31 October 2022

ACT : INCOME TAX ACT 58 OF 1962 (the Act)
SECTION : SECTIONS 1(1) – DEFINITION OF “GROSS INCOME”, 8E, 8EA, 10(1)(k)(i), 24J(1) – DEFINITION OF “INSTRUMENT”, 54, 58, 64F(1)(a), 64G(2) AND PARAGRAPHS 19, 20(1)(a), 38, 39, 43A AND 80(2) OF THE EIGHTH SCHEDULE TO THE ACT
SUBJECT : USE OF PREFERENCE SHARE PROCEEDS TO FUND EMPLOYEE SHARE OWNERSHIP PLAN

Preamble

This binding private ruling is published with the consent of the applicant(s) to which it has been issued. It is binding between SARS and the applicant and any co-applicant(s) only and published for general information. It does not constitute a practice generally prevailing.

1. Summary

This ruling determines the tax implications pertaining to the use of funds derived from the issue of preference shares to fund an employee share ownership plan (ESOP).

2. Relevant tax laws

In this ruling references to sections and paragraphs are to sections of the Act and paragraphs of the Eighth Schedule to the Act applicable as at 16 September 2022. Unless the context indicates otherwise any word or expression in this ruling bears the meaning ascribed to it in the Act.

This is a ruling on the interpretation and application of –

- section 1(1) – definition of “gross income”;
- section 8E;
- section 8EA;
- section 10(1)(k)(i);
- section 24J(1) – definition of “instrument”;
- section 54;
- section 58;
- section 64F(1)(a);
- section 64G(2);
- paragraph 19;

- paragraph 20(1)(a);
- paragraph 38;
- paragraph 39;
- paragraph 43A; and
- paragraph 80(2).

3. **Parties to the proposed transaction**

The applicant:	A listed resident company
Co-applicant 1:	A resident company that is a wholly-owned subsidiary of the applicant
Co-applicant 2:	A resident company that is wholly-owned by co-applicant 3
Co-applicant 3:	A resident trust established by the applicant
The participants:	Employees of the applicant and of its group companies
Third party:	A resident bank

4. **Description of the proposed transaction**

The applicant will establish the ESOP for the participants to create a long-term broad-based employee ownership in the applicant. Co-applicant 3 will acquire shares in the applicant on the open market as well as from co-applicant 1 that holds treasury shares in the applicant. Following the acquisitions, co-applicant 3 will hold approximately 3% of the applicant's issued share capital.

The steps for implementing the ESOP are as follows:

Phase I: Implementation of the ESOP

Step 1: Subscriptions for preference shares

- a) The third party will subscribe for senior front ranking cumulative A class preference shares (A Prefs) in co-applicant 2 and the applicant will subscribe for subordinated B class preference shares (B Prefs) in co-applicant 2.
- b) The A Prefs contain, amongst others, the following terms:
 - a redemption date on the fifth anniversary of the subscription date; and
 - a dividend rate linked to the prime lending rate, with dividends payable on a semi-annual basis.
- c) The security arrangements for the due compliance with the A Pref obligations by the issuer are as follows:
 - Co-applicant 2 will open an interest-bearing bank account to receive distributions from co-applicant 3 (the reserve account).

- Co-applicant 2 will open a second interest-bearing account into which the applicant, or its nominee, may pay amounts to subscribe, if necessary, for further back-ranked preference shares for purposes of providing an equity cure in relation to the security cover ratio (the equity cure account).
 - Co-applicant 3 will open an interest-bearing bank account to receive distributions from the applicant (the collection account).
 - Co-applicant 2 will cede in *securitatem debiti* to the third party its rights to –
 - the reserve account;
 - the rights to all other bank accounts; and
 - its interest in co-applicant 3.
 - Co-applicant 3 will provide a guarantee in respect of the obligations of co-applicant 2 under the A Prefs, which will be secured by a cession in *securitatem debiti* and pledge to the third party of –
 - the shares held in the applicant;
 - the shares held in co-applicant 2;
 - any other investments it may hold, from time to time, in co-applicant 2;
 - the collection account; and
 - the rights to all other bank accounts.
- d) The security arrangements will be linked to a security cover ratio (SCR), which will be calculated using the following formula:
- $A = (B+C) / (D-E)$, where
 - A = SCR measured daily;
 - B = the value of the applicant's shares;
 - C = funds in the collection account plus funds in the other accounts held by the trustees of co-applicant 3;
 - D = the redemption amount and other outstanding amounts in respect of the A Prefs; and
 - E = funds in the reserve account and the equity cure account.
- e) The applicant will subscribe for B Prefs in co-applicant 2. The B Prefs will yield a dividend rate of 120% of the prime lending rate and will be redeemable on the seventh anniversary of the subscription date. The dividends are payable on a semi-annual basis, but will be capitalised until the A Prefs have been redeemed in full.
- f) The terms of the B Prefs provide, amongst others, that the applicant, or its nominee, may subscribe for further back-ranked preference shares (the C and D Prefs), on the same terms as the B Prefs.

- g) The B Prefs are secured by a reversionary cession by co-applicant 2 to the applicant, or its nominee, of –
- the collection account;
 - the reserve account;
 - the rights to all other bank accounts; and
 - its interest in co-applicant 3.
- h) The B Prefs are also subject to a guarantee by co-applicant 3 to the applicant, or its nominee, in respect of the obligations of co-applicant 2 under the B Prefs. This guarantee will be secured by a reversionary security cession and pledge of –
- the shares held in the applicant;
 - the shares held in co-applicant 2;
 - any other investments it may hold, from time to time, in co-applicant 2;
 - the collection account; and
 - the rights to any other bank accounts.
- i) Any C Prefs and D Prefs issued will be subject to the same security arrangements as the B Prefs, but only to the extent that the funds derived from the issue of the C Prefs and D Prefs are applied for a “qualifying purpose” as defined in section 8EA(1).

Step 2 – Acquisition of Limited Vested Beneficiary (LVB) interest

- j) Co-applicant 2 will utilise the preference share subscriptions proceeds to make a cash contribution to co-applicant 3 and in exchange for the cash contribution, co-applicant 2 will obtain an LVB interest in co-applicant 3.
- k) In terms of the LVB interest, co-applicant 3 will have a vested right to receive 80% of all income and 100% of the cash contributions and 100% of the income attributable to unallocated units from co-applicant 3, until such time as a pre-determined gross distribution in an amount equal to the aggregate of the A Pref obligations, B Pref obligations, additional back-ranked preference share obligations and any other amount payable by co-applicant 2 to any member of the applicant’s group had been received by co-applicant 2 (the distribution hurdle). Thereafter, co-applicant 2 will cease to be a beneficiary of co-applicant 3.
- l) The distribution hurdle will provide sufficient cash liquidity for co-applicant 2 to service and ultimately redeem both the A Prefs and the B Prefs, in accordance with their terms.

Step 3 – Acquisition of ordinary shares in the applicant

- m) Co-applicant 3 will utilise a portion of the cash contribution to acquire shares of the applicant (comprising 1.2% of the applicant’s issued share capital) on the open market.

- n) Co-applicant 3 will utilise the remainder of the cash contribution to acquire treasury shares (comprising 1.8% of the applicant's issued share capital) from co-applicant 1 at a discount to the prevailing market value.

Step 4 – Addition of participants as beneficiaries

- o) The trustees of co-applicant 3 will allocate units (being a notional concept) to confer on the holder of each such unit the vested bundle of personal rights and obligations stipulated in the trust deed (the units) in favour of each participant.
- p) For a period of 10 years after the date on which the units are first allocated to the relevant participant, or the date on which the preference shares are finally redeemed, whichever is the later (Restriction Period), the units will be subject to the following restrictions:
- the units may not be encumbered, redeemed, disposed of or transferred to any other person (including a fellow participant); and
 - the units shall not confer on the participant in question, any right to any award from capital and no participant shall have any right to demand that the trustees make any award to that participant from capital other than upon the termination of co-applicant 3.
- q) Until such time as co-applicant 2 ceases to be a beneficiary of co-applicant 3, the participants will have vested rights to receive up to 20% of all income distributions from co-applicant 3. Once co-applicant 2 ceases to be a beneficiary of co-applicant 3, the participants will have vested rights to receive all income from co-applicant 3.
- r) The units will be subject to a 7-year vesting period, with the applicable vesting profile set out in each participant's allocation letter.
- s) 80% of the units will be allocated upfront, with 20% of units reserved for subsequent new participants (the reserve allocation).
- t) The reserve allocation is intended to be allocated within a period of five years from the ESOP implementation date. Units which remain or become unallocated units after the fifth anniversary of the ESOP implementation date shall be available for allocation to existing participants, provided that all units shall be allocated by the fourteenth anniversary of the ESOP implementation date.
- u) All vested units held by participants who cease to be employed will be retained by them unless the employment of the relevant participant is lawfully terminated for cause as a consequence of misconduct, as a result of committing a dismissible offence or conviction of a criminal offence, in which case all vested and unvested units allocated to that participant will be surrendered to co-applicant 3 for no consideration and be available for allocation to other participants.
- v) A participant who ceases to be employed for reasons other than mentioned in (u) above shall, notwithstanding such termination of the employment, be entitled to all vested units allocated, and shall automatically forfeit for no compensation all unvested units.

- w) Participants will be restricted from dealing in their vested units for the restricted period. At the end of the restricted period, all vested units held by participants will be redeemable for ordinary shares in the applicant, as described under Phase III.

Phase II: Operation of the ESOP

- x) The applicant will, from time to time in accordance with its dividend policy, declare dividends in respect of its ordinary shares.
- y) The participants will have a vested right to receive 20% of the dividends received in respect of the applicant's ordinary shares held by co-applicant 3, after which co-applicant 2 will, in terms of its LVB interest, be entitled to the remaining dividends (80% of such dividends plus the dividends attributable to the unallocated units – in both instances, net of any expenses incurred by co-applicant 3).
- z) The A Prefs and B Prefs terms provide for trigger events which, if they occur or continue to occur, will affect distributions to the participants as payment of the dividends on the A Prefs and B Prefs will be prioritised. The specified events include:
- failure by co-applicant 2 to meet its solvency and liquidity requirements;
 - non-payment of dividends on mandatory dividend payment dates;
 - non-payment of accrued dividends in excess of certain specified limits;
 - failure by co-applicant 2 to satisfy specified financial covenants while also failing to bring the SCR to 2.5 within three business days as provided for under the financial covenants; and
 - failure by co-applicant 2 to redeem the A Prefs and the B Prefs by the relevant specified redemption dates.

Phase III: Redemption of the A Prefs and the B Prefs

Step 1 – Repurchase and/or disposal on the open market of a portion of the applicant's ordinary shares

- aa) On the fifth anniversary of the A Prefs subscription date, assuming that the A Prefs are not refinanced, co-applicant 3 will dispose of so many ordinary shares in the applicant (on the open market and/or to the applicant) as is equal in value to the applicable remaining portion of the distribution hurdle (attributable to the A Prefs) not yet distributed to co-applicant 2 to provide sufficient cash liquidity for co-applicant 2 to ultimately redeem the A Prefs.
- bb) On the seventh anniversary of the B Prefs subscription date, assuming that the B Prefs are not refinanced, co-applicant 3 will similarly dispose of so many ordinary shares in the applicant (on the open market and/or to the applicant) as is equal in value to the applicable remaining portion of the distribution hurdle (attributable to the B Prefs) not yet distributed to co-applicant 2 to provide sufficient cash liquidity for co-applicant 2 to ultimately redeem the B Prefs.

- cc) Any C Prefs and D Prefs, to the extent that they have been issued, will be redeemed on a similar basis to the B Prefs and co-applicant 3 will similarly dispose of so many ordinary shares in the applicant (on the open market and/or to the applicant) as is equal in value to the remaining portion of the distribution hurdle (attributable to the additional back-ranked preference shares) not yet distributed to co-applicant 2 to provide sufficient cash liquidity to co-applicant 2 to ultimately redeem the C Prefs and the D Prefs.
- dd) On the fifth anniversary of the A Prefs subscription date, assuming that the A Prefs have not been refinanced, co-applicant 3 will dispose of so many of the ordinary shares in the applicant (on the open market and/or to the applicant) as is equal in value to the remaining portion of the distribution hurdle not yet distributed to co-applicant 2 (the settlement amount).

Step 2 – Distributions to co-applicant 2

- ee) Co-applicant 2, by virtue of its LVB interest, will have a vested right to receive the settlement amount.

Step 3 – Redemption of the A Prefs and the B Prefs

- ff) Co-applicant 2 will redeem the A Prefs and the B Prefs in accordance with their terms.
- gg) The LVB interest is automatically extinguished by co-applicant 3 upon redemption of the A Prefs and the B Prefs (the distribution hurdle will be overcome at this point) and co-applicant 2 will be liquidated.

Phase IV: Redemption of the units and distribution of ordinary shares in the applicant to the participants

- hh) At the end of each participant's relevant restriction period, the units will be redeemed in return for the distribution of the number of ordinary shares in the applicant, attributable to the participant. A portion of such shares will be sold by an independent stockbroker to settle the resulting Pay-As-You-Earn liability.

5. Conditions and assumptions

This binding private ruling is not subject to any additional conditions and assumptions.

6. Ruling

The ruling made in connection with the proposed transaction is as follows:

Phase I: Implementation of the ESOP

Step 1: Subscription for the A Prefs and B Prefs

- a) The preference shares will not constitute –
- “hybrid equity instruments” as defined in section 8E(1); nor
 - “third-party backed shares” as defined in section 8EA(1).

- b) Neither section 22B nor paragraph 43A will apply to the preference share dividends distributed to the third party and the applicant in respect of the A Prefs and B Prefs, respectively.

Step 2: Cash contribution to co-applicant 3

- c) The cash contribution by co-applicant 2 to co-applicant 3 will constitute expenditure incurred in acquiring the LVB interest resulting in a base cost for the LVB interest equal to the cash contribution under paragraph 20(1)(a).
- d) The LVB interest will not constitute an “instrument” as defined in section 24J(1) in the hands of co-applicant 2.
- e) No donations tax will be payable by co-applicant 2 in respect of the cash contribution to co-applicant 3 for purposes of section 54 and section 58.
- f) The receipt of the cash contribution by co-applicant 3 will not constitute “gross income” as defined in section 1(1).
- g) The receipt of the cash contribution by co-applicant 3 will not be subject to capital gains tax.

Step 3: Acquisition of ordinary shares in the applicant

- h) Co-applicant 1 will realise either a capital gain or a capital loss upon the disposal of its treasury shares held in the applicant to co-applicant 3, depending on whether the proceeds received are greater than or less than its base cost for such ordinary shares.
- i) In the event of a capital loss in the hands of co-applicant 1, the provisions of paragraph 39 will not apply.
- j) Neither paragraph 38 nor section 54 and section 58 will apply to the acquisition of the applicant’s ordinary shares from co-applicant 1 at a discount.

Phase II: Operation of the ESOP

- k) Dividends received by co-applicant 2 from co-applicant 3 in respect of its LVB interest will be exempt from dividends tax in terms of section 64F(1)(a) read with section 64G(2), provided that co-applicant 2 has by the date of payment submitted a declaration and a written undertaking to the applicant in the form prescribed by SARS in accordance with section 64G(2)(a)(ii).
- l) The dividends paid by the applicant will be exempt from income tax in the hands of co-applicant 2 under section 10(1)(k)(i).

Phase III: Redemption of the A Prefs and the B Prefs

Step 1: Repurchase and/or disposal on the open market of a portion of the applicant’s ordinary shares

- m) Any resultant capital gain on the disposal of the applicant’s shares on the open market will be subject to capital gains tax at the applicable rate in the hands of co-applicant 2.

- n) The settlement amount will, to the extent that it is a dividend, be exempt from normal tax under section 10(1)(k)(i) in the hands of co-applicant 2.
- o) The settlement amount will, to the extent that it is a dividend, be exempt from dividends tax under section 64F(1)(a) read with section 64G(2), provided that co-applicant 2 has by the date of payment submitted a declaration and a written undertaking to the applicant in the form prescribed by SARS in accordance with section 64G(2)(a)(ii).
- p) Paragraph 43A will not apply to the repurchase of the applicants ordinary shares held by co-applicant 3.

Step 3: Redemption of the A Prefs and the B Prefs

- q) Any redemption consideration payable in respect of the A Prefs and the B Prefs will not trigger the application of sections 8E, 8EA and paragraph 43A.
- r) To the extent that the redemption consideration constitutes a “dividend”, that dividend must be included in the holder’s “gross income” in accordance with paragraph (k) of the definition of “gross income” in section 1(1), but will be exempt from normal tax under section 10(1)(k)(i).
- s) No dividends tax should be withheld on any dividend distributions to the holders of the A Prefs and the B Prefs given the exemption applicable to resident companies, as provided for in section 64F(1)(a), provided that the relevant holder submits the necessary declaration and written undertaking to co-applicant 2 prior to the share redemption.
- t) Any capital losses triggered on the redemption of the A Prefs and the B Prefs, to the extent that the redemption amount constitutes a dividend that is exempt from normal tax under section 10(1)(k)(i) and dividends tax under section 64G(2), must be disregarded under paragraph 19.

Phase IV: Redemption of the units and distribution of ordinary shares in the applicant to the participants

- u) In respect of the vesting of the shares by co-applicant 3 in the participants, paragraph 38 will not apply under the current circumstances as such disposals will be regarded as being at arm’s length. Any capital losses determined will not be subject to paragraph 39.

7. Period for which this ruling is valid

This binding private ruling is valid for a period of seven years from 16 September 2022.