

South African Journal of Accounting Research

Donations tax implications of BEE transactions: More than meets the eye?

--Manuscript Draft--

Full Title:	Donations tax implications of BEE transactions: More than meets the eye?
Manuscript Number:	RSAR-2019-0027
Article Type:	Original Article
Keywords:	BEE structures; discount; donations tax; actual donation; deemed donation; adequate consideration
Abstract:	<p>The primary reason for companies entering into a Black Economic Empowerment (hereafter BEE) transaction is to achieve regulatory compliance. In a BEE transaction companies either issue new shares or sell existing shares, at a discount. The purpose of this study is to identify whether this discount element has donations tax implications. Donations tax is triggered by either actual or deemed donations. No actual donation takes place when new shares or existing are issued at a discount. The issue of new shares does not constitute property for purposes of section 54 of the South African Income Tax Act. The sale of existing shares at a discount in a BEE transaction lacks liberality or generosity. However, even if no actual donation takes place, a deemed donation can still take place in terms of section 58(1) of the Income Tax Act. A deemed donation takes place where property is disposed of for a consideration that is not adequate. The South African Revenue Service (SARS) have interpreted, that adequate consideration does not necessarily mean "fair market value". SARS ruled in a Binding Private Ruling that specifically addressed the issue at hand, that the disposal of the shares (at a discount) comprised an adequate consideration, hence no donations tax arises. SARS unfortunately did not give a reason for their ruling. The issue remains contentious and unclear. The recommendation is made, in the interest of certainty, that a legislative amendment be introduced into section 56, which will exempt BEE transactions from donations tax.</p>

Donations tax implications of BEE transactions: More than meets the eye?

Abstract

The primary reason for companies entering into a Black Economic Empowerment (hereafter BEE) transaction is to achieve regulatory compliance. In a BEE transaction companies either issue new shares or sell existing shares, at a discount. The purpose of this study is to identify whether this discount element has donations tax implications. Donations tax is triggered by either actual or deemed donations. No actual donation takes place when new shares or existing are issued at a discount. The issue of new shares does not constitute property for purposes of section 54 of the South African Income Tax Act. The sale of existing shares at a discount in a BEE transaction lacks liberality or generosity. However, even if no actual donation takes place, a deemed donation can still take place in terms of section 58(1) of the Income Tax Act. A deemed donation takes place where property is disposed of for a consideration that is not adequate. The South African Revenue Service (SARS) have interpreted, that adequate consideration does not necessarily mean “fair market value”. SARS ruled in a Binding Private Ruling that specifically addressed the issue at hand, that the disposal of the shares (at a discount) comprised an adequate consideration, hence no donations tax arises. SARS unfortunately did not give a reason for their ruling. The issue remains contentious and unclear. The recommendation is made, in the interest of certainty, that a legislative amendment be introduced into section 56, which will exempt BEE transactions from donations tax.

Keywords: BEE structures, discount, donations tax, actual donation, deemed donation, adequate consideration.

1. Introduction

South Africa's first democratic government was elected in 1994 and the mandate was clear: to redress the inequalities of the past in every sphere – political, social and economic (Department of Trade and Industry, n.d.). Since then, government has embarked on a comprehensive programme to provide a legislative framework for the transformation of South Africa's economy (Department of Trade and Industry, n.d.). In this regard, the following was introduced:

- a Strategy for Broad-Based Black Economic Empowerment (Department of Trade and Industry, 2003);
- the Broad-Based Black Economic Empowerment Act, 53 of 2003 (South Africa, 2003) (hereafter BEE Act); and
- the BEE Codes of Good Practice, Notice 112 of 2007 (South Africa, 2007).

In addition, the Companies Act, 71 of 2008 (South Africa, 2008) (hereafter the Companies Act) and the International Integrated Reporting Framework also introduced additional Black Economic Empowerment (hereafter BEE) reporting requirements (SAICA, 2014: 3). Therefore, an important reason for companies to enter into a BEE transaction is to achieve regulatory compliance. The hypothetical company aspiring to comply with these regulations, for the purpose of this research, will be referred to as the “BEE Company”. It is submitted that the BEE Company also aims to comply with these regulations in order to fulfil the company’s corporate social responsibilities, but more importantly for the potential financial gain. While no penalties are imposed on companies that do not comply with the regulatory requirements, a low level of BEE compliance will significantly affect the company’s ability to transact with government bodies, in particular, but also with other entities. The company’s BEE contribution level is therefore an essential aspect of its success; indeed, it can be said that this is the company’s licence to transact. This study will not aim to quantify these benefits.

This article will reveal that, to enable and facilitate BEE compliance with regulations, companies typically either issue new shares or sell existing shares at a discount to BEE shareholders. The present research will demonstrate that there is currently no certainty regarding whether donations tax is applicable to these BEE transactions. The research problem is therefore to establish whether donations tax is payable by a company entering into these BEE

transactions. According to Adam Smith, an economist and pioneer in the early 1700s, a good tax system should encompass four pillars, namely equity, certainty, convenience and economy (Smith, 1776:887-889). The research objective of this study is to demonstrate the lack of legislative certainty with regard to the donations tax implications of this class of BEE transaction and to make a recommendation to address this. The contribution of this research is therefore providing this certainty.

The study will investigate the potential donations tax implications of two BEE structures that are prevalent within the market. The possible donations tax identified at each transaction level will be evaluated from an actual- and deemed donations tax perspective. Furthermore, SARS' view will also be evaluated.

2. Research methodology

An interpretative research approach will be adopted for the present research as it seeks to understand and describe (Babbie & Mouton, 2009). The methodology to be applied can be described as a *doctrinal* research methodology (McKerchar, 2008), which provides a systematic exposition of the rules governing a particular legal category – in the present case, the legal rules relating to Part V (Donations Tax; ss. 54-64) of the South African Income Tax Act, 58 of 1962 (South Africa, 1962) (hereafter referred to as the Income Tax Act), together with SARS Binding Rulings and Interpretation Notes. The study thus analyses the relationships between the rules, explains areas of difficulty and is based purely on documentary data (McKerchar, 2008).

3. BEE structures and potential donations tax implications

3.1. Introduction

The possible application of donations tax to BEE transactions cannot be evaluated without conducting an analysis of the BEE structures prevalent in the market space. The first-generation structures relied heavily on external funding, which was provided mainly by institutional investors, and the success of these structures was underpinned by the growth in the value of the shares (Gardee (2014) and Hale, n.d.). It is stated that the market crashes of 1998 and 2008

resulted in the equity ending up in the hands of the financial institutions, which was not the desired objective of the empowerment structure. As a result of the failure of the first-generation BEE schemes, various new structures attempted to address this issue.

There are a number of complex BEE structures in the market using subsidiaries, Special Purpose Vehicles (hereafter SPV), empowerment trusts, etc., and a combination of funding by means of debt, equity, and hybrid instruments such as deferred shares, options and preference shares (Hale, n.d.: 22). These structures contained a general restriction, which entails a restriction on share trading, either totally or between qualifying BEE investors, for a limited period of between three to ten years (Van Zyl, 2015) (hereafter the restriction period). For example, the restriction period for the MTN Zakhele Futhi scheme is eight years (MTN Prospectus, 2016, 17 – 24). The present study was limited to evaluating BEE structures implemented by listed companies issuing or selling shares to BEE shareholders.

An analysis of the various structures revealed that the BEE transactions typically entailed issuing new shares at a discount and/or selling existing shares at a discount. It is this discount element that could have potential donations tax implications. For the purpose of this study, two structures will be presented to illustrate the discount element:

- Structure 1: SPV with third party loans; and
- Structure 2: SPV with notional vendor funding (hereafter NVF).



Structure 1: SPV with third party loans

According to Van Zyl (2015), BEE structures with third party loans work as follows:


Step 1 - Set-up and funding of SPV

[Insert Figure 1 here]

A subsidiary of the BEE company sets up a SPV with the sole purpose of facilitating the empowerment deal.


The SPV is funded as follows:


- the SPV issues ordinary shares at a discount to a subsidiary of the BEE Company;
- the SPV issues ordinary shares to Black members of the public at a discount;
- loan funding from the BEE Company (normally a subordinated loan); and/or
- loan funding from a third parties.

In other words,  Black members of the public do not buy the listed shares directly on the Johannesburg Stock Exchange (JSE) and instead acquire these shares indirectly. Only the mining industry, through the Mining Charter, requires a direct shareholding in the BEE Company (Department of Trade and Industry, 2010).

Step 2 - SPV applies funding to buy shares in BEE Company

[Insert Figure 2 here]

The BEE Company issues ordinary shares to the SPV at a discount to the market price. When the SPV buys the listed shares  on the BEE Company on the JSE, it is regulated through the JSE's trading platform. Initially, the BEE companies created a secondary trading platform for their BEE schemes, known as over-the-counter platform (Van Zyl, 2015). Subsequently the JSE has begun to absorb the over-the-counter market by launching a BEE Board (i.e. the JSE's platform for trading in BEE shares) in 2011 – now referred to as the Empowerment Segment (Johannesburg Stock Exchange, n.d).

The only asset that the SPV will have is the shareholding in the BEE Company which was acquired at a discount. The liabilities of the SPV will be mainly the loan funding obligations to the BEE Company and third parties. The loans are repaid by the SPV using the dividends that it receives on the shares that it holds in the BEE Company. The SPV debt will increase during the restriction period with interest on the outstanding loans and will decrease by any dividends received by the SPV. Any loan balance outstanding at the end of the restriction period becomes due and payable. The SPV will sell enough shares that it holds in the BEE Company at market value, in order repay its loans. In relation to the remaining shares, the directors of the SPV can then choose to either unbundle the shares that they own in the BEE Company to its shareholders (for example in the case of Telkom), or the SPV itself can continue to trade (for example Phuthum  ati) (Van Zyl, 2015).

Step 3 - Unbundling of shares

[Insert Figure 3 here]

As indirect funding was provided through a subsidiary of the BEE Company or a SPV, additional transactions will take place in the future. These additional transactions will typically take place after the restriction period. Either the subsidiary of the BEE Company will sell its existing SPV shares to the Black members of the public at a discount or the SPV will sell its existing shares in the BEE Company to the Black members of the public at a discount.

Based on the analysis of BEE structures funded with third party loans, as presented in steps one to three above, potential donations tax arises as a result of the discount element at the following transaction levels:

Step 1

- Donations tax may arise in the hands of the **SPV** as it issued shares at a discount to a subsidiary of the BEE Company.
- Donations tax may arise for the **SPV** as it issued shares to the Black members of the public at a discount.

Step 2

- Donations tax for the **BEE Company** on the issue of new shares at a discount.

Step 3

- Donations tax may arise for the **subsidiary of the BEE Company**, when in future it sells the existing shares it holds in the SPV at a discount to Black members of the public;
or
- Donations tax may arise for the **SPV**, when in future it sells its existing shares it holds in the BEE Company a discount to Black members of the public.

The potential donations tax implications at each of the transaction steps will be considered at two levels, namely:

- whether it comprises an actual donation; or

- a deemed donation.

3.2.1. *Step 1: SPV issuing new shares at a discount*

3.2.1.1 *Actual donation*

Section 54 of the Income Tax Act levies donations tax and reads as follows:

Subject to the provisions of section 56, there shall be paid for the benefit of the National Revenue Fund a tax (in this Act referred to as donations tax) on the value of any **property disposed of** (whether directly or indirectly and whether in trust or not) under any donation by any resident (in this Part referred to as the donor). (own emphasis)



According to De Koker and Williams (2016: §23.3), it is necessary to consider if the issue of shares by a company can constitute a disposal of “property” as defined in section 55 of the Income Tax Act. The term “property” is defined in section 55 as follows: “Property means any right in or to property movable or immovable, corporeal or incorporeal, wheresoever situated”.

When a company issues its own shares, it does not reduce the underlying value of the company and there is no transfer or alienation of “property” by the allotment (De Koker & Williams, 2016: §23.3; Juta, 2016). The company does not part with any “property”, although by issuing shares it reduces its ability to continue to issue shares, i.e. reduces the amount of unissued share capital (De Koker & Williams, 2016: §23.3).

It is submitted that the views expressed by the above commentators are correct – that when a company issues new shares, the issue of new shares does not constitute “property” of the company and therefore no actual donation has taken place. However, even if no actual donation has taken place in terms of section 54 of the Income Tax Act, it is still necessary to consider whether a deemed donation has taken place.

3.2.1.2 Deemed donation

A deemed donation arises in terms of section 58(1) of the Income Tax Act, which reads as follows:

Property disposed of under certain transactions deemed to have been disposed of under a donation — (1) Where any **property** has been **disposed of** for a consideration which, in the opinion of the Commissioner, is **not an adequate consideration** that property shall for the purposes of this Part be deemed to have been disposed of under a donation: Provided that in the determination of the value of such property a reduction shall be made of an amount equal to the value of the said consideration. (own emphasis)

The question will now be considered whether the issue of new shares at a discount by the SPV can be seen to be:

- property disposed of;
- not for adequate consideration.

Property disposed of

The deeming provision also requires “property” to be disposed of. However, as held by Justice Steyn CJ in the Supreme Court of Appeal case *Estate Furman & Others v CIR*, 1962, (3) SA 517 (A), 25 SATC 4 (hereafter *Estate Furman*), once a disposition is required by a statutory provision to be dealt with artificially as a donation (i.e. a deemed donation), the provision is not required to be interpreted as being limited to transactions possessing all the essential legal characteristics of a donation (De Koker & Williams, 2016: §23.5). Therefore, even though the issue of new shares by a company does not constitute “property”, a wider interpretation must be given to the deemed donation provision.

There are no court decisions specifically dealing with the question whether the issue of new shares constitutes a disposal in terms of section 58(1) of the Income Tax Act. There are, however, two court decisions that considered whether the issue of new shares constituted a disposition in the context of Estate Duty, namely *CIR v Estate Kohler*, 1953, (2) SA 584 (A), 18 SATC 354 (hereafter *Estate Kohler*) and *Estate Furman*. The first court case, *Estate Kohler*, was decided in the context of section 3(6) of the previous Death Duties Act, 29 of 1922. In

this Supreme Court of Appeal case, judge Schreiner JA held (at 17) that "...disposition certainly in this sort of legislation carries a wide meaning. In my opinion it includes such transactions as an allotment of shares by a company, although the company's estate is not diminished thereby".

Two of the three judges of the Appellate Division of the Supreme Court supported this view. Chief Justice Centlivres CJ, however, dissented from this view.

The Death Duties Act was subsequently replaced with the Estate Duty Act, 45 of 1955 (South Africa, 1955) (hereafter the Estate Duty Act). With the introduction of the new Estate Duty Act, the question of whether the issue of new shares constitutes a disposition was again considered by the court in the Supreme Court of Appeal case, *Estate Furman*. At that time, section 3(c)(iii) of the Estate Duty Act read as follows:

- (3)...Property which is deemed to be property of the deceased includes-
- (c) **any property donated under a donation** (other than a donation to a spouse under a duly registered ante-nuptial or post-nuptial contract or a *donatio mortis causa*) made-
 - (iii) by a body corporate, if such property is in terms of sub-sec. (2) of **sec. 54 quin** of the Income Tax Act, 31 of 1941, deemed to have been disposed of under a donation by the deceased (own emphasis).
- (4) For the purposes of para.(c) of sub-sec (3)
- (a) any disposition whereby **any person becomes entitled to receive** or acquire any property for a consideration which is, in the opinion of the Commissioner, is not a full consideration for that property, shall, to the extent to which the fair market value of the property, exceeds the said consideration, **be deemed to be a donation**. (own emphasis)

The Estate Duty Act at that time included property which was deemed to have been donated in terms of section 54quin of the Income Tax Act, 31 of 1941. Section 54quin(2) was the deemed donation provision at the time (equivalent to today's deeming provision, section 58(1)) of the Income Tax Act). In the *Estate Furman* case, all five judges unanimously decided that the allotment of shares at less than fair value was a donation, which was subject to Estate Duty in terms of section 3(c) of the then Estate Duty Act.

The question now is whether the judgments of the *Estate Kohler* and the *Estate Furman* cases, which were decided in the context of the old section 54quin of the Income Tax Act, 31 of 1941, can be extended and applied to the current donations tax provisions, in particular a deemed donation in terms of section 58(1) of the Income Tax Act. There are two opposing views on this matter.

Juta (2015) is of the view that the issue of shares is not a deemed donation. The argument is that it is difficult to conceive that a company can be said to dispose of its own shares, as shares in themselves are not property. Unissued shares cannot be reflected as an asset on the company's balance sheet. Juta further argues that where a company issues shares, the company's balance sheet is in fact enhanced by the consideration received, irrespective of whether it could have been issued for a far greater amount. J's alternative argument is that the *Estate Kohler* and *Estate Furman* cases were decided based on the wording of section 3(4)(a) of the Estate Duty Act, which looks at the disposition from the point of view of the donee (i.e., the person entitled to or receiving the property). In the present study, the subsidiary of the BEE company and Black members of the public are the donees, whereas the SPV is the donor. To contextualise J's viewpoint in relation to the present study, J is of the view that the issue of shares at a discount by the SPV cannot be a disposition of property from a deemed donations tax perspective, as SPV is the donor and not the donee. Spamer (2013) supports J's view and even unequivocally expressed this view in the context of a BEE transaction.

The opposing views, however, come in the form of an Income Tax Court case, as well as De Koker and Williams. In ITC 1387, 1984, 46 SATC 121 (at 123-4), the Judge J held that the provisions of section 58(1) of the Income Tax Act are substantially the same as the old section 3(4)(a) of the then Estate Duty Act. Based on the judgments of the *Estate Kohler* and *Estate Furman* cases, it can, therefore, be argued that the allotment of shares at less than fair value could qualify as a deemed donation. According to De Koker and Williams (2016: §23.5), "It is submitted, therefore, that the provisions of s 58(1) of the Income Tax Act are wide enough to include an allotment of shares by a company at a price that is below the current market price of the shares, and that liability for donations tax arises where such an allotment is made".

The authors support the views of the judge in ITC 1387, as our contention is that section 58(1) of the Income Tax Act is an anti-avoidance provision, which must be interpreted widely. Furthermore, it is submitted that J's alternative argument focused only on the provisions of section 4 of the Estate Duty Act (being from the donee's perspective), but did not consider section 3(c)(iii) of the Estate Duty Act, which considered the disposition from the donor's perspective. In other words, it appears that the then Estate Duty Act incorporated dispositions from both the donor and donee's perspective, as:

- section 3(c)(iii) considered the disposition from a donor's perspective; and
- section 4 considered the disposition from the donee's perspective.

Therefore, it seems to be clear that the issue of shares by a company is to be read into the phrase "...property has been disposed of...", in terms of section 58(1) of the Income Tax Act.

Adequate consideration

On the premise that the issue of shares is property disposed of under a donation, it must be considered if it was disposed of for an "adequate consideration".

There are no court decisions that deal with the question whether the issue of new shares at a discount constitutes adequate consideration. According to Van der Zwan (2013), in BEE transactions, a company may issue shares at a discount to the market value, where a company derives non-cash benefits in return. He then considers whether there can be a deemed donation under section 58(1) of the Income Tax Act and notes that it cannot be said that the issue of new shares by the company takes place at less than an adequate consideration as this would be in contravention of the Companies Act. In terms of section 40(1)(a) of the Companies Act, the board of a company may only issue shares (other than capitalisation shares or as a result of the conversion of rights of previously issued shares) for adequate consideration to the company.

There is no Interpretation Note expressing the interpretation of SARS on the meaning of "adequate consideration" in the context of section 58(1) of the Income Tax Act. However, SARS considered the term "adequate consideration" in Interpretation Note No.91: *Reduction of Debt* (2016) (hereafter IN 91). A transaction will either result in the application of the provisions in the Income Tax Act dealing with debt reductions, or donations tax provisions.

Stated differently, where donations tax is applicable, the reduction of debt provisions will not apply. IN 91 states the following (SARS: 2016: 35), “In SARS’s view the term “adequate consideration” does not necessarily mean “fair market value”. In deciding whether a particular consideration is adequate regard must be had to the circumstances of the case and the objectives of donations tax”.

It is evident that the Commissioner will not only consider the defined term “fair market value” but will also consider each case separately based on the specific facts and circumstances, as well as the intention of the levy of donations tax. In other words, a value less than market value will not always equate to inadequate consideration. Both Clegg and Stretch (2016: Chapter: 29.2.2) and De Koker and Williams (2016: §23.5) support SARS’ interpretation.

3.2.1.3 Conclusion on Step 1

The issue of new shares, it is contended, does not constitute “property” for the SPV and therefore no actual donation takes place. From a deemed donation perspective, it remains uncertain whether the issue of shares by the SPV at a discount will result in a deemed donation. SARS will only consider, on a case-by-case basis, whether consideration less than fair market value is adequate consideration.

3.2.2. Step 2: BEE Company issuing new shares at a discount

After the SPV is funded (as described in step 1 above), the SPV will use the funds to acquire shares in the BEE Company. The BEE Company issues these shares at a discount, which potentially triggers donations tax implications for the BEE Company. As this study was limited to BEE structures implemented by listed companies, no donations tax applies, as public companies are exempt in terms of section 56(1)(n) of the Income Tax Act. This exemption applies irrespective of whether the transaction is an actual or a deemed donation.

3.2.3. Step 3: Selling of existing shares at a discount

The subsidiary of the BEE Company may, after the restriction period, sell the shares it holds in the SPV at a discount to the Black members of the public. Alternatively, the SPV may sell

the shares it holds in the BEE Company at a discount to the Black members of the public. This discount may give rise to donations tax for the subsidiary of the BEE Company or the SPV.

3.2.3.1 *Actual donation*

Section 54 of the Income Tax Act levies donations tax and reads as follows, "... there shall be paid for the benefit of the National Revenue Fund a tax (in this Act referred to as donations tax) on the value of any **property** disposed of ... **under any donation** by any resident ... (own emphasis)".

As this step entails the sale of existing shares, as opposed to the issue of new shares, there are no grounds for the argument that property is being disposed of. The next question is whether the shares are being disposed of under a donation.

The Income Tax Act provides a definition of the term "donation" in section 55(1) as follows, "[D]onation' means any **gratuitous** disposal of property including any gratuitous waiver or renunciation of a right.' (emphasis added)".

Even though a "donation" is defined in the Income Tax Act, the meaning of "gratuitous" is not defined. Various court decisions have considered what an actual donation is. In *CIR v Estate Greenacre*, 1936, NPD 225, it was held that where something is received in return, it is not considered to be an actual donation. In *Estate Sayle v CIR*, 1945, AD 388, 13 SATC 170 (at 173), the court held that a donation is an act whereby the donee is enriched and the donor correspondingly impoverished. Both these principles were confirmed in *The Master v Thompson's Estate*, 1961, (2) SA 20 (FC), 24 SATC 157 (at 165) and *Ovenstone v SIR*, (2) SA 721 (AD) (at 736H-737A). Various tax law commentators agree with the principles established in these court decisions (Haupt (2016: 851); Clegg & Stretch (2016: Chapter 29.2.2)).

In 2004, *Welch's Estate v C: SARS*, 2004:12-17, 2 All SA 586 (SCA), 66 SATC 303, also considered what an actual donation entails. It is submitted that this case established two important principles, namely:

- Firstly, a donation only takes place if it is motivated by “pure liberality” or “disinterested benevolence”. This view is supported by De Koker and Williams (2016: §23.3).
- Secondly, if property is transferred to satisfy or discharge legal obligations, no donation takes place.

In other words, the motive is critical to determine whether or not a transaction triggers an actual donation.

There are no court decisions that specifically address the question whether the sale of shares in the context of a BEE transaction gives rise to donations tax. Two authors have addressed this question from the perspective of whether BEE deals can be seen as actual donations. According to Van der Zwan, (2013), there can be no actual donation under section 55 as he argues that there is no gratuitous disposal of the shares, as the transaction is motivated by economic business reasons. If any party makes a donation, it could be argued that it is the existing shareholders, as their immediate value in the company may be diluted, as the new shares are issued less than market value. However, Van der Zwan argues that there can be no donation by the existing shareholders as there is no disposal of property by these shareholders, this being a requirement to invoke an actual donation. Unfortunately, this view was only expressed in the context of a company issuing new shares at a discount in a BEE transaction. He failed to comment whether the same view will also apply to the sale of existing shares by a company.

Juta Law (2016: 55-2) commented in passing as follows:

An **interesting question** arises whether the provision will be applicable in Black Economic Empowerment deals ('BEE deals'). **Consideration lower than market value** of the assets disposed of are usually payable in terms of these deals. It is submitted that as a **BEE deal is entered into to comply with official government policy the deal is not motivated by pure liberality of generosity**. As a result, the issue of donation's tax does not arise. (emphasis added)

With respect regarding the above comment, the argument can be advanced that this comment conflates two matters, namely, an actual donation (gratuitous element/motive) versus a deemed donation (inadequate consideration). The view is supported that a BEE transaction is not motivated by pure liberality or generosity – in other words it is not an actual donation. However,

the deemed donation provisions do not take into account the motive for the transaction, but only consider whether property has been disposed of for inadequate consideration. To put it differently, one cannot only consider the motive and then argue that no possible donations tax arises. Therefore, the deeming provisions must still be considered.

3.2.3.2 *Deemed donation*

A deemed donation is triggered in terms of section 58(1) of the Income Tax Act, which reads as follows:

Property disposed of under certain transactions deemed to have been disposed of under a donation.—(1) Where any **property** has been **disposed of** for a consideration which, in the opinion of the Commissioner, is **not an adequate consideration** that property shall for the purposes of this Part be deemed to have been disposed of under a donation: Provided that in the determination of the value of such property a reduction shall be made of an amount equal to the value of the said consideration.(own emphasis)

It will now be considered whether the sale of existing shares by the subsidiary of the BEE company or the SPV, at a discount, to Black members of the public can be seen to be:

- property disposed of,
- not for adequate consideration.


Property

As this entails the sale of existing shares, as opposed to the issue of new shares, there are no grounds for the argument that property is being disposed of.

In *Welch's Estate v C: SARS*, 2004, (4) SA 173 (SCA), 66 SATC 303 (at 315), Marais JA held that, "...the definition of 'donation' in s 55(1) plays no role in interpreting or giving effect to the provision in s 58".

Marais JA continued as follows (at 315), "It is thus clear, in applying this provision [section 58], that the motive for the disposal is irrelevant; it is simply a question of whether the

consideration given for a disposal of property (whatever the motive) was, in the opinion of the Commissioner, adequate”.

If the proper construction of the wording of section 58(1) of the Income Tax Act is considered, the Commissioner may invoke the provisions of the section whenever there is a disposal of “property” under any transaction, irrespective of the motive, if he is of the opinion that the consideration given is not adequate (Clegg & Stretch, 2016: Chapter 29.2.2). There is no requirement that any motive of sheer liberality or benevolence must be present to invoke section 58(1) of the Income Tax Act (Juta , 2016). Consequently, the effect of this section is not confined to transactions entered into *animo donandi*, that is, where there is an intention to donate (Clegg & Stretch, 2016: Chapter 29.2.2).


Adequate consideration

There are no court decisions that deal with the sale of existing shares at a discount in a BEE transaction. As discussed earlier under point 3.2.1.2, it is evident from IN 91 that the Commissioner will not only consider the fair market value as adequate consideration, but will consider each case separately, based on the specific facts and circumstances. From a deemed donation perspective, it therefore remains uncertain whether the sale of existing shares by the subsidiary of the BEE company or the SPV, at a discount, will result in a deemed donation.

3.2.3.3. *Conclusion on Step 3*

The sale of existing shares is the disposal of property. The motive is, however, critical in determining whether a transaction triggers an actual donation. The “pure liberality” or “disinterested benevolence” requirement as established by Supreme Court of Appeal cases is lacking in a BEE transaction and, therefore, no actual donation takes place. The deemed donations tax implications remain unclear, however.

3.3. Structure 2: Special Purpose Vehicle with Notional Vendor Funding

Due to the poor performance of Structure 1 discussed above, more recent schemes have made use of NVF, for example, MTN Zakhele and Vodacom YeboYeth .

According to Spamer (2013), a NVF transaction in the context of a BEE transaction can be illustrated as follows:

Step 1 - Set-up of Special Purpose Vehicle and Notional Vendor Funding loan

[Insert Figure 4 here]

A SPV is set up with the sole purpose of facilitating the empowerment deal for the BEE Company. The BEE Company issues Class “A” shares to the SPV at nominal value. As the issue of shares takes place at nominal value, minimal cash is required. However, to compensate for the difference between the market value of the shares and the nominal value, an NVF loan arises. Craig Gradidge, an investment and retirement planning specialist at Gradidge Mahura Investments (cited by Van Zyl, 2015), explains NVF by way of the following simplified example.

The shares of the BEE Company, ABC Limited, are trading at a price of R100 a share, but the company sells them to the SPV at R1 a share. The rest of the buying price (R99) is a notional loan to the SPV (“notional” because no money has changed hands). Thus, for every 1 000 shares issued, ABC receives R1 000 and is owed R99 000. The company needs to perform well and pay enough in dividends during the empowerment period (when trading is restricted) to enable the investors to repay their debt. If, during the lock-in period, the share price increases from the original R100 a share to R200 a share, and the company pays a total of R49 a share in dividends (R49 000 in all), the SPV will be left with a debt of R50 000 (R99 000 – R49 000) when the lock-in period is lifted. This means that they will need to sell 250 shares (R250 x R200 = R50 000) at maturity to settle the debt. This will leave the SPV with 750 shares, which will often be converted into ordinary shares. If this happens, shareholders will be in the money. This simplified example does not take into account interest rates, CGT and call options that also form part of the debt the SPV needs to repay.

The loan balance will increase with the fixed or floating notional interest rate applied. The terms of issue of the Class “A” shares provide that no dividends will be paid until the NVF loan is reduced to nil. The NVF loan will be reduced by the dividends that would have been declared and paid on the Class “A” shares. When the NVF loans account reaches nil, the Class “A” shares will be converted into ordinary shares in the BEE Company. It is assumed that the Class “A” shares will hold voting rights. This scheme is an example of “deferred dividend

shares”, which give the BEE investor the same voting rights as ordinary shareholders, thereby meeting the control requirements of the BEE scorecards. However, the rights to received dividends are deferred until the dividends that would have been received during the deferred period by the BEE investor are equal to the amount that the BEE investor initially funded to acquire the shares (Spamer, 2013).

Step 2 - SPV issues new shares to members of the black public

[Insert Figure 5 here]

The SPV issues shares to Black members of the public at a discount to the market price. For example, MTN Zakhele Futhi shares were sold at a discount of 40.30% (MTN Prospectus, 2016:46).

Step 3 - Redemption/conversion of Class A shares

[Insert Figure 6 here]

The BEE Company will be granted a call option, for example 10 years from the date of issue, whereby it can redeem a variable number of Class “A” shares at the nominal value, using a prescribed formula. The BEE Company will cancel the number of Class “A” shares at nominal value and will grant the SPV the right to subscribe for the same number of ordinary shares. This subscription will take place at market value. The balance of the Class “A” shares that have not been redeemed will be converted into ordinary shares.

Based on the analysis of BEE structures funded with NVF loans, as presented in steps one to three above, potential donations tax arises as a result of the discount element at the following transaction levels:

Step 2

- Donations tax may arise for the **SPV** as it issued shares to Black members of the public at a discount.

Step 3

- If the SPV agrees to a redemption at nominal value in the future, possible donations tax arises for the **SPV** at the time of the redemption.

Even though the potential donations tax implications at each of the steps above should be considered at the two levels, namely:

- actual donation; and
- deemed donation,

the donations tax implications have already been discussed in full under Structure 1 in paragraph 3.2. For ease of reference, the conclusions drawn are repeated below.

3.3.1 Step 2: SPV issuing new shares at a discount

The issue of new shares does not constitute “property” for the SPV and therefore no actual donation takes place. From a deemed donation perspective, it remains uncertain whether the issuing of shares by the SPV at a discount will result in a deemed donation. SARS will only consider, on a case-by-case basis, whether consideration less than fair market value is adequate consideration.


3.3.2 Step 3: Redemption of Class A shares at nominal value

In terms of paragraph 11(1)(b) of the Eighth Schedule to the Income Tax Act, a disposal includes the redemption of an asset. The redemption of the Class “A” shares will therefore trigger a disposal for the SPV. As the redemption takes place at nominal value, potential donations tax arises.

In summary, the motive requirement of “pure liberality” or “disinterested benevolence”, as established by Supreme Court of Appeal cases, is lacking in a BEE transaction and therefore no actual donation arises. From a deemed donations tax perspective, consideration at less than fair market value may be adequate consideration, but SARS’ will only entertain this possibility based on the facts and circumstances of each case. The deemed donations tax implications therefore remain unclear.

4. SARS' view

Even though IN 91 deals with “Reduction of Debt”, it did express SARS’ view on “adequate consideration”. SARS indicated that adequate consideration does not necessarily equate to fair market value and that it will be considered on a case-by-case basis. In addition to IN 91, there are four published Binding Private Rulings that provide insight into SARS’ view of the donations tax implications in the context of BEE transactions. A Binding Private Ruling forms part of SARS’ advance ruling process, as defined in section 75 of the South African Tax Administration Act, 28 of 2011 (South Africa, 2011) (hereafter the Tax Administration Act). SARS may issue three types of advance tax rulings:

- Binding General Rulings – *Initiated by SARS on topics of general interest.*
-  Binding Private Rulings – *Initiated by the taxpayer to provide the taxpayer with certainty. An application fee is payable by the taxpayer. SARS may charge a fee.*
- Binding Class Rulings – *Initiated by the taxpayer to provide certainty for a specific class of persons. The identity of the applicants will not be revealed. SARS may charge a fee.*

Of the above three types of rulings, only the Binding General Rulings can apply to all taxpayers. In other words, Binding Private Rulings only holds binding effect between SARS and the specific taxpayer.

In terms of section 76 of the Tax Administration Act, the purpose of advance tax rulings is to promote clarity, consistency and certainty about SARS’ interpretation and application of tax laws.

In the context of the current study, the fact that there are four published Binding Private Rulings dealing with the donations tax implications of BBE transactions, illustrates that this matter is contentious and unclear, as taxpayers probably paid a fee (in terms of section 81 of the Tax Administration Act) to seek clarity and certainty. In all four Binding Private Rulings, SARS ruled that no donations tax applied. Binding Private Ruling 095 dealt specifically with one uncertainty identified in this study, i.e. whether issuing or selling shares at a discount in a BEE transaction is considered “adequate consideration” for the purposes of section 58(1) of the Income Tax Act.

The BEE structure applicable to Binding Private Ruling 095 was only briefly explained in bullet format. For ease of reference and consistency, the structure is analysed in terms of the various transaction steps. These steps can be depicted as follows:

[Insert Figure 7 here]



Step 1: Set-up of SPV and funding of SPV

The proposed transaction involved a company (hereafter Subsidiary of BEE Company) used to fund a BEE SPV, which would be established and funded to acquire shares in a target company (hereafter BEE Company).

The subsidiary of the BEE Company would provide the majority of the funding in the SPV by subscribing for:

- redeemable cumulative fixed term preference shares; and
- ordinary shares

at par value.

Step 2: SPV issues new shares to Black members of the public

Nominal funding is also provided by the BEE Party (a Black member of the public) by subscribing for preference and ordinary shares in the SPV.

Step 3: Redemption of preference shares and disposal of ordinary shares

When the funding term of the preference shares comes to an end, the subsidiary of the BEE Company would evaluate its return received and would dispose of its ordinary shares held in the SPV at an amount that would achieve any balance of the target internal rate of return (hereafter IRR) not yet earned. The BEE Party would have the first right to acquire these ordinary shares.

Should the subsidiary of the BEE Company achieve its targeted IRR, the ordinary shares may be disposed of at par value (this is the value per share at issue date). If, however, the return on

the preference shares should achieve, for example 90% of the target IRR, the subsidiary of the BEE Company may dispose of the ordinary shares for a sum sufficient to meet the outstanding 10%.

Based on the analysis of the above structure, it appears that the discount elements, and therefore the potential donations tax implications, arise at the following transaction levels:

Step 2

- Donations tax for the **SPV** on the issue of preference and ordinary shares in the SPV at nominal value to the BEE Party.

Step 3

- Donations tax for the **subsidiary of the BEE Company** in respect of the ordinary shares disposed of at par value, i.e. where the subsidiary of the BEE Company has achieved its targeted IRR or a percentage of it.

The assumptions, as indicated above, were made for the purpose of this study, as the ruling failed to identify the potential donations tax implications at the various transaction steps. The ruling only had a subject heading of “Adequate consideration as contemplated under section 58(1)”. As a result, SARS only ruled on the disposal leg of the transactions.

SARS ruled that the subsidiary of the BEE Company’s consideration for the sale of the ordinary shares in the SPV in terms of its funding structure would constitute adequate consideration and hence the ordinary shares were not deemed to have been disposed of under a donation in terms of section 58(1) of the Income Tax Act.

In commenting on Binding Private Ruling 095, De Koker and Williams (2016: §23.5) state that:

It seems to be implicit (but it is regrettably not explicit) in a Binding Private Ruling 95 of 24 February 2011 that SARS **took account of the monetary value of non-monetary benefits** in ruling that a disposal of shares at par, apparently irrespective of their market value, in the context of a particular Black Economic Empowerment transaction was, in the circumstances of that matter, a disposal for ‘adequate consideration’ as envisaged in s 58(1) and was therefore not deemed to be a donation (own emphasis).



5. Conclusion

The primary reason for companies entering into a BEE transaction is to achieve regulatory compliance. In analysing the BEE structures from the perspective of a listed company, it was evident that Black members of the public do not buy the listed shares on the JSE directly and instead acquire these shares indirectly, the only exception being the mining industry, where direct shareholding is required.

The study revealed that a discount element arises at two levels i.e.:

- the issue of shares at a discount; and/or
- the disposal/redemption of existing shares at a discount.

Where shares are issued or disposed of by a listed company at a discount in a BEE transaction, no donations tax arises, as public companies are exempt from donations tax in terms of section 56(1)(n) of the Income Tax Act. Even though this study was limited to listed companies, the study revealed that the discount element often arises at an unlisted company level, as highlighted by Structures 1 and 2 as well as in Binding Private Ruling 095. The issue, therefore, remains whether donations tax implications arises.

The conclusions reached by this study in respect of Structures 1 and 2 can be summarised as follows:



	ACTUAL DONATION	DEEMED DONATION
Legislative provision	Section 54 of the Income Tax Act: “...any property disposed of ... under any donation”	Section 58(1) of the Income Tax Act: “... property has been disposed of for a consideration which ... is not an adequate consideration”
Issue of shares at a discount	Property: No No Donations Tax	Property disposed of: Yes Adequate consideration: Not necessarily = fair market value What is adequate consideration?
Disposal/Redemption of existing shares at a discount	Property: Yes Donation: No, not motivated by pure liberality or generosity No Donations Tax	Property disposed of: Yes Adequate consideration: Not necessarily = fair market value What is adequate consideration?

SARS published four Binding Private Rulings dealing with donations tax implications within the broader context of BBE structures. In all four rulings, SARS ruled that no donations tax applied. One ruling dealt specifically with the one uncertainty identified in this study, i.e. whether issuing or selling of shares at a discount in a BEE transaction is considered “adequate consideration” for the purposes of section 58(1) of the Income Tax Act. It is surmised that the BEE structure presented by the taxpayer to SARS in this ruling had discount elements arising at both levels, i.e. the issue and disposal of shares. SARS’ ruling, however, only addressed the disposal of shares.

SARS ruled that the disposal of the shares in terms of the BEE transaction constitutes adequate consideration, hence no donations tax arises. SARS unfortunately did not give a reason for their ruling. Tax specialists commenting on this ruling have expressed the view that it was implied, but regrettably not explicitly stated, that SARS probably took into account the monetary value of non-monetary benefits (De Koker and Williams (2016: §23.5).

Taxpayers pro^{ly} had to pay a fee to SARS to obtain the binding private rulings. This illustrates that the donations tax implications in BEE transactions are contentious and unclear. ^{he} words of Adam Smith, a good tax system should encompass four pillars, namely equity, certainty, convenience and economy (Smith, 1776:887-889). It can be asserted that taxpayers should not have to go to the length of paying a fee and obtaining a tax ruling to seek certainty on the issue of whether the discount elements present in a BEE transaction trigger donations tax.

The recommendation is therefore made that a legislative amendment should be introduced into section 56 of the Income Tax Act, which exempts BEE transactions from donations tax. This exemption will provide certainty for taxpayers. Any possible abuse of this exemption will, it is submitted, be caught by the General ^{Anti-Avoidance} Provisions contained in sections 80A – 80L of the Income Tax Act.

References

Babbie, E. and Mouton, J. (2009). *The practice of social research*. Cape Town: Oxford University Press.

CIR v Estate Greenacre, 1936, NPD 225.

CIR v Estate Kohler, 1953, (2) SA 584 (A), 18 SATC 354.

Clegg, D. and Stretch, R. (2016). *Income Tax in South Africa Commentary*. South Africa: LexisNexis Butterworths [Online].

De Koker A. P. and Williams, R. C. (2015). *Silke on South African Income Tax*. South Africa: LexisNexis Butterworths [Online].

Department of Trade and Industry. [n.d.]. *Broad-Based Black Economic Empowerment*. Available from: https://www.thedti.gov.za/economic_empowerment/bee.jsp. (Accessed 21/10/2015).

Department of Trade and Industry. (2003). *South Africa's Economic Transformation: A Strategy for Broad-Based Black Economic Empowerment*. Available from: http://www.dti.gov.za/economic_empowerment/bee_codes.jsp (Accessed 14/12/2015).

Department of Trade and Industry. (2010). *Mining Charter*. Available from: <http://www.mqa.org.za/sites/default/files/Mining%20Charter%20Amended%20September%202010.pdf> (Accessed 21/09/2016).

Estate Furman & Others v CIR, 1962, (3) SA 517 (A), 25 SATC 4.

Estate Sayle v CIR, 1945, AD 388, 13 SATC 170.

Gardee, R. (2014). *BEE share schemes: Why we need more and why they're good for SA*. Available from: <http://www.biznews.com/otc/2014/02/21/bee-share-schemes-good-us-need-riaz-gardee/> (Accessed 07/10/2016).

Hale, A. [n.d.]. *Financial Assistance for Empowerment*. Available from: <http://www.slideshare.net/waveruss/beebrochurelr> (Accessed: 14/10/2016).

Hale, A. [n.d.]. *The Evolution of BEE equity participation*. Available from: <http://www.bowman.co.za/FileBrowser/ArticleDocuments/BEEGuide.pdf> (Accessed: 14/10/2016).

- Haupt, P. (2019). *Notes on South African Income Tax*. Roggebaai, South Africa: H&H Publications.
- ITC 1387, 1984, 46 SATC 121.
- Johannesburg Stock Exchange. [n.d.]. *Empowerment segment*. Available from: <https://www.jse.co.za/capital/empowerment> (Accessed 21/09/2016).
- Juta w. (2016). *Juta's Tax Library*. South Africa: Juta Law Online Publications.
- McKerchar, M. (2008). Philosophical Paradigms, Inquiry Strategies and Knowledge Claims: Applying the Principles of Research Design and Conduct to Taxation. *eJITaxR* 1; 6(1) *eJournal of Tax Research*, 5.
- MTN. (2016). *Prospectus: MTN Zakhele Futhi*. Available from: <https://mtnzakhelefuthi.nedsecure.co.za/Home/Documentation> (Accessed 21/09/2016).
- Ovenstone v Secretary for Inland Revenue, 1980, (2) SA 721 (AD).
- Smith, A. (1776). *The Wealth of Nations*. The Modern Library Classics (Reprinted 2000).
- South Africa (Republic). Acts, statutes etc. (1922). *Death Duties Act (Act No 29 of 1922) (as amended)*. Pretoria. Government Printer.
- South Africa (Republic). Acts, statutes etc. (1955). *Estate Duty Act (Act No 45 of 1955) (as amended)*. Pretoria. Government Printer.
- South Africa (Republic). Acts, statutes etc. (1962). *Income Tax Act (Act No 58 of 1962) (as amended)*. Pretoria. Government Printer.
- South Africa (Republic). Acts, statutes etc. (2003). *Broad-Based Black Economic Empowerment Act (Act No 53 of 2003) (as amended)*. Pretoria. Government Printer.
- South Africa (Republic). Acts, statutes etc. (2007). *Broad-Based Black Economic Empowerment Codes of Good Practice, (Notice 112 of 2007)*. Pretoria. Government Printer.
- South Africa (Republic). Acts, statutes etc. (2008). *Companies Act (Act No 71 of 2008) (as amended)*. Pretoria. Government Printer.
- South Africa (Republic). Acts, statutes etc. (2011). *Tax Administration Act (Act No 28 of 2011) (as amended)*. Pretoria. Government Printer.
- South African Institute of Chartered Accountants (SAICA). (2014). *B-BBEE Thought Leadership Paper: Insightful Corporate Reporting*. Available from: <https://www.saica.co.za/Portals/0/Technical/ThoughtLeadershipPaperCorpRep.pdf>

(Accessed: 15/10/2016).

South African Revenue Service. (2011). *Binding Private Ruling BPR 095: Adequate consideration as contemplated under section 58(1)*. Available from:

<http://www.sars.gov.za/AllDocs/LegalDoclib/Rulings/LAPD-IntR-R-BPR-2012-95%20-%20Adequate%20Consideration%20Section%2058.pdf>.

(Accessed 21/20/2015).

South African Revenue Service. (2016). *Interpretation Note No.91: Reduction of Debt*.

Available from: <http://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2016-05%20-%20IN91%20Reduction%20of%20debt.pdf>

(Accessed 30/10/2018).

Spamer, S. (2013). *The imaginary world of notional vendor finance*. Available from:

<http://www.thesait.org.za/news/120219/The-imaginary-world-of-notional-vendor-finance.htm#>

(Accessed 13/10/2016).

The Master v Thompson's Estate, 1961, (2) SA 20 (FC), 24 SATC 157.

Van der Zwan, P. (2013). *Shares Issued in BBBEE Arrangements: Are these Transactions*

Tax Free? Available from: <http://www.thesait.org.za/news/142512/Shares-Issued-in-BBBEE-Arrangements-Are-these-Transactions-Tax-Free.htm>

(Accessed: 17/10/2016).

Van Zyl, A. (2015). *How BBBEE shares have fared*. Available from:

<http://www.iol.co.za/business/personal-finance/financial-planning/investments/how-bbbee-shares-have-fared-1943376>

(Accessed 21/09/2016).

Welch's Estate v C: SARS, 2004, 2 All SA 586 (SCA), 66 SATC 303.

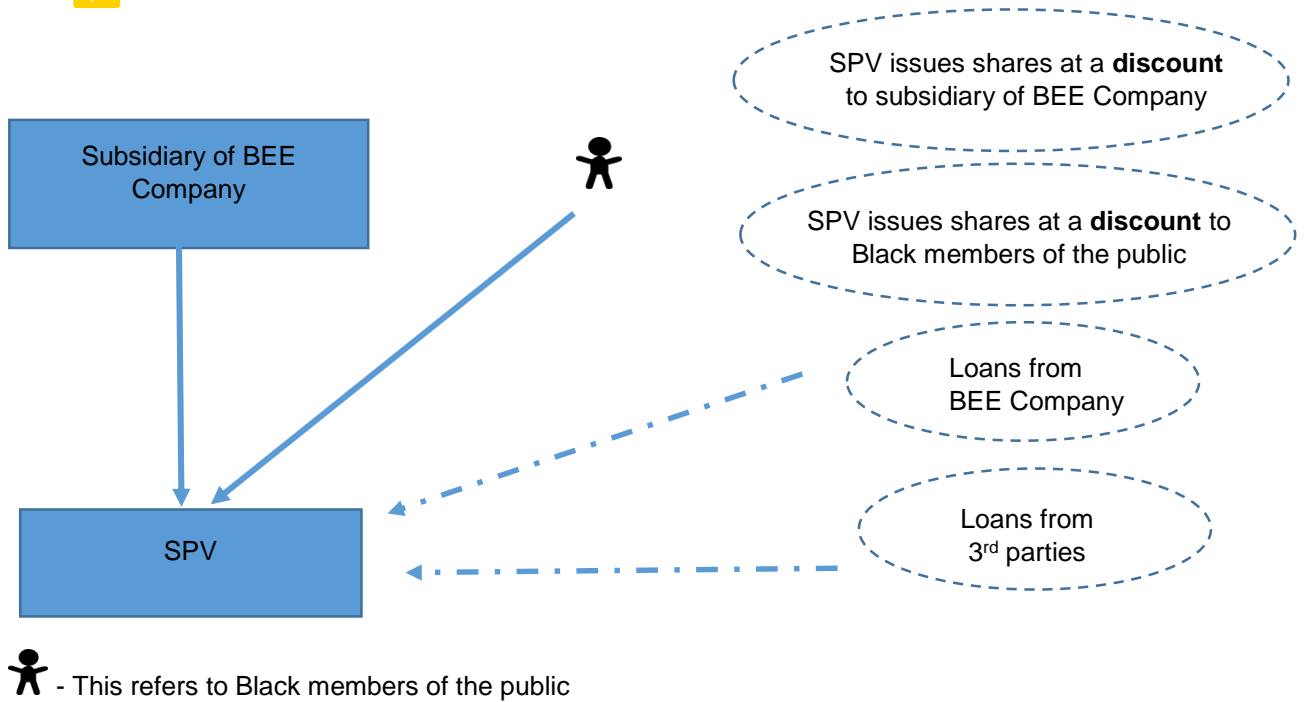


Figure 1

Source: Own design, based on Van Zyl (2015)

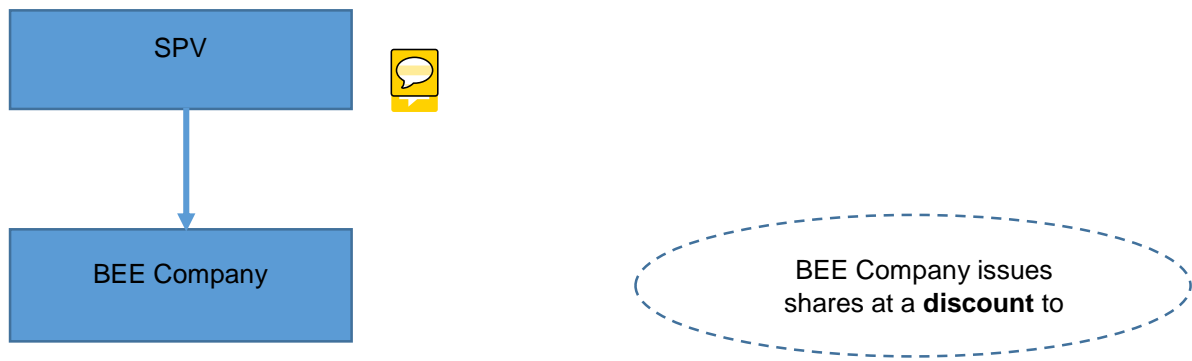


Figure 2

Source: Own design, based on Van Zyl (2015)

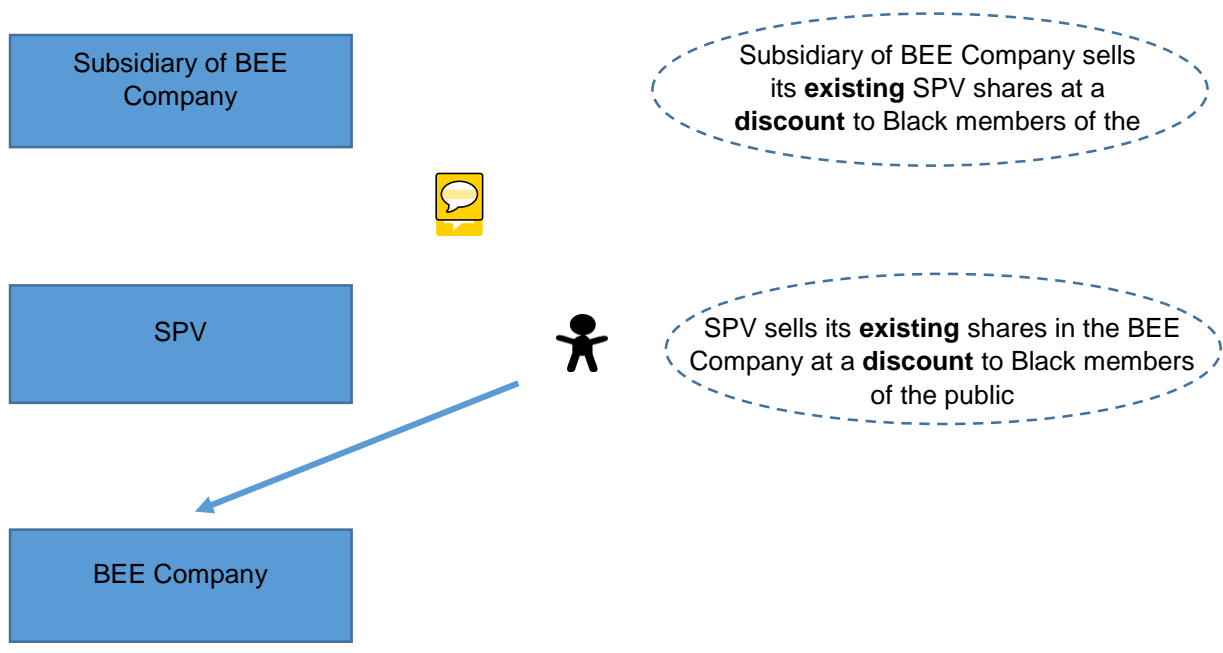


Figure 3

Source: Own design, based on Van Zyl (2015)

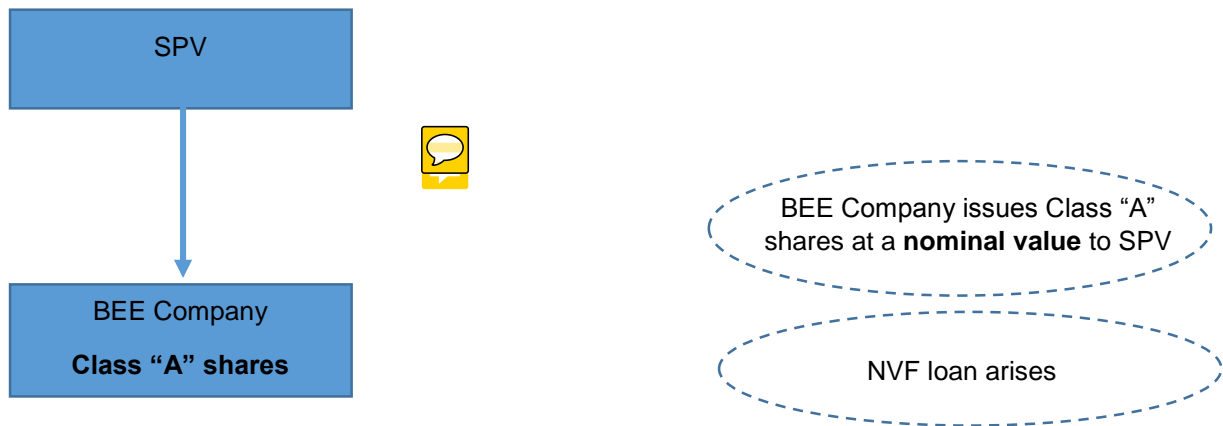


Figure 4

Source: Own design, based on Spamer (2013)

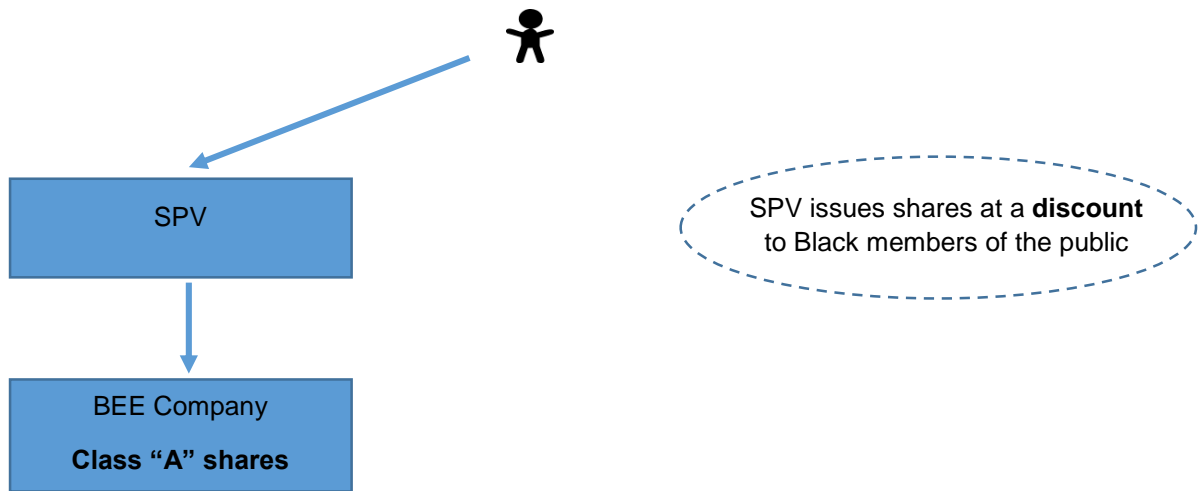


Figure 5

Source: Own design, based on Spamer (2013)

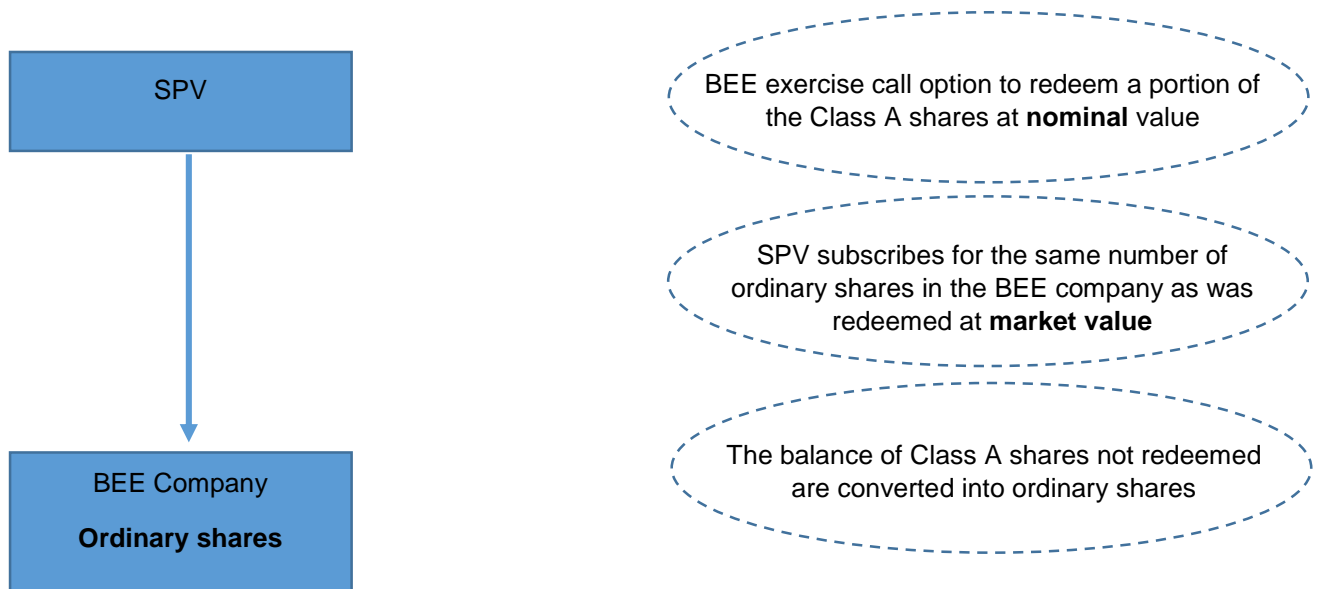


Figure 6

Source: Own design, based on Spamer (2013)

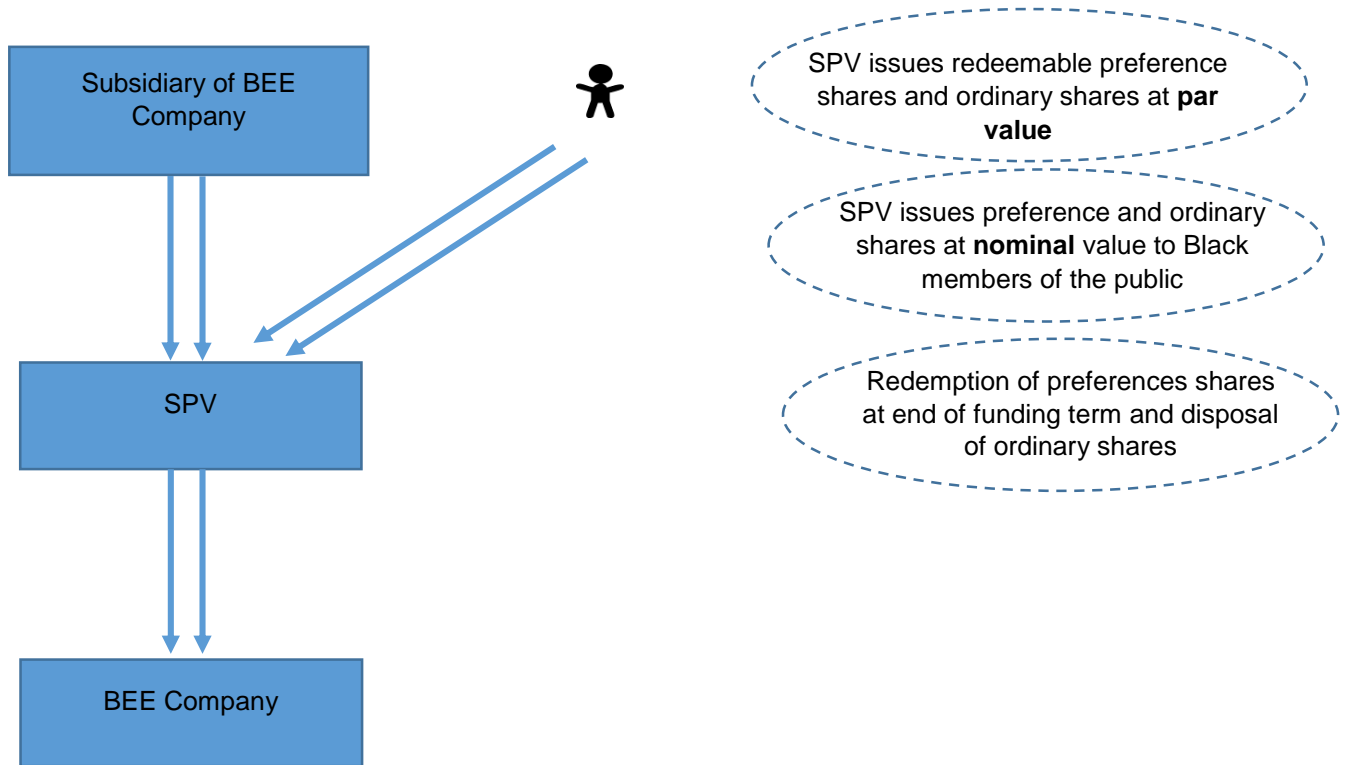


Figure 7

Source: Own design, based on Binding Private Ruling 095