

# Preference share funding and the potential application of paragraph 43A of the Eighth Schedule of the Income Tax Act



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In a preference share funding transaction, the funder subscribes for preference shares in the share capital of a company. In contrast to a loan where interest on a debt facility is taxable in the hands of the lender, the dividends received by the holder of the preference shares are generally exempt from income tax. This tax benefit is, in turn, advantageous to the company as the funder can charge the company a lower funding rate than would otherwise have been charged had the funding been advanced in the form of a loan.

However, there are certain instances in which the dividends received in respect of preference shares become taxable. What follows is a brief synopsis of one such circumstance, of which parties should be cognisant when entering into a preference share funding arrangement.

## **Funding Preference Shares and the EquityKicker**

Although a limitless number of rights could potentially apply to a share, preference shares are commonly understood, in the funding industry to fall within two broad categories:

- Funding preference shares. These shares entitle their holders to (i) a return of capital equal to its subscription price and (ii) dividends calculated on that subscription price with reference to a specified rate of interest or the time value of money.
- Equity kicker preference shares (hereafter referred to as equity kickers). These shares are issued at a nominal issue price. In contrast to funding preference shares, dividends in respect of equity kickers are calculated with reference to the value of the issuer or all or some of the issuers assets.

### **The Acquisition of Voting Rights**

Holders of preference shares are typically not entitled to any voting rights. However, it is not uncommon for the terms of funding preference shares to contain provision for the holder (or, collectively, the holders) of such shares to become entitled to a majority of voting rights should a default (ie a trigger event) in respect of the preference shares occur.

This mechanism in terms of which a holder of preference shares acquires voting rights is potentially problematic for tax purposes, specifically where the funding structure includes redeemable equity kickers.

### **Paragraph 43A of the Eighth Schedule of the Income Tax Act**

Paragraph 43A of the Eighth Schedule of the Income Tax Act applies if:

- a company (the shareholder) disposes of a share which it holds in another company (the issuer);
- at any time during the period of eighteen months prior to the date of that disposal the shareholder held a qualifying interest in the issuer;
- as part of the disposal of the share or within the period of eighteen months prior to that disposal, the issuer pays an exempt dividend in respect of the

applicable share to the shareholder (and an exempt dividend is a dividend that is exempt from both the normal tax and the dividends tax); and

- a portion of those exempt dividends constitute extraordinary exempt dividends.

A shareholder holds a qualifying interest in a company if it holds, inter alia, 50% of the voting rights in that company or 20% of the voting rights in that company if no other person holds a majority of the voting rights in that company.

If paragraph 43A applies, the extraordinary exempt dividends are deemed to form part of the proceeds of the disposal of the share (ie are subject to capital gains tax). An exempt dividend is an extraordinary exempt dividend if the applicable share (i) is a preference share (as defined in s8EA of the Income Tax Act), to the extent to which the dividends in respect of that share exceed dividends calculated at a rate of 15% per annum, or (ii) is not a preference share, the dividend exceeds 15% of the higher of the market value of the share at the beginning of the eighteen month period and the market value of the share on the date of its disposal.

If, in terms of a preference share funding arrangement (i) the terms of the funding preference shares provide that the holder of such preference shares becomes entitled to voting rights equal to or in excess of the qualifying interest thresholds set out in paragraph 43A, if a trigger event occurs; and (ii) the holder, at the date of such occurrence, also holds an equity kicker which is redeemable at the election of the holder as a result of the occurrence of the trigger event, then:

- the holder will hold a qualifying interest in the issuer by virtue of the voting rights that attach to its funding preference shares;
- the dividends that accrue to the holder in respect of the equity kicker held by it will constitute

extraordinary exempt dividends to the extent to which it exceeds 15% of the higher of the market value of the equity kicker on the date on which the equity kicker is redeemed and the date eighteen months prior to that redemption date;and

- on the assumption that the market value of the equity kicker on the redemption date will exceed its market value on the date eighteen months prior to the redemption date (i) the market value of the equity on its redemption date will be attributable entirely to the dividend payable in respect of that share, and (ii) 85% of those dividends will accordingly constitute extraordinary exempt dividends and will be subject to capital gains tax in the hands of the holder.

In conclusion, when entering into a preference share funding arrangement where the funder is also to hold a redeemable equity kicker, we recommend ensuring that the terms of the funding preference shares do not contain provision for the funder to acquire voting rights in the manner contemplated above. Thatway, the funder can never hold a qualifying interest in the issuer and, accordingly, paragraph 43A will not have application.

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