SARS issues important tax ruling for renewable energy financing structures

Author: Mansoor Parker (ENSAfrica).

On 13 April 2016, the South African Revenue Service (“**SARS**”) issued Binding Private Ruling 228 (“**BPR 228**”), which dealt with the issue whereby a project company becomes an operating company for the purpose of s8EA of the Income Tax Act, No 58 of 1962 (“**ITA 1962**”). This question is an important one in the context of financing the activities of renewable energy project companies but its relevance stretches further to many other infrastructure-related project companies.

BPR 228: facts and circumstances

In BPR 228, the applicant taxpayer sought a tax ruling from SARS concerning its financing of a newly established project company. The applicant proposed injecting capital into the project company by means of loan funding as well as subscribing for 25% of the ordinary shares in the project company.

The applicant would finance the subscription price of the ordinary shares in the project company out of the proceeds of issuing ordinary shares to its holding company and issuing preference shares to the co-applicant, a finance provider.

The co-applicant required the applicant’s holding company to provide the co-applicant with a guarantee for any amount which the applicant had contracted to pay to the co-applicant, but fails to pay in respect of the preference shares. The co-applicant also required a cession and pledge by the applicant’s holding company of its shares in the applicant.

The transaction steps are contained in the in the diagram below.

This sort of financing structure is typical in the context of the government’s Renewable Energy Independent Power Producer Programme. Finance providers typically favour preference share funding because dividends from preference shares are normally exempt from income tax making it a cheaper form of funding.

The impact of section 8EA

Section 8EA was introduced in order to strengthen the anti-avoidance rules where the dividends in respect of the share issues were guaranteed by third parties. Where the dividends are guaranteed by third parties, section 8EA will treat the dividend as income. The result for the finance providers is that the dividend becomes taxable.

Finance providers normally protect themselves against this risk by requiring the preference share issuer to “gross-up” the amount of the dividend by increasing the amount payable to the finance provider to include taxes that would be incurred by the finance provider. This increases the cost to the preference share issuer.

The safety hatch in section 8EA: the operating company exception

Section 8EA was, subsequent to its introduction, amended to provide greater relief for transactions, especially in the context of black economic empowerment, where shares are issued to finance the acquisition of shares in an operating target company. One of the ways in which parties may avoid the anti-avoidance rule is if the consideration for the issue of the shares is applied directly or indirectly to acquire equity shares in an operating company.

In BPR 228, at the time of the applicant’s investment, the project company would not be operating or providing the goods or services that it intends to provide for consideration. The project company was expected to be operational within 18 months from the commencement of the construction of a plant.

SARS ruled that the applicant’s subscription for the ordinary shares in the project company will not be regarded as having been applied for a “qualifying purpose” as defined in s8EA(1). Consequently, the project company will not be an “operating company” at the relevant time.

Section 8EA defines an operating company as follows:

“**operating company**” means—
(a) any company that carries on business continuously, and in the course or furtherance of that business—

(i) provides goods or services for consideration; or

(ii) carries on exploration for natural resources;

(b) any company that is a controlling group company in relation to a company contemplated in paragraph(a); or

(c) any company that is a listed company;”

In order to determine whether the project company in BPR 228 is an operating company, it must first be ascertained that it “carries on business continuously.” The ITA 1962 does not contain an exclusive definition of the meaning of “carries on business continuously”. It is a factual question which is divided into two: does the project company carry on business and is that business carried on continuously? Thus, isolated transactions in the nature of trade do not satisfy the “carries on business continuously” requirement because they do not involve a continuity of operations.

BPR 228 seems to be based on the fact that the project company is not yet carrying on business. This is relevant for renewable energy transactions where the funds derived from the preference shares are usually used to acquire equity in a project company which intends to construct and thereafter operate a plant that will generate the renewable energy for subsequent sale. At the time of the acquisition of the equity in the project company, the project company is not carrying on business. This means the funds derived from the issue of the preference shares do not have a qualifying purpose.

Several views have been expressed in the past concerning this issue. One view was that a purposive interpretation should be applied because the intention of the project company is to become an operating company after the construction phase of the plant is completed. On this latter interpretation, the meaning of "carries on business continuously" should be enlarged in order to capture companies which intend to carry on business. BPR 228 dismisses this view.

BPR 228 does not explain how it arrived at the conclusion that the project company is not an operating company. We believe that SARS took the position that the words "carries on business continuously" must be interpreted in their plain, obvious and common sense and that the context in section 8EA does not furnish any grounds to enlarge its interpretation to companies that **intend** to carry on business continuously.

Mansoor Parker

tax | executive
mparker@ENSafrica.com
+27 83 680 2074

add to Outlook contacts

print