

BINDING PRIVATE RULING: BPR 240

DATE: 13 June 2016

ACT : INCOME TAX ACT NO. 58 OF 1962 (the Act)
SECTION : SECTIONS 1(1) – DEFINITION OF “GROSS INCOME”, 8(4)(a), 11(a), 23(g), 23H, 24C, 24J, 24L AND 24M OF THE ACT AND PART VI OF THE EIGHTH SCHEDULE TO THE ACT
SUBJECT : TAXATION OF PARTIES TO SHARE INDEX LINKED NOTES

1. Summary

This ruling determines the income tax consequences resulting from the issue of notes that provide a return determined with reference to a share index, issued by a special purpose vehicle to its holding company that is an insurer.

2. Relevant tax laws

This is a binding private ruling issued in accordance with section 78(1) and published in accordance with section 87(2) of the Tax Administration Act No. 28 of 2011.

In this ruling references to sections are to sections of the Act applicable as at 10 May 2016. 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 the provisions of –

- section 1(1) – definition of “gross income”;
- section 8(4)(a);
- section 11(a) read with section 23(g);
- section 23H;
- section 24C;
- section 24J;
- section 24L;
- section 24M; and
- Part VI of the Eighth Schedule.

3. Parties to the proposed transaction

Applicant: A company incorporated in and a resident of South Africa

Co-Applicant: A company incorporated in and a resident of South Africa whose shares are wholly owned by the Applicant

4. Description of the proposed transaction

The Applicant carries on the business of a registered long-term insurer and is registered as such under the Long-Term Insurance Act No. 52 of 1988. The Applicant wishes to provide its policyholders with a zero tracking error investment which tracks a specified share index.

The Applicant proposes to enter into transactions with the Co-Applicant in terms of which the Co-Applicant will issue notes to the Applicant that will track a specified share index.

The Co-Applicant's business will be to carry on hedging and other speculative transactions in order to enable it to perform its obligations under the note.

The Applicant will be the holder of the note, and the Co-Applicant will be the issuer of the note. The Co-Applicant will use the subscription proceeds (subscription amount) to enter into various hedging activities in order to enable it to pay the relevant return to the Applicant on the redemption date concerned. In this regard, the note will provide for an obligation undertaken by the issuer to provide exposure to a specified index with a zero tracking error. The Applicant will be exposed to the specified index for the duration of the term of the note.

Additional terms of the note will be as follows:

- a) The underlying reference asset of the note will be either the SATRIX 40 or another similar index and will not include any bonds or other similar instruments.
- b) The note will be issued for an indefinite term, subject to a minimum of 5 years. Only in exceptional circumstances would it be possible to redeem the note prior to the initial 5 year period.
- c) The note will be redeemable at the option of the Applicant.
- d) The note will be redeemed for an amount determined with reference to the performance of the relevant index.
- e) The Applicant will not be entitled to any distributions in respect of the note during the term of the note.
- f) The Co-Applicant will bear all risk pertaining to the ability to provide a zero tracking error to the Applicant in respect of the reference index. To the extent that it is not able to do so, the Co-Applicant will be liable for the loss. Equally, any profit from over-performing in relation to the index will be retained and will be subject to tax.

5. Conditions and assumptions

This binding private ruling is made subject to the additional condition and assumption that the Co-Applicant will carry on a trade.

6. Ruling

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

- a) The subscription amount for the note must be included in the “gross income”, as defined in section 1(1), of the Co-Applicant in the year of assessment in which the note is issued.
- b) The amount payable by the Co-Applicant to the Applicant on the redemption of the note will be deductible from the income of the Co-Applicant under section 11(a) read with section 23(g). The deduction, based on a reasonable estimate of the amount payable in the future (estimated redemption amount), will be allowed in the year of assessment in which the note is issued.
- c) Any estimated redemption amount so deducted that exceeds the actual redemption amount payable at the date of redemption will be recouped in the Co-Applicant under section 8(4)(a) in the year of assessment in which the note is redeemed.
- d) If the amount payable at the date of redemption exceeds the estimated redemption amount deducted a further deduction will be allowed under section 11(a) read with section 23(g) in the year of assessment in which the note is redeemed.
- e) No further deduction under section 11(a) or inclusion in gross income under section 8(4)(a) in respect of the change in the value of the estimated redemption amount of the note may be made in the years of assessment between the year of assessment in which the note was issued and the year of assessment in which the note is redeemed.
- f) The note will not constitute an “instrument”, as defined in section 24J(1).
- g) Sections 23H, 24C, 24L and 24M will not apply to the note.
- h) The subscription amount paid by the Applicant for the note will be regarded as expenditure incurred on the acquisition of a capital asset in respect of the Applicant’s policy holder business. The subscription amount paid will therefore not be deductible under section 11(a). Further, the receipt on redemption of the note must be treated as proceeds on disposal of a capital asset under Part VI of the Eighth Schedule to the Act.

7. Period for which this ruling is valid

This binding private ruling is valid for a period of 5 years from 10 May 2016.