

BINDING PRIVATE RULING: BPR 242

DATE: 15 June 2016

ACT : INCOME TAX ACT NO. 58 OF 1962 (the Act)
SECTION : SECTIONS 1(1) – DEFINITION OF “CONTROLLED GROUP COMPANY”, “EQUITY SHARE” AND “HOTEL KEEPER”, 11(e), 12C(1)(d), 12J(1) – DEFINITION OF “QUALIFYING COMPANY” AND “QUALIFYING SHARE” AND 12J(6A)(b)(ii)
SUBJECT : VENTURE CAPITAL COMPANY INVESTMENT IN QUALIFYING COMPANIES CARRYING ON BUSINESS AS HOTEL KEEPERS

1. Summary

This ruling determines –

- the meaning of “controlled group company” and “equity share” with reference to companies that propose to issue different classes of ordinary shares;
- the application of section 12J(6A)(b)(ii) in relation to the granting of an option to purchase additional assets once qualifying shares have been issued to the venture capital company and the subsequent exercising of the option; and
- the meaning of “hotel keeper” and the allowances that a hotel keeper may claim.

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 as at 17 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 “controlled group company”, “equity share” and “hotel keeper”;
- section 11(e);
- section 12C(1)(d);
- section 12J(1) – definition of “qualifying company” and “qualifying share”; and
- section 12J(6A)(b)(ii).

3. Parties to the proposed transaction

The Applicant:	A company incorporated in and a resident of South Africa that has been approved as a “venture capital company” as defined in section 12J(1)
Co-Applicant 1:	A company incorporated in and a resident of South Africa
Co-Applicant 2:	A company incorporated in and a resident of South Africa
Co-Investor:	A company incorporated in South Africa

4. Description of the proposed transaction

The Applicant intends to invest in qualifying companies that will carry on the business of hotel keepers.

The Co-Applicants intend to carry on the business of hotel keepers. They will each appoint a company (manager) to operate and manage their respective hotels. The manager will guarantee each of them a certain level of earnings before interest, tax, depreciation and amortisation (the guaranteed EBITDA) per annum.

The Applicant intends to exit this investment on or before the fifth anniversary of the investment. The Co-Applicants will endeavour to sell their respective hotels with the intention to distribute the proceeds to their shareholders.

The steps to implement the proposed transaction are as follows:

a) Transaction 1

- i) The Applicant will subscribe for A class ordinary shares and the Co-Investor will subscribe for B class ordinary shares in Co-Applicant 1. The total subscription proceeds will be less than R50 million. The Applicant will always hold less than 70% of the total number of shares in issue in Co-Applicant 1 but will contribute more than its proportionate share in monetary terms to the share capital of Co-Applicant 1.
- ii) The A and B class shares will carry the following distribution rights:
 - (aa) The A class shares will be entitled to a profit distribution on an annual basis in an amount equal to the guaranteed EBITDA, less any third party debt payments.
 - (bb) The B class shares will be entitled to a distribution of the remaining profits on an annual basis.
 - (cc) On exit, the holders of the A and B class shares will be entitled to a return of capital distribution of their respective amounts contributed together with a cumulative compound annual return linked to prime, with the A class shares ranking ahead of the B class shares. The A and B class shares will then participate in the remaining assets of Co-Applicant 1 on a *pari passu* basis, *pro rata* to their number of shares held. The B class shares may receive, as a distribution *in specie*, the common areas in lieu of the cash distribution.

- iii) Co-Applicant 1 will use the subscription proceeds to acquire in cash from a seller hotel rooms held under sectional title in an existing hotel (first tranche) together with their undivided shares in various common areas, including the reception area, the restaurant, canteen and parking areas as a going concern for a purchase price equal to the subscription proceeds.
- iv) The seller will grant Co-Applicant 1 an option to acquire additional sectional title units in the hotel (second tranche) which acquisition will be funded by third party debt. The option will be granted at no charge and will be exercisable for a period of four months from the signature date of the sale of the first tranche. The purpose of the option is to allow the third party financier sufficient time to evaluate the performance and trading results of the business of Co-Applicant 1 before agreeing to advance a loan to Co-Applicant 1 to fund the acquisition of the second tranche. The aggregate cost of the sectional title units in the first tranche and the second tranche will exceed R50 million.
- v) The seller will cede and assign its rights and obligations under a hotel management agreement to Co-Applicant 1 in terms of which the manager has been appointed as agent and exclusive operator of the hotel from which sectional title units will be acquired by Co-Applicant 1. The manager will control and manage the sectional title units as a hotel business in exchange for a management fee. Guests who use the sectional title units will have the same access to all the hotel's facilities, including the restaurant, as any other guest who might occupy a room owned by the seller.

b) Transaction 2

- i) The Applicant will subscribe for A class ordinary shares and the Co-Investor will subscribe for B class ordinary shares in Co-Applicant 2. The total subscription proceeds will be less than R50 million. The Applicant will always hold less than 70% of the issued shares in Co-Applicant 2 but will contribute more than its proportionate share in monetary terms to the share capital of Co-Applicant 2.
- ii) The A and B class shares will carry the same distribution rights as the A and B class shares under transaction 1 save that on exit, the B class shares will not be entitled to receive, as a distribution *in specie*, the common areas in lieu of the cash distribution.
- iii) Co-Applicant 2 will use the subscription proceeds to acquire in cash newly developed rooms to be held under sectional title in a hotel from a property developer, together with the sectional title units' undivided shares in various common areas including the reception area and the parking areas for a purchase price equal to the subscription proceeds. Co-Applicant 2 will be granted the right of use of the remaining common areas including the restaurant area, canteen and gym.

- iv) Co-Applicant 2 will enter into a hotel management agreement with the manager in terms of which the manager will be appointed as agent and exclusive operator of the hotel from which Co-Applicant 2 will acquire sectional title units. The manager will control and manage the sectional title units as a hotel business and will be paid a management fee. Guests who use the sectional title units will have the same access to all the hotel's facilities, including the restaurant.

5. Conditions and assumptions

This binding private ruling is subject to the additional condition and assumption that the asset book values of each of the Co-Applicants do not exceed R50 million immediately after the issue to each of them of qualifying shares.

6. Ruling

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

- a) For purposes of the definition of "qualifying share" in section 12J(1), each share of the Co-Applicants will constitute an "equity share" as defined in section 1(1).
- b) For purposes of the definition of "qualifying company" in section 12J(1), neither of the Co-Applicants will constitute a "controlled group company" for so long as the number of equity shares to be held by the Applicant in each of them will constitute less than 70% of the total number of equity shares, irrespective of the fact that the Applicant may invest more than 70% of the aggregate share capital in each of the Co-Applicants in monetary terms.
- c) The existence of the option granted to Co-Applicant 1 to acquire additional sectional title units will not constitute non-compliance with section 12J(6A)(b)(ii) nor will the exercise of the option immediately after the acquisition of the first tranche of sectional title units constitute non-compliance with section 12J(6A)(b)(ii).
- d) The Co-Applicants will each carry on the business of an "hotel keeper" as defined in section 1(1) through the agency of the manager.
- e) The Co-Applicants will be eligible to claim allowances in respect of assets that will be used by them in their businesses under section 12C(1)(d) or 11(e), as specified in an annexure to the ruling letter, which is not published herewith.

7. Period for which this ruling is valid

This binding private ruling is valid for a period of 7 years from 17 May 2016.