BINDING PRIVATE RULING: BPR 314

DATE: 13 December 2018

ACT : INCOME TAX ACT 58 OF 1962 (the Act)

SECTION : SECTIONS 1(1) – DEFINITIONS OF "CONTROLLED GROUP COMPANY", "EQUITY SHARE" AND "HOTEL KEEPER"; 12J(1) – DEFINITIONS OF "IMPERMISSIBLE TRADE", "QUALIFYING COMPANY" AND "QUALIFYING SHARE"; AND 12J(6A)

SUBJECT : VENTURE CAPITAL COMPANY – INVESTMENT IN HOTEL DEVELOPMENT

Preamble

This binding private ruling is published by consent of the applicant(s) to which it has been issued. It is binding as between SARS and the applicant and any co-applicant(s) only and published for general information. It does not constitute a practice generally prevailing.

1. Summary

This ruling determines the tax consequences of an investment in a new hotel development by a venture capital company.

2. Relevant tax laws

In this ruling references to sections are to sections of the Act applicable as at 6 November 2018. 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 –

- section 1(1), – definitions of "controlled group company", "equity share" and "hotel keeper";
- section 12J(1), – paragraph (*a*) of the definition of "impermissible trade"; "qualifying company" and "qualifying share"; and
- section 12J(6A).

3. Parties to the proposed transaction

The applicant:	A resident company which has been approved under section 12J(5) as a venture capital company as defined in section 12J(1)
Co-applicant:	A resident company
Company A:	A resident company
Company B:	A resident company

4. Description of the proposed transaction

The co-applicant will be a qualifying company in relation to the applicant and will be carrying on the trade of a hotel keeper.

To this end, the co-applicant has concluded a contract with a developer to purchase sectional units in a development (once the building has been built) which will include a hotel.

The co-applicant will appoint a hotel operator, Company A, to operate the hotel on behalf of and as agent for the co-applicant.

The memorandum of incorporation ("MOI") of the co-applicant amongst others sets out the preferences, rights, limitations and other terms of its shares. The following are material terms:

- The authorised shares comprise 1,000 A shares of no par value and 10,000 B shares of no par value. The A shares will be issued to the applicant.
- The holder of the A shares will be entitled to a first distribution from the co-applicant in the form of a "Hurdle Amount" with notional interest at the after tax equivalent of prime plus 2% as provided for in the MOI.
- The holder of the B shares will not be entitled to participate in the profits or capital of the co-applicant until an amount equal to the Hurdle Amount has been distributed to the applicant. Thereafter, however, the A shares and the B shares will rank *pari passu* in all respects (and, in any event, they will rank *pari passu* as regards voting rights from date of issue).

It is intended that the applicant will subscribe for 690 A shares and the hotel operator for 310 B shares.

The co-applicant will conclude an agreement with a developer for a hotel still to be built and fitted out, but will be paying about 65% of the purchase price upfront as a deposit.

The co-applicant will deposit the subscription amount with the developer in pursuance of the acquisition of the hotel units.

Because the operator will have already subscribed for the B shares and concluded the hotel management agreement, the applicant believed that it could be at risk if the operator, or another company in the same group as the operator, were to start operating a hotel in the vicinity of the one to be owned and operated by the co-applicant, and in competition with it. Accordingly, to protect the applicant's interests and that of the co-applicant, it was agreed that (a) the co-applicant would be entitled to cancel the hotel management agreement, and (b) the applicant's management company, Company B, would be granted an option to acquire the B shares from the operator at original cost (or to nominate some other person (such as a new operator) to acquire those shares at cost). It is noteworthy that –

- the option may only be exercised upon cancellation of the hotel management agreement; and
- if the option has not been exercised at the date when the hotel opens for commercial operation, it lapses.

The difference between the purchase price and the deposit will be funded by a bank loan to be raised by the co-applicant.

The co-applicant will own the hotel, where it will supply board and lodging (that is to say sleeping accommodation) together with meals. The following practical arrangements will be in place:

- A continental breakfast will be supplied daily to guests in the lobby of the hotel. This meal will be included in the room rate charged to hotel guests and the hotel operator will be responsible for providing this meal. No liquor will be provided with this meal.
- A restaurant will be on the same premises as the hotel and it will be operated by an external restaurant operator. The restaurant operator will serve meals and liquor. The space occupied by the restaurant will be owned by a third party, not the qualifying company, and the external restaurant operator will rent space from the owner.
- The continental breakfast provided to guests will be sourced from the restaurant operator. The restaurant operator will bill the hotel operator for this and the hotel will bear this cost.
- Guests to the hotel will have the option to charge their bills from the restaurant to their hotel room bill. The restaurant operator will bill the hotel for this. The hotel will then on-bill the guests and no mark-up will be applied by the hotel on this bill.
- Hotel guests will have the option of ordering room service from the restaurant operated by the restaurant operator. Room service will include meals and liquor. Again, the restaurant operator will bill the hotel for this and the hotel will in turn on-bill this to the guest, no mark-up will be applied by the hotel on this bill.
- A mini-bar offering liquor service will not be provided by the hotel operator in guest rooms.
- The restaurant operator will be responsible for obtaining the liquor licence.

5. Conditions and assumptions

This binding private ruling is subject to the additional condition and assumption that there will be no service level agreement between the hotel and a third party with regards to the supply of liquor.

6. Ruling

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

a) For the purposes of the definition of "qualifying company" in section 12J(1), the co-applicant will not constitute a controlled group company for so long as the number of equity shares which the applicant holds constitutes less than 70% of the total number of equity shares in issue.

b) For the purpose of the definition of "qualifying share" in section 12J(1), the shares held by both the applicant and the hotel operator will be “equity shares” as defined in section 1(1).

c) Paragraph (*a*) of the definition of "impermissible trade" in section 12J(1) will not be applicable to the co-applicant, notwithstanding the fact that the co-applicant will, on receipt of the subscription monies for the equity shares, use same to pre-pay the developer for immovable property still to be developed and built, and to be delivered more than two years' thereafter.

d) Once hotel operations commence, the co-applicant will be carrying on trade as a hotel keeper for the purposes of the Act.

e) There will be no breach of the provisions of section 12J(6A)(*b*)(ii) even though, once transfer is taken of the sectional units, the co-applicant's assets will increase to an amount in excess of R50 million, the increase being funded by the taking on of bank debt.

7. Period for which this ruling is valid

This binding private ruling is valid for a period of five years from the date of the ruling.

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