

BPR 314: An interesting ruling on several levels

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On 13 December 2018, the South African Revenue Service issued Binding Private Ruling 314, which deals with interesting aspects relevant to Venture Capital Companies (VCCs) but also issues of more general interest.

The ruling was sought in the context of a VCC investing in a company that intends to develop a hotel and thereafter to carry on the business of a hotel-keeper.

The VCC [tax](#) regime was introduced to encourage investment, through VCCs, into qualifying unlisted companies, with investors acquiring shares in the VCC. The tax attraction of the regime is that investors can tax-deduct the cost of their VCC shares.

The VCC that applied for BPR 314 wanted to invest in a hotel-keeper. The particular attributes of the proposed investment raised interesting tax issues discussed below.

In order to qualify under the VCC regime, the qualifying company is not allowed to carry on a trade in respect of fixed property, other than a trade carried on as hotel-keeper. In this case, the hotel-keeper company did not have a readily available hotel business, but planned to have suitable premises constructed by a developer. It was ruled that the company will not be regarded as carrying on a trade in respect of fixed property prior to the hotel business becoming operational, despite:

- the construction period being estimated at two or more years; and
- the subscription price received by the company from the VCC and its other shareholder being utilised solely to pay a 65% deposit to the property developer.

Another requirement of the VCC regime is that the shares for which the VCC subscribes in the hotel-keeper company must qualify as equity shares, which are not hybrid equity instruments or third-party backed shares. The VCC subscribed for A shares, and the entity, which is to operate the hotel subscribed for B shares, in the hotel-keeper company. The A shares had preferential distribution rights, with the B shares only becoming eligible for participation after the A shares have earned a hurdle amount with notional interest at the after-tax equivalent of prime plus 2%. The ruling confirmed that these arrangements would not:

- alter or taint the nature of the shares issued to the VCC and the hotel operator, as "equity shares";
- result in the shares issued to the VCC as hybrid equity instruments or third-party backed shares.

Quite interestingly, the ruling, with reference to a limitation on VCCs' percentage investments in underlying companies, indicates that, in determining a shareholder's percentage equity interest in a company, no account is to be taken of the different rights attaching to different share classes. The percentage interest of each shareholder is calculated purely with reference to the number of equity shares held by each shareholder. Such a view could hold interesting implications for other areas of tax law, for example to determine whether a shareholder qualifies for the participation exemption for foreign dividends, or whether a company forms part of a group of companies.

It was indicated above that 65% of the cost of acquisition of the hotel premises was covered by the subscription price paid for the shares issued to the VCC and the hotel operator. The balance of the purchase price would be raised by bank funding. Upon completion of the premises, it is estimated that the hotel-keeper's assets could exceed R50 million. Limitations apply to the amounts which a VCC could spend on investments in companies holding assets with a book value in excess of R50 million. It was ruled that, because the hotel-keeper's assets would exceed R50 million after completion of the construction as a result of the bank funding (and not the funds raised on subscription), these limitations would not apply.

Finally, the ruling is interesting insofar as it indicates structuring opportunities to get around the often-experienced problem of liquor provided by hotel businesses. VCCs wanting to invest in hotel businesses need to take into account the fact that any trade carried on in respect of liquor is an impermissible trade, so that a VCC is not allowed to invest in a hotel-keeper if its trade includes the provision of liquor. On the other hand, the provision of meals is a requirement in order to qualify as a hotel-keeper. It leaves taxpayers with the dilemma that a hotel-keeper, in order to be an attractive investment for a VCC, must provide meals without liquor. It can, therefore, not solve the problem by outsourcing the restaurant completely, because then it would not provide meals. And if it takes on the restaurant function, it will be barred from serving liquor in its restaurant. It appears from the ruling that SARS will be satisfied that meals, but not liquor, will be provided if:

- a simple meal without any liquor, such as breakfast, is served on the hotel premises (owned by the hotel-keeper company) and the cost of this meal is included in the room rate charged to the hotel guests. It will be in order for the hotel to source (and buy) the meal from the external restaurant operator referred to below;
- a liquor-serving restaurant operates on the same premises as the hotel, but the space occupied by the restaurant must be owned by a third party (also the owner of a liquor licence) and the restaurant must be operated by an external restaurant operator;
- no mini-bars offering a liquor service are available in hotel rooms; and
- guests can have the option to charge their restaurant bills to their hotel room bill, as long as the hotel pays the restaurant operator the same amount that is charged to the guests' hotel bill. Guests can also order room service (including liquor) from the restaurant, on the same basis (i.e. the hotel cannot make a margin).



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