SECURITY SPVS AND TAX NEUTRALITY – DOES THE JUDGMENT IN CAPSTONE 556 (PTY) LTD V CSARS [2014] JOL 32201(WCC) PROVIDE CLARITY ABOUT THE TAX NEUTRALITY OF SECURITY SPVS?

By Betsie Strydom, Partner, Bowman Gilfillan.

Despite the bad press that special purpose vehicles ("SPVs") received during the Enron scandal, SPVs are still an everyday feature of many financial structures. SPVs are commonly used in project finance transactions and in respect of employee incentive schemes, and normally serve a specific business purpose: they are generally created to be independent, bankruptcy remote vehicles and allow the financiers in syndicated loan transactions to share the proceeds of the security provided by the borrower. For example, a typical greenfields renewable energy project might have several financiers and "Security SPVs" would typically be an integral part of the financing arrangements required by the financiers of such a project.

Typically, a Security SPV is obliged to guarantee a debt owed to financiers. To safeguard itself and to ensure that it can make payment under the guarantee, it will obtain an indemnity from the borrower (and sometimes other parties, e.g. the borrower's shareholders) for the amount that it is required to pay under that guarantee, and it will hold security given by the borrower (or those other parties) for the obligations of the parties who gave the indemnity. The rationale for using a Security SPV is that the financiers/lenders should be protected, should the borrower default and also to enable all the lenders to share in the proceeds of the security. To ensure this, Security SPVs are restricted from conducting other activities save for the activities related to their specific purpose, and often the ownership of the SPV is held by an independent trust or other remote vehicle, so that the Security SPV is not related to the other parties to the transaction.

Generally the Security SPV does not receive any fee for the performance of its functions and the intention is that the Security SPV will not suffer an economic loss. The Security SPVs ability to pay amounts in settlement of guaranteed obligations is, in practice, limited to the proceeds it obtains from the assets held as security and, in many cases, its liability under the guarantee is contractually limited to such proceeds.

When an event of default occurs, the Security SPV is contractually obliged to make a demand under the indemnity (or indemnities), enforce the security (i.e. realize the encumbered assets) and use the proceeds received for these assets in reduction of its obligations to the lenders (generally these are guaranteed obligations). The Security SPV normally receives any proceeds of the enforcement for its own account, and not as the agent of any one of the lenders.

Not only are Security SPVs intended to be bankruptcy remote vehicles, they are also created to be "tax neutral" in respect of their receipts and any payments that they have to make in terms of the security arrangements (pledges, mortgages, etc.).

In order to determine whether a Security SPV is tax neutral, the tax treatment of its receipts and expenditure should match, and in this context the questions that have to be considered are:

- whether the receipt by the Security SPV of proceeds for the realization of security is capital or revenue in nature;
- if these proceeds are capital in nature, how the payment to the lenders, in settlement of the guaranteed obligations should be treated, in other words, what can be

included in the base cost that can be deducted from the proceeds, in order to minimise any capital gain; and

- if the tax authorities treat the proceeds as a revenue receipt, how the expenditure by the Security SPV in respect of its obligations under the guarantee should be treated (in other words, whether payments by the Security SPV in terms of its obligations can be deducted in terms of the general deduction formula, which inter alia requires the SPV to be conducting a trade).

In the recent judgment of **Capstone 556 Pty Ltd v CSARS** [2014] JOL 32201(WCC) (which upheld an appeal against the judgment of the Tax Court in **ITC 1867**, 75 SATC 273 ("**ITC 1867**")) ("**Capstone**") the High Court had to decide whether the proceeds of the sale shares that had been sold by an SPV were capital or revenue in nature. **Capstone** has been hailed as a well-reasoned case that clarifies the capital/revenue issue. In fact, in the context of establishing the tax neutrality of security SPVs, the difference in the approach adopted by the Tax Court and the judgment of the High Court has raises several questions about security SPVs.

In **ITC 1867**, the Cape Tax Court had to decide whether the proceeds from the sale of shares by a SPV which had been created with the sole purpose of acquiring and holding these shares, were of a capital or revenue nature. The Court also had to decide whether the expenditure incurred by the SPV in respect of indemnity obligations that it had assumed, and its obligation to pay a so-called 'equity kicker", could be deducted by the SPV. Davis J (at p281) summarised the tax questions that had to be answered:

> "[2] *If the proceeds are of a capital nature, then the further question arises as to whether an expenditure… in respect of an indemnity obligation arising as a concomitant of the purchase of the … shares, ought to be excluded from the capital gain made … on the sale of the … shares, in that this amount formed part of the base cost thereof.*
>
> [3] *By contrast, if the gain is classified as of a revenue nature, the question arises whether the expenditures … constitute deduction from the revenue gain.*"

In **ITC 1867** the Tax Court:

- held that the profits of a Security SPV were revenue in nature; and
- allowed the deduction of expenses, namely an equity kicker and an indemnity payment, in terms of the general deduction formula, in section 11(a) and section 23(g) of the ITA. Davis J seems to have accepted that the SPV conducted a trade, although he did not comment specifically on this aspect.

The end result in **ITC 1867** achieved "tax neutrality" – the taxpayer had to include the proceeds in its gross income but it was able to claim a tax deduction for the expenses incurred in terms in respect of the equity kicker and the indemnity obligations.

In **Capstone** the High Court overturned Davis J's decision. The difference in approach by the Tax Court and the High Court as to whether the proceeds are revenue or capital and whether the expenditure can be deducted, has raised questions about how the tax neutrality of Security SPVs can be ensured.

In **Capstone** the High Court held that a company which had been created as an SPV for the purpose of acquiring shares and which was contractually precluded from doing anything other than acquiring and holding those shares, received the proceeds as capital. It also found that the security SPV was not conducting a trade.

In **Capstone**, the High Court regarded the purpose with which the SPV acquired and held the shares, and the fact that it could not engage in any other activities, as relevant to the question whether the shares were held as a capital asset. The High Court emphasized the fact that the SPV clearly conducted no trade, it did not hold board meetings and its only intention was to honour its contractual obligations. The proceeds of the sale of shares were held to be capital in nature.

However, when it came to the SPVs expenditure, the High Court regarded the payment of the equity kicker as part of the cost of borrowing - only because the expenditure was linked to listed shares, was the SPV allowed to include one third of this expense in its base cost. No further discussion on what could be included in the base cost generally appears in the judgment. The High Court also held that the taxpayer's indemnity obligation was not a cost of acquisition, but a cost of disposal of the shares and therefore had to be included in the taxpayer's capital gain. The result in **Capstone** cannot be regarded as a tax neutral result.

Capstone also echoes the opinion of the (then) Appellate Division in **CIR v Pick 'n Pay Employee Share Trust** 54 SATC 271 (A) where the Appellate Division held that the profits of an employee share trust which had been created only for the purchase and sale of shares on behalf of employees of the employer company, were capital in nature and that the trust was not carrying on a trade.

The facts in **Capstone** were complicated and the judgment of the tax treatment of the indemnity obligations was based on the specific facts of that case. However, for many of the standard Security SPVs which are obliged to make payments to the financiers in terms of their guarantee obligations, the question arises whether the proceeds will be treated as capital (on the authority of the **Capstone** case) and whether the Security SPV can include the payments made under its guarantee obligations as part of the base cost. Certainty about the principles on which the tax neutrality of Security SPVs can be based is important, particularly as the question of whether an SPV conducts a trade is unsettled: both **Capstone** and the **Pick 'n Pay** cases held that SPVs do not trade, whilst in **ITC 1867** the Tax Court seems to have accepted the fact that the SPV conduct a trade. Whether or not an SPV conducts a trade, and would therefore allowed to deduct its expenses in terms of the general deduction formula, therefore remains to be settled.

If the approach in **Capstone** is followed it is important to have certainty about what can be included in the base cost, which in turn is deducted from the proceeds to determine the capital gain or loss. The CGT legislation is vague and questions remain. Financiers will require certainty on this issue. If tax neutrality of security SPVs is an important element of the structure, careful attention will have to be given to the issues raised in **ITC 1867** and the **Capstone** case.