

BINDING PRIVATE RULING: BPR 257

DATE: 16 January 2017

ACT : INCOME TAX ACT 58 OF 1962 (the Act)
SECTION : SECTIONS 1(1) – DEFINITION OF “GROSS INCOME”, 8F, 8FA, 11(a), 19, 23(g), 24J, 24JA, 24JB AND 25B AND PARAGRAPH 12A OF THE EIGHTH SCHEDULE
SUBJECT : ISLAMIC FINANCING ARRANGEMENT

1. Summary

This ruling determines the income tax consequences of an Islamic financing arrangement, known as a “mudaraba” arrangement, for the parties.

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 28 of 2011.

In this ruling references to sections and paragraphs are to sections of the Act and paragraphs of the Eighth Schedule to the Act applicable as at 27 October 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 8F;
- section 8FA;
- section 11(a) read with section 23(g);
- section 19;
- section 24J;
- section 24JA;
- section 24JB;
- section 25B; and
- paragraph 12A.

3. Parties to the proposed transaction

The Applicant: An unlisted public company incorporated in and a resident of South Africa

The Trust:	A vesting trust, to be established under the laws of South Africa
The Sukuk Certificate Holders:	Members of the general public who will make capital contributions to the Trust and become its beneficiaries (the Class)

4. Description of the proposed transaction

The Applicant, in consultation with the Registrar of Banks, has resolved to proceed with an offer of a tier 2 capital instrument in the form of tier 2 certificates via a mudaraba arrangement.

Members of the general public will be invited to subscribe for sukuk certificates which will be issued by the Trust in terms of an investor subscription agreement.

The Trust will in turn subscribe for the tier 2 certificates which will be issued by the Applicant, as a mudaraba arrangement. These arrangements between all the parties to be involved are jointly referred to as a mudaraba sukuk.

The funds raised by the Applicant are to assist the Applicant to manage its capital adequacy requirements, as prescribed by the Registrar of Banks in terms of the Banks Act 94 of 1990, by Regulation 38(14) of the Regulations relating to Banks (published under Government Notice R1029 in *Government Gazette* 35950 of 12 December 2012). This is intended to allow the Applicant to expand its operations.

The funds to be raised from the issue of the tier 2 certificates will be invested in the Applicant's general pool which will earn a profit from mudaraba arrangements, which essentially entail the joining of the skills of the Applicant with the funds of the Trust to earn a shared profit from the intended joint use of the skills and the funds. This return will be paid to the Trust and then onward, after accounting for the Trust's expenses, to the Class.

The proposed steps will be as follows:

- A vesting trust, (the Trust) will be established under the laws of South Africa.
- The Trust will raise funding from investors (the Class), subject to the trust deed, the investor terms and conditions and in terms of the investor subscription agreement.
- The Trust will apply the amounts received from the Class to subscribe for the tier 2 certificates to be issued by the Applicant in terms of the mudaraba arrangement.
- In terms of the mudaraba arrangement, the Trust will be the capital provider (in Islamic terms, be the '*rab al-maal*') and the Applicant will provide the labour (in Islamic terms, be the '*mudarib*').
- The Applicant will invest the mudaraba capital raised from the issue of the tier 2 certificates in an Islamic business portfolio of sharia-compliant arrangements (deposit pool).

- Profits from the investment of the mudaraba capital will be shared between the Applicant and the Trust in a pre-determined profit-sharing ratio.
- Any profits to be received by or accrued to the Trust will be passed on to the Class, in accordance with the conduit principle.

The salient features of the mudaraba sukuk, as set out in the relevant agreements referred to above, will be as follows:

- Distributable profits of the deposit pool, if any, will be allocated between the Applicant as the *mudarib*, the Trust and other depositors of the Applicant in accordance with an agreed profit sharing ratio.
- The Applicant will calculate the periodic distribution amounts due to the Trust based on a pre-determined profit-sharing ratio. Payment of these periodic distribution amounts will be made monthly in arrears, on the last day of each month in each year. Periodic distribution amounts that are not paid to the Trust will be credited to a mudaraba reserve by the Applicant and re-invested for the benefit of the Trust. The mudaraba reserve is subordinated on the same basis as the tier 2 certificates.
- The Trust will in turn make payments of periodic distribution amounts pro-rata to the Class according to their respective holdings. Periodic distribution amounts are payable monthly in arrears on each distribution date (the last day of each month in each year).
- The term of the instrument is for a 10 year period, although the Applicant will have the right to redeem the instrument after five years, upon which the Trust will give notice to redeem all the sukuk certificates.
- The redemption or variation of the tier 2 certificates will be subject to the following conditions –
 - prior consent from the Registrar of Banks; and
 - at the time of the notice of redemption or variation and following the redemption or variation, the Applicant will be compliant with regulatory capital requirements.
- The tier 2 certificates and as a result the sukuk certificates may be written off either partly or in full, in certain circumstances as set out in the terms and conditions of their issue.
- No recourse shall be had for the payment of any amount owing in terms of the proposed transaction, or a claim against the Trust or the Applicant, to the extent that the sukuk assets and the tier 2 certificates have been exhausted following which all obligations of the Trust and the Applicant shall be discharged.

5. Conditions and assumptions

This binding private ruling is subject to the following additional conditions and assumptions:

- a) The mudaraba arrangement will be a “sharia arrangement” as defined in section 24JA(1).

- b) The proceeds of the tier 2 certificates will not be recognised as profit and loss in the statement of comprehensive income in respect of the financial assets and liabilities of the Applicant.

6. Ruling

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

- a) Section 24JA, insofar as it applies to a “sukuk” as defined, will not apply to the sukuk certificates to be issued by the Trust.
- b) The proceeds from the issue of the sukuk certificates will not form part of the Trust’s “gross income” as defined in section 1(1).
- c) The proceeds from the issue of the tier 2 certificates will not form part of the Applicant’s “gross income” as defined in section 1(1).
- d) Section 24JA(2) will apply to the mudaraba agreement to be entered into between the Applicant and the Trust. Accordingly, the periodic distribution amounts received by or accruing in favour of the Trust will constitute “interest”, as defined in section 24J(1).
- e) The periodic distribution amounts paid to the Trust will be deductible by the Applicant, under section 11(a) read with section 23(g).
- f) The periodic distribution amounts will retain their nature as interest on distribution to the Class under section 25B(1).
- g) As the Class have vested rights to the income of the Trust, section 25B(1) will apply and as a result thereof, the Trust will have no income as the Trust’s income will be deemed to be the income of the Class.
- h) If any tier 2 certificate is redeemed for less than its subscription price, section 19 and paragraph 12A will not be applicable to the difference between the subscription amount and the redemption amount.
- i) Sections 8F and 8FA will not apply to the mudaraba agreement.
- j) Section 24JB will not apply to the mudaraba agreement.

7. Period for which this ruling is valid

This binding private ruling is valid for a period of 10 years from the date the mudaraba sukuk is issued.