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The taxation of the returns on debt and equity in South Africa

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The University of Witwatersrand, Johannesburg

THE TAXATION OF THE RETURNS ON DEBT AND EQUITY IN SOUTH AFRICA

A research report submitted to the Faculty of Commerce, Law and Management in partial fulfillment of the requirements for the degree of Master of Commerce (specialising in Taxation).

Johannesburg, 2015

Neil Wortmann

ABSTRACT

The existing South African tax system only acknowledges debt financing through the deduction allowed for interest payments, as compared to equity financing where no such deduction is allowed for dividend payments. Taxpayers are prejudiced should they wish to use equity financing to fund a project or company. The deductibility of interest creates the incentive for taxpayers to use debt funding even when it may not be in the best interests of the company. This paper considers some of the complications of the different tax treatment of the returns on debt and equity. Alternative models including the comprehensive business income tax, an allowance for corporate equity and a deduction for dividends are considered in order to establish whether the taxation of the returns on debt and equity could be improved or simplified in South Africa.

Key Words: debt, equity, hybrid instruments, tax deductibility, comprehensive business income tax, allowance for corporate equity, dividend deductibility, South Africa

DECLARATION

I declare that this research report is my own unaided work. It is submitted for the degree of Master of Commerce at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination at any other university.

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Neil Wortmann

Date: 02 April 2015

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Chapter 1: Introduction

Background

Companies typically fund their operations through the issuance of debt or equity. The tax consequences of the returns on debt and equity are different. Interest (being the return on debt) is allowed as a deduction under section 24J of the Income Tax Act 58 of 1962 ('Income Tax Act'), whilst dividends (being the return on equity) are not eligible for the same corresponding deduction. Similarly, a creditor that earns interest on debt includes the interest in taxable income (subject to certain exemptions) whilst the dividends earned by a shareholder in relation to an equity investment are exempt from normal tax under section 10(1)(*k*) (subject to certain restrictions). Unless the context otherwise indicates, section numbers refer to the Income Tax Act. The analysis is limited to normal tax and does not consider the effect of dividends tax. The different tax treatment of the returns of debt and equity is likely to stem from the view that interest is a cost to a company whilst dividends are viewed as a distribution of remaining profits after all costs, including taxes, have been incurred.

Debt and equity have different commercial features. Debt has a senior creditor claim (compared to equity) in a company and typically yields a return in the form of interest. Equity is subordinated to debt and benefits from the residual profits and value in the company (Ross, Westerfield, Jordan and Firer, 2001). Debt is typically a lower risk instrument (compared to equity) that yields a more predictable but lower yielding return in the form of interest. Equity is typically a higher risk instrument (compared to debt) with more volatile and potentially higher returns in the form of capital appreciation and/or higher dividends. As equity benefits from the residual value of the company, profits that are not distributed as dividends should increase the value of the equity. Equity holders take on more business risk than debt holders. The value of equity is typically much more price sensitive to business risk factors and economic data insofar as it impacts on investors' perception of future company profitability. The value of debt is less sensitive to these factors as a reduction in future profitability will typically not impact on the company's ability to service the interest on its debt or redeem the principal debt at maturity. The price sensitivity of debt to a

company's profitability should only apply in extreme cases where the credit fundamentals of a company are affected to such an extent that the debt holder expects to not have the principal amount of the debt repaid or interest paid. Whilst commercial differences between debt and equity exist, if one takes the view that both debt and equity are merely alternative forms of financing, then a different treatment of the returns on debt and equity becomes difficult to justify. This is particularly relevant where the distinction between debt and equity becomes difficult to determine, as is often the case with hybrid instruments where features of both debt and equity are prevalent.

Whilst the legal nature and label of debt and equity normally dictates the tax consequences of the returns, the Income Tax Act incorporates specific sections to overcome perceived abuse of the tax base of the country and to tax instruments according to their true substance. Sections 8E, 8EA, 8F (as amended) and 8FA (as amended) serve to re-characterise the returns on debt and equity. Sections 23M (effective January 2015) and 23N serve to impose limitations on interest deductions particularly where the use of debt is deemed to be excessive. Section 24O, on the contrary, allows for interest deductions in circumstances that would not normally qualify in terms of the general deduction formula. The sections referred to in this paragraph are all required because of the different tax treatment of the returns on debt and equity. These sections include 1) key features of when the return on financial instruments should be treated as that applicable to debt or that applicable to equity, 2) when the use of debt or equity is deemed appropriate, and 3) when the deduction of interest from income should be allowed. The different tax treatment of the returns on debt and equity, and the need to introduce the sections mentioned in this paragraph to address these concerns creates complexities in the tax system.

It is the writer's contention that these complexities may be avoided through an equal tax treatment of the returns on debt and equity. Three alternative proposals are considered. Two major reform proposals namely the comprehensive business income tax and the allowance for corporate equity have been developed internationally to deal with the different tax treatment of the returns on debt and equity. Whilst the comprehensive business income tax provides that neither a return on debt nor a return on equity may be deducted, the allowance for corporate equity provides for the

deduction of an imputed return on equity together with the existing deduction for interest on debt (Bond, 2000; Devereux and Freeman, 1991). The third alternative proposal for a tax system is one that allows for a deduction of dividends paid. The alternative tax systems will be reviewed in order to establish whether the taxation of the returns on debt and equity could be improved or simplified in South Africa.

The Research Problem

The Statement of the Problem:

How could the taxation of the returns on debt and equity in South Africa be improved or simplified?

The Sub-Problems

The first sub-problem is to understand the commercial characteristics and legal nature of debt and equity.

The second sub-problem addresses the tax treatment of the returns on debt and equity and the implications of the different tax treatment for companies and investors. The need to limit interest deductions from a company's income and the reclassification of the returns on debt and equity is reviewed.

The third sub-problem considers alternative proposals intended to remove the different tax treatment of the returns of debt and equity. The comprehensive business income tax and the allowance for corporate equity proposals will be considered in a South African context. A system that allows for a full deduction on dividends paid will also be considered as an alternative approach to taxing the returns on equity in South Africa. The three alternative models above will be investigated in order to assess whether South African tax legislation dealing with the returns on debt and equity can be improved or simplified.

Research Methodology

The research follows a qualitative research methodology and consists of a review of international and South African literature and South African legislation. The literature review includes books, periodicals, government media releases, tax cases and online articles.

Scope and Limitations

The research is focused on South Africa but draws on international principles of debt and equity as determined by international statutes and courts.

Chapter 2: The definitions and key commercial attributes of debt and equity

Financial instruments can take the form of debt or equity. It is important to understand how each are defined and the commercial attributes of each.

The National Treasury stated in the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012:

> Debt and share instruments have a number of differences in their features and their consequences.
>
> - In commercial terms, debt represents a claim on a specified stream of cash flows. In its purest form, this claim comes in the form of interest that is payable despite the financial performance of the debtor. Shares, on the other hand, represent a contingent claim by shareholders on dividends that are directly or indirectly based on company profits.
> - In tax terms, debt payments are typically deductible by the payer with the same payments being includible as income by the payee. Depending on the circumstances, a tax incentive may exist for a taxpayer to attach a label to a debt or a share instrument that differs from the underlying substance.

Debt:

A debt is normally structured as a contractual relationship whereby a creditor agrees to advance an amount to a debtor. The terms of the agreement would typically stipulate an amount of interest payable to the creditor in order to provide the creditor with a return on the amount advanced. The debtor would be obligated to return the amount advanced (principle amount) at the contractual maturity date.

The Oxford English Dictionary defines debt as:

> That which is owed or due; anything (as money, goods, or service) which one person is under obligation to pay or render to another.

The definition focuses on the obligation to repay an amount.

The Income Tax Act does not have a definition for debt. The definition of financial instrument in section 1 is wide and incorporates the concept of both debt and equity:

> "**financial instrument**" includes—
> (a) a loan, advance, debt, bond, debenture, bill, share, promissory note, banker's acceptance, negotiable certificate of deposit, deposit with a financial institution, a participatory interest in a portfolio of a collective investment scheme, or a similar instrument;
> (b) any repurchase or resale agreement, forward purchase arrangement, forward sale arrangement, futures contract, option contract or swap contract;
> (c) any other contractual right or obligation the value of which is determined directly or indirectly with reference to—
> (i) a debt security or equity;
> (ii) any commodity as quoted on an exchange; or
> (iii) a rate index or a specified index;
> (d) any interest-bearing arrangement; and
> (e) any financial arrangement based on or determined with reference to the time value of money or cash flow or the exchange or transfer of an asset;

Section 8E has a narrower definition of financial instrument and it is aligned to that of debt:

> "**financial instrument**" means any—
> (a) interest-bearing arrangement; or
> (b) financial arrangement based on or determined with reference to a specified rate of interest or the time value of money;

The International Financial Reporting Standards defines a financial liability in IAS32 as follows:

> A financial liability is any liability that is:

(a) a contractual obligation:
(i) to deliver cash or another financial asset to another entity; or
(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or…

The definitions above all make reference to the contractual obligation that one person has to another to repay an amount that is advanced by the creditor to a debtor. The Income Tax Act definitions include the concept of interest payable on the amount advanced.

Equity:

Section 1 in the Income Tax Act defines a share as follows:

"**share**" means, in relation to any company, any unit into which the proprietary interest in that company is divided.

The Companies Act 71 of 2008 ('Companies Act') has a very similar definition for a share in chapter 1 as follows:

"**share**" means one of the units into which the proprietary interest in a profit company is divided.

The Income Tax Act also defines an equity share in section 1 as follows:

"**equity share**" means any share in a company, excluding any share that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution;

The definitions for equity lacks the obligation to return an amount as is found in the debt definitions and instead refers to the right to a proprietary interest or ownership of a company. An equity share goes further to exclude shares that have limitations on the dividend rights or return of capital of the share.

Equity does not typically have contractual rights to dividends and any distributions are usually at the discretion of the board of directors. The board of directors of a company need to meet the solvency and liquidity requirements as set out in section 46 of the Companies Act in order to make a distribution. Debt has a contractual claim against a company as compared to equity which benefits from the residual interest in

the company. Debt has a senior ranking claim when compared to equity in terms of the Insolvency Act, 1936.

Commercial constituents of debt and equity:

Further to the definitions of debt and equity, it is also important to understand the commercial constituents of debt and equity. In the writer's opinion, the key commercial differences between debt and equity are 1) a factor of risk, 2) the tenor of the instrument, and 3) the rights to ownership and control of the company. Debt has a senior claim in a company (compared to equity) and offers no strategic bearing on the operations of the business, unless an event of default occurs. A debt provider has the right of repayment of the capital advanced and expects to receive an interest rate commensurate with the credit risk of the debt instrument. Debt holders receive no further right to participate in the profits of the company beyond this. Equity has rights to the residual profits and value of a company. Equity is of a perpetual nature and does not have rights of repayment on the capital advanced. Equity has no contractual rights to distributions as these are subject to the discretion of the board of directors as set out in section 46 of the Companies Act. Equity has a proprietary interest in a company, has voting rights and a level of control over the company.

Financial instruments that contain features of both debt and equity are common. The classification of such instruments as either debt or equity is not an easy task. Hefer JA said in *Erf 3183/1 Ladysmith (Pty) Ltd and Another v CIR* that 'the courts will not be deceived by the form of a transaction: it will rend aside the veil in which it is wrapped and examine the true nature and substance'. The true nature and substance of debt and equity should be considered in this context. There are international cases that deal with determining whether a financial instrument constitutes debt or equity and are helpful in determining the commercial attributes of debt and equity. In *Pepsico Puerto Rico Inc. v. Commissioner*, T.C. Memo 2012-269 (2012), the United States Tax Court was asked to consider whether certain advance agreements issued were more appropriately characterised as debt than as equity. The judgment relied on 13 factors (the 'Dixie Dairy Factors') that have developed over time in case law and were described in *Dixie Dairies Corp. v. Commissioner*.

The Dixie Dairy Factors are described below:

1. **Name or label**:

   ‘The issuance of a stock certificate indicates an equity contribution; the issuance of a bond, debenture, or note is indicative of a bona fide indebtedness.’ *Hardman v. United States*, 827 F.2d at 1412, as cited in *Dixie Dairies*.

2. **Fixed maturity date**:

   ‘The presence of a fixed maturity date indicates a fixed obligation to repay, a characteristic of a debt obligation. The absence of the same on the other hand would indicate that repayment was in some way tied to the fortunes of the business, indicative of an equity advance.’ *Estate of Mixon*, 464 F.2d at 404, as cited in *Dixie Dairies*.

3. **Source of payments**:

   ‘If repayment is possible only out of corporate earnings, the transaction has the appearance of a contribution of equity capital but if repayment is not dependent upon earnings, the transaction reflects a loan to the corporation.’ *Calumet Indus., Inc. v. Commissioner*, 95 T.C. at 287-288, as cited in *Dixie Dairies.*

4. **Right to enforce payments**:

   ‘A definite obligation to repay an advance, including interest thereon, suggests a loan obligation.’ *Laidlaw Transp., Inc. v. Commissioner*, *T.C. Memo* 1998- 232, as cited in *Dixie Dairies*.

5. **Participation in management as a result of the advances**:

   ‘The right of the entity advancing funds to participate in the management of the receiving entity’s business demonstrates that the advance may not have been bona fide debt and instead was intended as an equity investment.’ *Offshore, Inc. v. Commissioner*, 97 T.C. 579, 603 (1991), as cited in *Dixie Dairies*.

6. **Status in relation to regular corporate creditors**:

   ‘Whether an advance is subordinated to obligations to other creditors bears on whether the taxpayer advancing the funds was acting as a creditor or an investor.’ *Estate of Mixon*, 464 F.2d at 406, as cited in *Dixie Dairies.*

7. **Intent of the parties**:

'It is relevant whether the parties intended, at the time of the issuance of the debentures, to create a debtor-creditor relationship. The intent of the parties, in turn, may be reflected by their subsequent acts; the manner in which the parties treat the instruments is relevant in determining their character.' *A.R. Lantz Co*., 424 F.2d at 1333 (citing *Taft v. Commissioner*, 314 F.2d 620 (9th Cir. 1963), as cited in *Dixie Dairies*.

8. **Identity of interest between creditor and stockholder**:

'If advances are made by stockholders in proportion to their respective stock ownership, an equity capital contribution is indicated.' *Estate of Mixon*, 464 F.2d at 409; *Monon R.R. v. Commissioner*, 55 T.C. at 358), as cited in *Dixie Dairies*.

9. **Thinness of capital structure in relation to debt**:

'The purpose of examining the debt-to-equity ratio in characterising an advance is to determine whether a corporation is so thinly capitalised that repayment would be unlikely.' *CMA Consol Inc. v. Commissioner, T.C. Memo*. 2005-16, as cited in *Dixie Dairies*.

10. **Ability of corporation to obtain credit from outside sources**:

'The touchstone of economic reality is whether an outside lender would have made the payments in the same form and on the same terms.' *Segel v. Commissioner*, 89 T.C. at 828, as cited in *Dixie Dairies.*

11. **Use to which advances were put**:

'Where a corporation uses an advance of funds to acquire capital assets, the advance is more likely to be characterised as equity. Use of advances to meet the daily operating needs of the corporation, rather than to purchase capital assets, is indicative of bona fide indebtedness.' *Estate of Mixon*, 464 F.2d at 410, as cited in *Dixie Dairies*.

12. **Failure of the debtor to repay**:

'The repayment of an advance may support its characterisation as bona fide indebtedness.' *Estate of Mixon*, 464 F.2d at 410, as cited in *Dixie Dairies.*

13. **Risk involved in making advances**:

'A significant consideration in our inquiry is "whether the funds were advanced with reasonable expectations of repayment regardless of the

success of the venture or were placed at the risk of the business.' *Gilbert v. Commissioner*, 248 F.2d at 406, as cited in *Dixie Dairies*.

The court in *Dixie Dairies* noted that each factor is not equally significant, that no single factor is determinative and that not all of the factors are relevant to each case. *Pepsico Puerto Rico* goes further to say that 'The focus of a debt-versus-equity inquiry generally narrows to whether there was an intent to create a debt with a reasonable expectation of repayment and, if so, whether that intent comports with the economic reality of creating a debtor-creditor relationship' (*Fin Hay Realty Co. v. United States*, 398 F.2d 694, 697 (3d Cir. 1968), as cited in *Pepsico Puerto Rico*).

Dixie Dairies makes it clear that the determination of financial instruments as debt or equity is complex, depends on many factors and the surrounding factors to each case. It is often the intention of the taxpayer that needs to be assessed in order to determine whether a true debtor-creditor relationship was intended or rather an equity contribution in order to benefit from the profits and value of a company. A key commercial attribute of debt raised by *Pepsico Puerto Rico* is the repayment of the advance amount and inherent risk therein to not be of an equity nature (ie: reliant on the profits of the company).

Chapter 3: The current taxation of the returns on debt and equity in South Africa and the implications for companies and investors

The tax consequences of debt and equity are different both for the company and the investor. The interest expense on debt is allowed as a deduction under section 24J provided *inter alia* that it is incurred in the production of the income. A creditor in relation to interest earned includes the interest income in taxable income (subject to certain exemptions). Dividends declared on equity are viewed as a distribution of profits and do not allow for a deduction from income. Dividend income received by a

shareholder is exempt from normal tax under section 10(1)(*k*) (subject to certain restrictions).

Whilst the commercial attributes, risk profile and return expectations of debt and equity differ, they both constitute alternative forms of capital for a company. If one takes the view that debt and equity are merely alternative forms of capital for a company, both of which are used in the production of income, and both interest and dividends are expenses which a company is required to pay for the use of capital advanced to it, then any distinction between the return on debt and equity does not withstand scrutiny (Boltar, 1996). The reason for the different tax treatment seems to originate from the view that interest is a cost to a company, whilst dividends are a distribution of profits after all costs, including tax, have been paid.

The different tax treatment of the returns on debt and equity allow taxpayers to structure their capital requirements either as debt or equity and choose a tax treatment that suits their needs. This can be problematic as taxpayers are able to create financial instruments that take the legal form of debt but take on commercial characteristics of equity, and vice versa. The Income Tax Act seeks to overcome this by including certain sections that re-characterise interest as dividend *in specie* and dividends as income. Sections 8E and 8EA are specific sections targeting certain equity instruments with debt-like features. If applicable, these sections re-characterise dividend income as normal income in the hands of the holder, thus resulting in such amount being taxed in full. Interestingly, the section does not provide for a deduction for the issuing company should dividends be re-characterised as income. Further, sections 8E and 8EA do not serve to re-characterise dividends as interest but rather as income. Dividends affected by sections 8E and 8EA are therefore not impacted by sections of the Income Tax Act that specifically apply to interest or dividends as the re-characterised income is neither interest nor dividends. Sections 8F and 8FA are sections targeting debt instruments with equity-like features. These sections deem interest income as dividend *in specie* where applicable and are taxed accordingly. The deduction of the interest is disallowed for the issuing company and the debt holder receives an exempt return. Whilst the provisions of sections 8E, 8EA, 8F and 8FA ('Specific Sections') are technical and extensive, the intention here is to identify

which features of the Dixie Dairy Factors the Income Tax Act has identified in determining a financial instrument as debt or equity.

Section 8E has two main features being the redemption period and security that have a bearing on whether the return on certain shares will be treated as income.

1. **Redemption Period**: The obligation on the part of the issuer to redeem a share or the option on the part of the holder to have a share redeemed within three years from the date of issue of that share will serve to re-characterise the dividend income as income. Two Dixie Dairy Factors find application:
    1. fixed maturity date; and
    2. rights to enforce payments.

2. **Security**: Any preference share[1] that is secured by or subject to an arrangement in terms of which a financial instrument[2] may not be disposed of will also serve to re-characterise the return on the shares as income. The section includes a proviso that the re-characterisation is not applicable in circumstances where the funds derived from the issue of the preference shares was used for a so-called qualifying purpose as set out in section 8EA. The qualifying purpose is discussed further below. This impact of security on the classification of debt and equity bears closeness to the following Dixie Dairy Factors:
    1. source of payments;
    2. rights to enforce payments;
    3. status in relation to regular corporate creditors; and
    4. risk involved in making advances.

    The expectation of repayment for a preference share that benefits from a financial instrument as security is expected to be significantly higher and

[1] A preference share is defined in section 8EA:

> "**preference share**" means any share—
>
> (**a**) other than an equity share; or
>
> (**b**) that is an equity share, if the amount of any dividend or foreign dividend in respect of that share is based on or determined with reference to a specified rate of interest or the time value of money;

[2] This refers to the definition of financial instrument in section 8E referred to in Chapter 2.

less dependent on the corporate earnings of the company (which is characteristic of equity).

Section 8EA re-characterises dividends on so-called third party backed shares as income in certain cases. Third party backed shares refer to preference shares that benefit from an enforcement right that is enforceable against another party, or that other party has an enforcement obligation in relation to that share. Section 8EA covers situations where holders of preference shares enter into various other agreements linked to the performance of the preference shares with third parties in order to mitigate the risk inherent in the issuing company. Section 8EA (and the security provision described in section 8E) are not applicable where the proceeds of the preference shares are used for a so-called qualifying purpose and the enforcement right or enforcement obligation is enforceable against a specified list of persons. A qualifying purpose in summary refers to the proceeds of the preference shares being used for the direct or indirect acquisition of equity shares. The qualifying purpose also allows for the proceeds to be used for the refinancing of debt (and any associated interest thereon) or preference shares (and any associated dividends thereon) where the proceeds of the original funding was used to directly or indirectly acquire equity shares. The following Dixie Dairy Factors have been identified in section 8EA:

1. source of payments;
2. rights to enforce payments;
3. status in relation to regular corporate creditors;
4. use to which advances were put; and
5. risk involved in making advances.

It is common for debt providers to require guarantees from other companies within a group of companies in order to gain access to the assets and cash flow of the key operating companies within a group of companies. Section 8EA seems to address this debt-like feature.

Section 8F has three main features being conversion, payment obligation and redemption period that have a bearing on whether the interest on debt will be treated as a dividend *in specie* and not deductible for the issuing company.

1. **Conversion**: The obligation or entitlements on the part of the issuing company to convert or exchange debt for shares will re-characterise the interest on the debt as dividend *in specie*, and taxed accordingly. This provision does not apply where the market value of those shares is equal to the amount owed in terms of the debt at the time of the exchange. The following Dixie Dairy Factors find application:
    1. rights to enforce payments;
    2. intent of the parties;
    3. failure of the debtor to repay;
    4. risk involved in making advances.

    The ability of a company to extinguish a debt obligation through the issuance of shares at a value that does not reflect the capital amount advanced under a debt obligation lends itself to equity risk and is not reflective of a true debtor-creditor relationship.

2. **Payment Obligation**: in the event that the obligation of the company to pay an amount in respect of a debt is conditional on the market value of the assets of the company not being less than the market value of the liabilities of the company then the interest on the debt will be re-characterised as dividend *in specie*, and taxed accordingly. As mentioned in Chapter 2, the board of directors of a company needs to meet the solvency and liquidity requirements as set out in section 46 of the Companies Act in order to make any proposed distribution in terms of a share. One of the requirements of the solvency and liquidity test is for the market value of the assets of the company to exceed the market value of its liabilities. A payment obligation under this scenario has a direct link to the payment obligation under the return on equity, and is therefore equity-like in nature. The following Dixie Dairy Factors find application:
    1. rights to enforce payments;
    2. status in relation to regular corporate creditors;
    3. intent of the parties; and
    4. risk involved in making advances.

3. **Redemption Period**: if the repayment date of a debt instrument is greater than 30 years from redemption date then the debt instrument is seen as equity-like and the interest income taxed as dividend *in specie*. Whilst a debt with a repayment date of greater than 30 years may still technically have a repayment date it can be argued that the repayment is in many ways tied to the long term fortunes of the company, reliant on company profits and therefore indicative of an equity advance. Three Dixie Dairy Factors find application:
    a. fixed maturity date;
    b. intent of the parties; and
    c. risk involved in making advances.

Section 8FA provides that where the interest rate on a debt is not determined with some specified rate of interest or time value of money, or the interest rate is increased by reference to the profits of the company then that applicable portion will be re-characterised as dividend *in specie*, and taxed accordingly. A debt instrument with this type of feature bears closeness to the very definition of equity which gives equity the right to the remaining profits of the company. Three Dixie Dairy Factors find application, as the return on the debt instrument is more in line with what one would expect to find with equity. These include:

1. Source of payments;
2. Intent of the parties; and
3. Risk involved in making advances.

The taxation of the returns on debt and equity are clearly very different. The Income Tax Act attempts to overcome the ability of taxpayers to structure debt instruments with equity features and equity instruments with debt features. Certain aspects of the commercial nature of debt and equity as determined by international tax courts have found their way into South African tax legislation. It is the writer's opinion that is it unlikely for the South African courts to go beyond the Specific Sections and refer to international case law in order to determine the true nature and substance of a financial instrument. The Specific Sections have been enacted for this purpose and one would expect that the courts refer to the Specific Sections in order to address how to deal with these transactions. South African taxpayers therefore only need to refer to

the commercial features described in the Specific Sections. The key Dixie Dairy Factors that the Income Tax Act focuses on in the Specific Sections are:

1. Fixed maturity date;
2. Source of payments;
3. Rights to enforce payments;
4. Status in relation to regular corporate creditors;
5. Intent of the parties; and
6. Risk involved in making advances.

The implications of the current taxation of the returns on debt and equity is that companies and investors are able to structure their affairs in order to either receive an exempt return together with no corresponding deduction for the company, or a taxable return together with a corresponding deduction for the company, subject to the Specific Sections. From an issuing company's perspective, a debt instrument typically makes the most sense provided a tax deduction is allowed on the return on debt. An investor would typically be more interested in receiving an exempt return as is the case with the return on equity. With the prescriptive nature of the Specific Sections, taxpayers may be able to structure debt instruments that retain equity features and / or equity instruments that retain debt-like features. Investors may even want a return on a debt instrument to be re-classified as a dividend *in specie* and ensure that the debt instrument purposely falls within the scope of sections 8F or 8FA. The result is that taxpayers may still be able to structure their affairs where the returns on debt and equity do not necessarily conform to the commercial nature of debt or equity. In a cross-border context, it may also be that certain instruments qualify for equity or debt treatment in South Africa but as debt or equity, respectively, in another jurisdiction. The writer's contention is that the Specific Sections go some way in solving the issue of debt and equity not complying with their commercial nature but that they still allow for it in some shape or form (as will be expanded on in the next chapter). An equal treatment of the returns on debt and equity would remove the issue of debt and equity not complying with their commercial nature.

Chapter 4: The complications for taxpayers and the South African Revenue Service in the sections that limit or re-characterise the returns on debt and equity

Difficulty in determining debt and equity:

The writer's view is that the true determination of debt and equity is a difficult task particularly where the intention of the parties is a determining factor. The starting point is the label of the instrument but one has to consider the true nature and substance of the instrument. The inclusion of the Specific Sections into the Income Tax Act means that the return on equity or debt instruments will be taxed depending on the specific criteria described therein. In the writer's opinion one need only look at the Specific Sections in South African law in order to address the re-characterisation of the returns on debt and equity. It remains possible therefore for companies to issue equity instruments that retain certain commercial debt features or debt instruments that retain certain commercial equity features provided the instruments fall outside of the criteria set out in the Specific Sections.

Whilst the label or legal nature of the instrument will not be sufficient for tax purposes, the specific situations as described in the Specific Sections are very prescriptive and only consider some of the commercial features of debt and equity described by the Dixie Dairy Factors. The Specific Sections also serve to re-charaterise the return on debt and equity based on single factors. The court in the *Dixie Dairies* case noted that each of the Dixie Dairy Factors is not equally significant, that no single factor is determinative and that not all of the factors are relevant to each case. The complexity of the factors that comprise the commercial make-up of debt and equity as compared to the single factors in the Specific Sections makes it possible for equity instruments to still maintain various commercial debt features and its return not re-characterised accordingly, and vice versa. One single factor may also not be enough to re-characterise the nature of an instrument as either debt or equity. In substance the remaining factors may be more reflective of a true debt or equity instrument. The construct of the Income Tax Act therefore means that one could re-characterise the returns of debt and equity when the commercial reality does not justify it.

The prescriptive nature of the Specific Sections allows taxpayers to create financial instruments that purposely fall outside or are affected by the Specific Sections. This is illustrated through the following two examples.

> Example 1: It is possible to construct an equity instrument with debt features that simply fall outside the scope of sections 8E and 8EA. For example a preference share transaction with a redemption date of 3 years and 1 month (ie: greater than 3 years) will fall outside of the scope of section 8E. The principle of redemption however remains in the equity instrument and yet does not re-characterise the nature of the return. Similarly, a debt instrument with a repayment date of 29 years and 11 months (ie: less than 30 years) could also be implemented. It is arguable that the instrument is more equity-like as the repayment date is so far in the future. The return maintains its debt nature from a tax perspective given that the 30 year requirement in section 8F is not met.
>
> Example 2: An investor may wish to invest in an instrument that yields income that is exempt whilst the investee company may not wish to issue shares or preference shares. The investee company may be able to issue a loan and ensure that it includes a feature found in section 8F or 8FA, for example the obligation to make an interest payment requires the market value of the assets of the company to exceed the market value of the liabilities. The interest income on the loan would then be re-characterised as dividend *in specie*. It could be argued that in this case the instrument is in substance still a debt instrument as the remaining factors outweigh this single factor, yet the company is able to ensure an exempt return through the re-characterisation applicable in section 8F. Furthermore, the company is not required to comply with all of the requirements as set out in sections 8E and 8EA had it issued shares or preference shares, as these sections do not deal with debt instruments.

The test for a debt is ultimately to test whether a true debtor-creditor relationship was intended. The Specific Sections may serve to capture some of the commercial

arrangements that trigger a debt or equity-like instrument but will never in the writer's opinion be able to fully capture the intention of the parties entering into a financing transaction. The analysis is not meant as a criticism of the Specific Sections but rather intended to illustrate the practical difficulties in drafting the various commercial aspects of debt and equity. It is very difficult to include all the features that make-up the commercial features of debt and equity as described by the Dixie Dairy Factors, especially given that not all the features are always relevant in each case, and that the surrounding facts and circumstances need to be considered.

The result of the above is that the intention of the Specific Sections could be defeated given that not all of the commercial features of debt and equity can, in the opinion of the writer, be drafted into legislation. In addition, with the prescriptive nature of the Specific Sections, it remains possible to structure financial instruments to fall outside or purposely into the Specific Sections and not be impacted, or may purposely be impacted, by the legislation.

Inconsistency in determining debt and equity:

The Specific Sections consider different commercial factors for sections 8E and 8EA as compared to sections 8F and 8FA. Where similar commercial factors are considered, the requirements are different. Section 8E has the fixed maturity date and security as its two debt-like characteristics. Section 8EA considers support provided from third parties as its debt characteristic. Section 8F has the convertibility of debt into equity, the obligation to repay the debt and the fixed maturity date as its factors. Sections 8FA has a reference to a capped interest rate with reference to the time value of money as its commercial factor of debt.

There are two factors that apply to both 8E and 8EA, and 8F and 8FA. The first is a capped return that references an interest rate or time value of money. This concept has been incorporated into the definitions of a 'hybrid equity instrument' in section 8E and definition of 'preference share' in section 8EA. This concept is also present in the definition of 'hybrid interest' in section 8FA. The other factor that has been consistently applied is the redemption period of the instrument. The concept of a

redemption period is included in the definition of 'hybrid equity instrument' in section 8E and refers to a period of 3 years from the date of issue. Three years is therefore the critical date for the Income Tax Act whereby equity 'crosses the rubicon' and its return taxed like the return on debt. The redemption period is included in the definition of 'hybrid debt instrument' in section 8F and refers to a period of 30 years from the date of issue. The determination for debt to be reclassified as equity is therefore set at 30 years. Any instrument that has a redemption date of less than 3 years from the issue date is therefore clearly debt-like, whilst any instrument that has a redemption date of greater than 30 years from issue date, is clearly equity-like, for the Income Tax Act. A redemption date between 3 years and 30 years remains unaffected by the Specific Sections and provide no guidance as to its nature.

The writer is of the view that a section that sets out a consistent set of parameters for both debt and equity would be more helpful for taxpayers should a different tax treatment on the return on debt and equity be the preferred approach.

Funding of Equity

The Income Tax Act requires, *inter alia,* in terms of section 11(*a*) that expenditure and losses are to be incurred in the production of the income, as part of the general deduction formula, in order to qualify for a deduction.

Income is defined in section 1 as follows:

> "**income**" means the amount remaining of the gross income of any person for any year or period of assessment after deducting there from any amounts exempt from normal tax under Part I of Chapter II;

Dividends are exempt from normal tax (subject to certain restrictions) under section 10(1)(*k*)[3] and do not form part of income as defined. Companies that wish to fund the acquisition of shares with the use of debt will not be able to claim the interest

[3] **10. Exemptions**. – (1) There shall be exempt from normal tax –

> …
> (*k*) (i) dividend (other than dividends paid or declared by a head quarter company) received by or accrued to any person…

expenditure as a tax deduction in the ordinary course. On the other hand the lender will be taxed on the interest income earned.

Section 24O does deem interest to be in the production of income if the company uses the proceeds of the debt to acquire equity shares but only in instances where the acquiring company becomes a controlling group company (>70% ownership) in relation to the acquired company. The deduction for interest paid or incurred in respect of the debt is limited in terms of section 23N to:

- 40 per cent of the debtor's taxable income (before taking into account interest received or accrued and interest paid or incurred); plus
- Interest received or accrued; less
- Interest paid or incurred in respect of debt falling outside the limitation.

Whilst section 24O is helpful for taxpayers, it has its limitations and only applies in certain circumstances described above. Companies in South Africa therefore find debt funding to be an inefficient form of funding to acquire shares from a tax perspective where section 24O cannot be used to claim a deduction for interest paid or incurred.

It makes sense for the acquisition of shares to be funded with equity as the inability to deduct the interest is matched with an exempt return for the investor. A well-established preference share market has developed in South Africa and is often used in situations where the issuer of the preference shares uses the funds to acquire equity shares. A preference share is defined in section 8EA as follows:

> "**preference share**" means any share—
> (a) other than an equity share; or
> (b) that is an equity share, if an amount of any dividend or foreign dividend in result of that share is based on or determined with reference to a specified rate of interest or the time value of money;

An equity share is defined in section 1 as follows:

> "**equity share**" means any share in a company, excluding any share that, neither as respects dividends nor as returns of capital, carried any right to participate beyond a specified amount in a distribution;

A preference share as defined is therefore a share where a limitation is placed on the dividend or return of capital from that share or where the dividend or foreign dividend makes reference to a specified rate of interest or the time value of money. Preference shares as defined are therefore very clearly debt-like equity instruments.

Preference shares can be used as an alternative form of financing in instances where a company wishes to acquire equity shares. As the instrument yields an exempt dividend, the mismatch of non-deductibility for the issuer and taxation of the interest for the investor is avoided. The exempt nature of the dividend would typically also mean that the investor is able to accept a lower return. Preference shares are often redeemable in nature which is a further feature of debt. Investors often wish to improve the credit position of preference shares, as one would expect with debt. This is often done by the investor entering into certain security arrangements and / or benefiting from guarantees from other group companies or the right to put the preference shares to another group company in certain situations. It is arguable that the risk of these preference shares is therefore more akin to debt than to equity.

Sections 8E and 8EA allow for equity instruments to have debt-like features in circumstances where the proceeds are used to acquire equity shares in operating companies, or to refinance debt (and any associated interest thereon) or preference shares (and any associated dividends thereon) that were originally used to acquire shares in an operating company. The requirement for interest to be in the production of income in order to qualify for a deduction and the different tax treatment of debt and equity has in the writer's opinion exacerbated the need for equity with debt-like features in South Africa. The purpose of preference shares is therefore critical when the investor is looking to improve the credit position of the preference shares.

It is interesting and problematic that the issuing company's purpose in terms of the 'qualifying purpose' affects the tax nature of the returns on the preference shares in the hands of the holder. The purpose to which the issuer used the funds is not within the control of the holder, and can create complications particularly given that sections 8E and 8EA are very technical in nature and subject to interpretation. There may be instances where the technical wording of the legislation may not conform to the perceived intention of the legislation.

In summary, it is the writer's contention that the construct of the current Income Tax Act exacerbates the need for debt-like equity instruments in order to overcome the non-deducibility of interest by issuing debt to fund the acquisition of equity. The

various security positions, exclusions and interpretation needed for the sections 8E and 8EA makes for a complicated tax system.

Leverage and Debt Profit Shifting

The deductibility of interest on debt can create distortion in the financing decisions of companies. Fatica, Hemmelgarn and Nicodème (2012) identify two types of economic distortions, being the shifting of taxable profits from one jurisdiction to another through the use of interest on debt (described as debt profit shifting) and excessive use of debt.

The deductibility of interest creates opportunities to shift and decrease taxable income via debt-shifting arrangements and the use of hybrid instruments. The different tax treatment of the returns on debt and equity creates opportunities for companies and investors to either keep the tax base in the company through the use of equity or shift the tax base from the company to the investor through the use of debt. This is most relevant amongst companies that form part of the same economic unit and in international situations where the borrower is in a high tax jurisdiction and the investor is in a low tax jurisdiction (de Mooij, 2011). Even outside the cross-border group company context, the deductibility of interest creates the incentive for companies to use debt financing. Interest is typically payable regardless of the profitability of the company and can add financial distress on a company and ultimately add to systemic risk of a country (de Mooij, 2011). The different tax treatment of the returns on debt and equity can create the incentive for poorly capitalised companies which in turn can increase systemic risk.

The National Treasury published a request for public comment in April 2013 for incorporation in the 2013 Tax Laws Amendment Bill for proposed limitations against excessive interest tax deductions in April 2013. The background commentary summarises National Treasury's concerns on interest deductibility:

> Over the past several years, tax schemes by some corporates have become an increasing concern locally as well as globally. The recent OECD paper notes that "while there are many ways in which domestic tax bases can be eroded, a significant source of base erosion is profit shifting". One of the most significant types of base erosion in South

Africa comes in the form of excessive deductions by some corporates with income effectively shifted to a no-tax or low-tax jurisdiction or converted to a different type of income in another jurisdiction. These deductions are typically channeled as interest, royalties, service fees and insurance premiums. Of greatest concern is excessive deductible interest (*writer's emphasis*). In terms of excessive deductible interest, Government has identified four recurring concerns:

1. **Hybrid Debt**: Hybrid debt instruments essentially involve instruments with the label of debt but with substantive features being more indicative of shares (equity). These instruments are typically labeled as debt in South Africa so that payments are deductible. However, these instruments are often labeled as equity in the other jurisdiction so as to benefit from cross-border arbitrage. Most of these instruments would otherwise be labeled as shares if tax were not a consideration.

2. **Connected person debt**: The relationship between creditor and debtor often becomes blurred once both parties form part of the same economic unit. This situation often arises when a parent company lends money to a wholly owned subsidiary. In this situation, the terms of the instrument are somewhat irrelevant because both parties can change the terms at will to serve the overall interests of the group. As a result, the debt label for instruments in these circumstances is often driven by tax and other regulatory factors; whereas, the payments often represent substantive capital contributions to be repaid only if the subsidiary at issue is profitable.

3. **Transfer pricing**: In a cross-border context, excessive interest can arise if the interest yield is driven by tax considerations as opposed to arm's length commercial reasons, especially if the debtor and creditor are connected persons. Also of concern is "lending" that would not arise in a commercial context. In these cases, transfer pricing adjustments can be used to eliminate debt with excessive interest or excessive debt.

4. **Acquisition debt**: While the need to obtain debt financing for acquisitions is well understood, excessive debt becomes problematic because excessive debt (or over gearing) is often anchored on the expectation that the interest will be paid from future profits. If allowed to extremes, the interest on the debt often eliminates taxable profits for years to come. Acquisition debt of greatest concern is mezzanine and subordinated debt (i.e. debt containing an escalating number of equity features). Besides tax concerns, excessive debt gives rise to governance concerns with the excessive debt creating excessive risk (as a number of entities and economies have "painfully" discovered in recent years).

The Income Tax Act introduced sections 8F and 8FA in order to cover the concern raised by hybrid debt instruments. Section 23K was effective until 31 March 2014 and limited the interest deduction in respect of debt used for a group reorganisation transaction or an acquisition transaction as defined. The section provided that no deduction was allowed in respect of interest incurred for debt used for an acquisition in terms of a reorganistion transaction as defined in section 23K or for the purpose of the acquisition of an equity share in a company in terms of section 24O. The

acquiring company was able to seek a directive from the Commissioner[4] stating that the deduction of the interest was allowed.

Section 23K was replaced with a more formulaic limitation of interest deductions in respect of reorganistion and acquisition transactions described above. This is set out in section 23N (effective 1 April 2014) and covers the concern raised through the use of acquisition debt. Section 23M (effective 1 January 2015) relies on the same formulae and applies to interest deductions in respect of debts owed to persons not subject to South African tax in terms of chapter 2 of the Income Tax Act. This covers the concern on connected person debt and transfer pricing. Whilst section 23K has its advantages in that the Commissioner could examine the entire transaction and all the surrounding facts and circumstances, it was not practical for taxpayers seeking debt-financing when attempting to acquire control of companies. National Treasury stated that deal making of this nature needs clear guidelines when seeking finance before core negotiations can be undertaken (National Treasury, 2013). The deduction for interest paid or incurred in respect of the debt is limited in terms of sections 23M and 23N to:

- 40 per cent of the debtor's taxable income (before taking into account interest received or accrued and interest paid or incurred); plus
- Interest received or accrued; less
- Interest paid or incurred in respect of debt falling outside the limitation.

The legislation required to combat the various concerns comes as a direct result of the deductibility of interest, whilst the same deduction is not afforded to dividends. The sections are relevant where debt is used in circumstances where the National Treasury believe that equity should be the correct instrument or where the amount of debt is deemed to be excessive. The deductibility of the return on debt as compared to the return on equity can therefore create a riskier economic system through the increased use of debt increasing the systemic risk in the economy. The need for all the various

[4] Commissioner is defined in section 1 as:

> "**Commissioner**" means the Commissioner for the South African Revenue Service appointed in terms of section 6 of the South African Revenue Service Act, 1997 (Act No. 34 of 1997), or the Acting Commissioner designated in terms of section 7 the that Act.

pieces of legislation required to combat the use of leverage, creates in the writer's opinion, a more complicated taxation system.

Chapter 5: Alternatives to the different tax treatment of the returns on debt and equity

The different tax treatment of debt and equity leads to a complicated financial system particularly in the case of hybrid instruments that have commercial features of both debt and equity. If one takes the view that debt and equity are merely alternative forms of funding with different risk and return profiles, then a different tax treatment is difficult to justify. The writer is of the view that debt and equity serve to separate a company's capital structure into tranches. Debt has a senior-ranking claim with a return that is commensurate with the risk. Equity has a subordinated claim and is exposed to all of the residual risk and profits of the company. De Mooij (2012) states that the original rationale to allow a deduction for only debt namely that interest is a cost of doing business and equity returns reflect business income, makes no sense economically. He states that 'in economic terms, both payments represent a return to capital and there is no a priori reason to tax one differently from the other' (De Mooij, 2012). With the difficulties of an unequal tax treatment of the returns on debt and equity, together with no compelling economic reason as to why this should be the case, then an equal tax treatment of debt and equity should be seriously considered.

Two major reform proposals namely the comprehensive business income tax and the allowance for corporate equity have been developed internationally to deal with the issue. The US Treasury proposed the comprehensive business income tax in 1992 whilst the Capital Taxes Committee of the Institute for Fiscal Studies elaborated the allowance for corporate equity system in 1991 after originally being advanced by Boadway and Bruce in 1984 (Devereux and Freeman, 1991). The comprehensive business income tax provides that neither interest nor a return on equity may be deducted. In other words the return on debt is treated like the return on equity from a

tax perspective. The allowance for corporate equity provides for, besides the deduction of debt interest, also for the deduction of an imputed return on equity from the profit tax base (Bond, 2000). The tax treatment on the return on equity therefore bears a closer resemblance to the tax treatment on the return on debt. Both models are focused on increasing neutrality with regard to the investment and financial decisions of companies and to reduce the distortions in the existing tax system. An alternative to the allowance for corporate equity is to allow for a deduction of all dividends paid together with a corresponding taxation of dividends in the hands of the holder. The comprehensive business income tax, allowance for corporate equity and a deduction of dividends will be considered as alternatives to the existing tax system.

Comprehensive Business Income Tax

The comprehensive business income tax ('CBIT') seeks to eliminate the incentive for debt-financed investment by disallowing a deduction for interest payments (Mooij and Devereux, 2009). The neutrality between debt and equity is achieved by treating the returns on debt like the returns on equity from a tax perspective. In order to avoid double taxation an exemption or credit should also be provided for interest earned.

The comprehensive business income tax model serves to simplify the taxation of debt and equity. With an equal treatment of the returns on debt and equity the Specific Sections would become irrelevant and could therefore be repealed. Concerns of thin capitalisation and debt profit shifting would also be removed as the incentive to use debt for interest deductibility purposes would no longer apply. One would expect companies to make use of debt and equity instruments for the commercial purposes for which they were intended and not be swayed by the different tax consequences of each. The incentive to use hybrid instruments (specifically debt instruments with equity-like features) would decrease as the tax advantage of debt is eliminated. One would expect better capitalised companies leading to a more stable financial system with reduced systemic risk. The comprehensive business income tax therefore has many positive benefits.

There are no real-world experiments of actual CBIT regimes. Yet, countries have imposed reforms that limit the deductibility of interest in some way, usually through thin-capitalisation rules (Mooij and Devereux, 2009). Sections 8F, 8FA, 23K, 23M and 23N are examples where this has been introduced in South Africa. The South African legislation therefore has some features contained in the comprehensive business income tax model but as stated earlier, is ultimately intended to cover situations where debt instruments have equity characteristics or excessive debt is used. The sections described above therefore cover specific concerns and fall short of the implications of a full comprehensive business income tax which would effectively eliminate the need for the sections described above altogether.

The comprehensive business income tax is a broad based tax on capital at the level of the firm (Mooij and Devereux, 2009). The model raises the cost of capital on debt-financed investments and broadens the tax base. With companies being responsible for a significant portion of economic activity, an increase in the cost of investment could have a materially negative impact on economic growth as fewer investment decisions become profitable. The widening of the tax base means that the corporate tax rate could potentially be reduced and could mitigate some of the effects of the comprehensive business income tax. Sorenson (2007) states that on balance the cost of capital for low yielding investments financed by debt is likely to rise, leading to lower investments. The Medium Term Budget Policy Statement 2014 states that one of the challenges of the South African government is to encourage greater private-sector investment in the economy. It was stated that 'removing obstacles to private investment must be a priority for government at all levels' (Medium Term Budget Policy Statement, 2014). New ventures may yield marginal returns for a number of years before they become more profitable. The comprehensive business income tax benefits companies that are profitable and arguably at a time when less tax relief is needed. The comprehensive business income tax is therefore in contrast to the objectives of the National Treasury.

The comprehensive business income tax is a diversion from the economic cost of financing investment. Interest is an economic cost of capital necessary to fund investment and is currently deductible in terms of the general deduction formula. A model that disallows interest as an economic cost may serve to neutralise and thereby

simplify some features of the tax treatment of the returns on debt and equity, but is not reflective of the true economic cost of borrowing. Introducing economic distortions into the tax system does not, in the writer's opinion, improve the taxation of the returns on debt and equity. The distortions of the comprehensive business income tax can be illustrated by the following example:

Current	**CBIT 1**	**CBIT 2**	
1000	1000	1500	Profit Before Interest and Taxes
-200	-200	-200	Interest
800	**800**	**1300**	Profit Before Tax
-224	-280	-420	Tax (28%)
576	**520**	**880**	Profit After Tax
28%	35%	32%	Effective Tax Rate (Tax / Profit Before Tax)

'**Current**' refers to a hypothetical company that is taxed under existing legislation, specifically where the interest charged is allowed as a deduction. '**CBIT 1**' refers to the same company that is taxed under the comprehensive business income tax (ie: where no deduction is allowed for interest). '**CBIT 2'** refers to another more profitable company taxed under the comprehensive business income tax (ie: where no deduction is allowed for interest).

The example illustrates how the effective tax rate of a company increases as a result of the comprehensive business income tax. This is depicted by the effective tax rate for CBIT 1 being higher than Current. The example also shows the volatility of the effective tax rate of companies under the comprehensive business income tax for different levels of profitability as the effective tax rate is lower under CBIT 2 than CBIT 1. The example shows how the comprehensive business income tax benefits more profitable businesses. Highly profitable investments financed by equity will be taxed lighter so that these investments will expand. The comprehensive business income tax will therefore serve to lower the effective tax rate on already profitable business and increase the effective tax rate on lower yielding investments (Sorenson, 2007). Whilst the current tax system may be prejudicial to equity financed companies, the comprehensive business income tax prejudices marginal investments that are funded with debt.

It is likely that the comprehensive business income tax model could be seen as an obstacle to private investment and met with resistance in South Africa. The introduction of economic distortions brought about by the comprehensive business income tax would not in the writer's opinion improve the taxation of the returns on debt and equity in South Africa. The implementation of the comprehensive business income tax in its entirety in South Africa seems unlikely when considering the objectives of the National Treasury.

Allowance for Corporate Equity

Allowance for corporate equity attempts to obtain neutrality between debt and equity by allowing for a notional interest deduction on the book value of equity. Isaacs (1997) summarised equity for this purpose as:

- shareholders' funds for the previous period (if any), plus
- any new equity contributed, plus
- any allowance for corporate equity for the previous period, plus
- any taxable profits for the previous period, plus
- dividends received and amounts realised in disposals of other companies' shares,

less

- the tax paid on those profits, plus
- dividends and distributions to shareholders and capital repaid, plus
- amounts invested in the share capital of other companies.

IFS Capital Taxes Group (1991) stated that 'the amount of the allowance in any period will be calculated by reference to a normal commercial rate of interest, fixed by the government and based on the current rate for medium-dated gilts'.

The allowance of corporate equity is a tax on economic rents as no tax is levied on projects with a return that matches the cost of capital (Mooij and Devereux, 2009). To the extent that the allowance for corporate equity represents a company's required rate of return, there should be the beneficial effect that a marginal investment would

not be deterred by the tax (Isaacs, 1997). The model serves to reduce the cost of capital and increase the profitability of an investment, particularly for marginal and asset intensive projects.

IFS Capital Taxes Group (1991) stated that 'the obvious result of such a reform, so far as the company is concerned, is that it is largely unconcerned as to whether it finances itself by raising debt or equity or through retained profits. In any case, the normal rate of return on such capital (as represented by the rate fixed by the government for equity capital or retained profits and by the actual interest rate paid on its debt) is effectively exempt from tax and is taxable only at the personal level.'

Klemm (2007) provides for the following list of advantages of the allowance for corporate equity (provided that the correct notional interest rate is chosen).

- **Neutrality for financing choices.** Firms will be indifferent to debt or equity finance, at least regarding the corporate tax implications.
- **Neutrality to investment.** No tax is charged on marginal projects, as for such projects the notional return will exactly match the pre-tax profits. Hence any investment that would be worthwhile in the absence of tax remains worthwhile when taxed.
- **Method of tax depreciation is irrelevant.** Any increase in depreciation in early years, will reduce the stock of equity and hence the allowance for corporate equity in later years, which exactly offsets in net present value terms any benefit from earlier depreciation.
- **Unaffected by inflation.** Any increase in monetary profits that is due to inflation will be offset by a higher notional return, as the notional interest rate will also be higher as a result of inflation. Indexation is therefore unnecessary.

Klemm (2007) provides for the following disadvantages of the system:

- **Higher corporate tax rate.** Because of the narrower tax base, a higher tax rate needs to be set if the same amount of revenue is to be collected. This could be harmful in the presence of tax competition for mobile economic rents.

- **Doubtful double tax relief.** There may be doubts as to whether other countries will accept corporate tax payments under an allowance for corporate equity system.

A major drawback of the allowance for corporate equity (for the National Treasury's perspective) is a reduction in the corporate tax base and resultant corporate tax revenue. The allowance for corporate equity does not specifically call for the taxation of the returns on equity in the hands of the holder in order to counter the erosion of the tax base. The loss in corporate tax revenue could be overcome through an increase in the corporate tax rate but this too may lead to unfavourable outcomes. Higher corporate tax bases would make a country less attractive environment for investment especially in a global environment where economic rents can be shifted to offshore jurisdictions (Mooij and Devereux, 2009).

An allowance for corporate equity system with an increased tax rate would favour capital intensive projects with high asset bases and discriminate against highly profitable projects with lower asset values. Isaacs (1997) states that the allowance for corporate equity 'would radically redistribute the burden of taxation between different companies — those earning below the average return on capital gaining and those with a higher rate of return losing. For better or worse, however, the broad pattern is clear, with the more successful companies suffering a tax increase and the less successful enjoying a tax reduction.' Highly profitable businesses would therefore effectively be subsidising the reduction in tax paid by less profitable ones which is more consistent with the progressive income tax system applicable to natural persons.

The applicable rate of the notional interest deduction on the book value of equity for the allowance for corporate equity should be considered in the context of achieving neutrality between the use of debt and equity. Bond and Devereux (1995) suggest that the appropriate notional return of the allowance for corporate equity should be the risk-free nominal interest rate, as the tax advantage is certain. The writer is of the view that the appropriate notional return should be the cost of debt for the company in the case where neutrality of the return on debt and equity is the primary goal. A rate that is less than that would mean that the tax benefits of debt would still be higher than equity for the issuing company, despite it being reduced. A notional return for

the allowance for corporate equity that is higher than debt would mean that the tax benefits for a company of using equity are higher than that of debt. If the ultimate intention of the allowance for corporate equity is to create neutrality between debt and equity and for companies to not be swayed by the tax treatment of the returns on each, then an equal rate needs to be applied to both debt and equity in order to determine the allowance to be granted.

There have been various countries that have experimented with an allowance for corporate equity. Italy, Croatia and Austria all implemented the allowance for corporate equity or models that draw on the principles found in allowance for corporate equity but have subsequently all abolished the system. Brazil and Belgium are currently the only two countries that implement an allowance for corporate equity type system.

Brazil applies a variant of the allowance for corporate equity whereby a so-called remuneration of equity can be paid as interest and be deducted at the corporate level. The remuneration applies to distributed profits only and applies to the book value of equity with a rate equal to that on long-term loans (Mooij and Devereux, 2009). The empirical evidence of Klemm (2007) had the following three key findings:

1. a small reduction in debt;
2. an increased dividend payout of companies; and
3. ambiguous results on the impact on the level of investment.

Belgium introduced an allowance for corporate equity system in 2006. The so-called notional interest deduction applies to all companies subject to Belgian corporate tax to deduct from their income a fictitious interest calculated on the basis of their shareholder's equity (net assets). The main purpose of the measure was to reduce the tax discrimination between debt and equity. The rules were stated to have the following positive effects:

1. A general reduction of the effective corporate tax rate for all companies, and a higher return after tax on investment
2. The promotion of capital-intensive investments in Belgium, and an incentive for multinationals to examine the possibility of allocating such activities as intra-group financing, central procurement and factoring to a Belgian group entity.

Kestens, Cauwenberge and Christiaens (2012) investigated whether changes in the debt ratios of Belgian small and medium-sized enterprises reflect changes in tax incentives induced by the notional interest deduction, up to three years after its introduction. To measure the tax incentives of the notional interest deduction, they incorporated the notional interest deduction into a simulation procedure of marginal tax rates. The result was that 1) the notional interest deduction caused a significant decline in the average simulated marginal tax rates and 2) the change in simulated marginal tax rates due to the introduction of the notional interest deduction was significant in explaining the change in debt ratios.

The ability to achieve neutrality between debt and equity through an equal treatment of the returns on debt and equity through the allowance for corporate equity model has its advantages and disadvantages. In the writer's opinion, the allowance for corporate equity model is a better model from an economic standpoint than the existing South African tax system and the corporate business income tax model. The model is more reflective of the economic cost of capital as both debt and equity have a cost necessary to attract capital. This is true regardless of the commercial nature and return expectations of debt and equity. Whilst many countries that introduced the allowance for corporate equity have subsequently abolished it, Belgium is still using the system today and Brazil is using a variant thereof.

Tax Deduction for Dividends

A further alternative to the comprehensive business income tax and the allowance for corporate equity is to allow for a deduction of all dividends paid together with a corresponding taxation of dividends in the hands of the holder. The system would mean that dividends are essentially treated as interest, ensuring neutrality between debt and equity financing. This system results in a tax on all undistributed profits of a company (Boltar, 1996). The burden of income tax is shifted from the company to the equity holder and only remaining income is taxed at the company level. The introduction of such a system is closely aligned to the general deduction formula. It is

arguable that dividends are expenditure, actually incurred, during a year of assessment, in the production of the income, not of a capital nature and laid out for the purposes of trade. The requirements of the general deduction formula are therefore met. A return on equity is equally required as a return on debt in order to attract investors and there is no compelling reason as to why it should be treated differently.

A tax deduction for dividends discriminates against firms that wish to use profits to finance future investment and creates the incentive for companies that pay dividends. In this regard, the allowance for corporate equity is a better tax as all companies benefit equally for its equity capital regardless of its dividend policy. The tax deduction for dividends on the other hand creates a much simpler system to regulate and is less costly to the fiscus. A deduction of a notional interest rate on equity under the allowance for corporate equity model, without a corresponding inclusion of the notional interest rate on equity in the hands of the equity holders, means that tax revenue is significantly reduced. A tax deduction for dividends for the issuer should provide for the taxation of dividends paid for the holder. The fiscus is therefore arguably no worse off by allowing for a tax deduction for dividends as the burden of tax is simply shifted from the company level to the equity holder for the return on the equity.

One of the potential benefits achieved through the neutrality of the returns on debt and equity is that the incentive for debt financing is reduced, thereby reducing systemic risk with better capitalised companies. One may argue that a deduction of dividends creates the incentive for companies to distribute profits to shareholders through dividend payments and that this too leads to poorly capitalised companies. Whilst this incentive may exist, the fact that the directors of a company need to pass the solvency and liquidity requirements as set out in section 46 in the Companies Act together with the fact that directors of a company are not obligated to pay dividends, counters this risk. A tax deduction for dividends should therefore reduce the systemic risk as compared to the current model.

Chapter 6: Conclusion

The different tax treatment on the returns on debt and equity is an international system and seems to originate from the view that interest paid on debt is an expense to a company whereas dividends represent a distribution of after tax profits. Dividends are exempt as the income has already been taxed at the corporate level. This paper serves to highlight some of the difficulties that the different tax treatment of the returns on debt and equity creates. The issue becomes particularly pronounced in the case of hybrid instruments where commercial features of debt and equity are present. The different tax treatment on the returns of debt and equity creates the need to look at the commercial nature of debt and equity and the need for the Income Tax Act to incorporate a host of legislation to counter potential abuse of the South African tax base and limit excessive interest deductibility. The Specific Sections introduced into the Income Tax Act have been compared to the Dixie Dairy Factors in so far as the commercial attributes of debt and equity are concerned. Whilst the Specific Sections go some way to overcome the issues associated with the difference tax treatment on the returns on debt and equity, there remains significant scope for commercial attributes of debt to be incorporated into equity instruments and vice versa. The need for the Specific Sections together with sections 23M, 23N and 24O add an additional layer of complexity into the South African tax system. The amount of amendments to the Specific Sections to counter all these various concerns clearly takes a significant amount of time all of which could be eliminated through an equal treatment of the returns on debt and equity.

In the writer's opinion, the current view of interest on debt as a cost of business and equity as a distribution of profits should be challenged. Both debt and equity are alternative forms of financing for a company with different commercial expectations of risk and return associated to each. This in itself is not a good reason for a different tax treatment on the returns that they generate. It is arguable that dividends meet the requirements of the general deduction formula, as they are expenditure, actually incurred, during a year of assessment, in the production of the income, not of a capital nature and laid out for the purposes of trade.

An equal treatment of the returns on debt and equity can be achieved through treating the return on debt more like the return on equity. This is achieved by disallowing a deduction for interest as proposed by the comprehensive business income tax system. Alternatively the return on equity can be treated more like the return on debt by either allowing for a notional interest rate on the book value of equity, as is the case with the allowance for corporate equity, or providing for a deduction for dividends. The allowance for corporate equity has a broader application and has the beneficial aspect of applying regardless of whether a company chooses to pay dividends or not. A tax deduction for dividends applies to dividends paid only and is similar to the tax system in Brazil where a portion of dividends up to the level of the notional return are treated as interest and taxed accordingly.

There are no real world examples of the comprehensive business income tax. The system is described as a tax on the capital of the firm. The disallowance of interest under the comprehensive business income tax system is in the opinion of the writer a move in the wrong direction despite neutrality being achieved on the returns on debt and equity. The system is a diversion from economic reality as interest is an economic cost of issuing debt and should be taken into consideration. The system prejudices against marginal investments and would, in the writer's opinion, act as a deterrent to investment in South Africa.

The allowance for corporate equity and a tax deduction on dividends are better taxation systems. Both systems are more reflective of economic reality as both interest and dividends are costs incurred by companies in order to produce income. It is the writer's view that a system that allows for a deduction of dividends is the most appropriate model in South Africa. The cost to the fiscus is expected to be small as all deductions for dividends allowed at the company level are countered with the taxation thereof at the equity holder level. It is the return on debt and equity actually received that creates the complications created by a different tax treatment on the returns on debt and equity. A model that focuses on the dividends paid is therefore more appropriate, rather than allowing for a fictitious notional interest deduction on the book value of equity. The allowance for corporate equity remains a viable model but is not as comprehensive as a model that allows for the deduction of dividends alone.

A full review of the challenges to implementing a change of the taxation system is beyond the scope of this paper but is expected to be met with some opposition. The current taxation of the returns on debt and equity is an international system and deviating from this model is expected to bring about much concern. Isaac (1997) states that 'even in the fullness of "ripe time", it remains true that changes in the tax system are very costly — for both administrators and taxpayers — so that both sides are rightly careful to satisfy themselves that the net benefits of a proposed tax reform will be large enough and robust enough to outweigh the costs of the transition.' A transition to an equal treatment of the returns on debt and equity is ultimately a policy decision for the National Treasury.

In summary, the returns on debt and equity could be simplified through an equal treatment of both. The comprehensive income tax system would however in the opinion of the writer not be an improvement. The allowance for corporate equity and a deduction for dividends would in the writer's opinion improve the existing taxation of the returns on debt and equity, and of these two a deduction for dividends is preferred. The implementation of such a system is expected to be met with resistance given the substantial deviation from international practice. Comfort is however taken from the fact that Belgium has implemented an allowance for corporate equity and Brazil a form thereof which restricts the deduction to the amount of the dividends paid. It may be worth a review by the National Treasury to consider an equal treatment of the returns on debt and equity through the allowance for corporate equity or allowing for a deduction on dividends.

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