



**University of the Witwatersrand, Johannesburg**

**Master of Commerce, Taxation**

**An analysis of the South African tax policy on hybrid debt  
instruments with reference to international developments**

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

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## **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 in any other university. Any uses made within the report of the work of authors in any form (e.g. ideas, quotations, text, tables) are properly acknowledged at the point of their use in the report. A full list of references has been included at the end of the report.

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## **Abstract**

The popularity of hybrid instruments as a tax planning technique has grown over the years. There is an increasing global awareness on the use of these instruments and on addressing the tax gaps created by these instruments. South Africa introduced significant amendments to the legislation on hybrid debt instruments, ahead of many countries around the globe. This research report examines hybrid debt instruments and the tax concerns which have created the need for specific tax legislation addressing such instruments. It considers tax policies proposed by the international tax fraternity, global trends in changes to tax policies and South Africa's stance on such tax policies. The amended section 8F and new section 8FA of the Income Tax Act are included in this consideration.

**Key words:** arrangement, debt, deductible, dividend, equity, host country, interest, hybrid debt instrument, hybrid interest, home country, tax

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## **CHAPTER ONE – Background and relevance**

### **Introduction**

Over the years, there has been an increasing awareness of tax planning techniques undertaken by individual corporations and multinational groups (OECD, 2013a:13). There appears to be a growing trend towards the use of tax planning techniques by multinational groups and, consequently, the reduction of corporate taxes that are paid by these groups (OECD, 2013a:15). Globalisation and economic developments have resulted in multinational groups structuring their operations across different countries (OECD, 2013a:25). This progression towards global business models which extend across different tax jurisdictions has contributed to the use of tax planning techniques and the ability of these multinational groups to reduce their overall taxes. In addition, domestic and international taxation rules may not have kept pace with these changes and advancements, creating further opportunities for tax planning (OECD, 2013a:27-28). One of the tax planning techniques identified is the use of hybrid instruments, which is considered a key area that needs to be addressed by tax authorities (OECD, 2013a:47).

A hybrid instrument is understood to be an instrument that combines the characteristics of two financial instruments, namely, a debt instrument and an equity instrument. Due to the blend of debt and equity characteristics in these instruments, these instruments are capable of being viewed and treated differently by different tax jurisdictions, either as debt or as equity (Johannesen, 2014:40; OECD, 2012:7). This inconsistent tax treatment by jurisdictions can create the potential for tax benefits to be derived by the parties to the instrument (being the

party issuing the instrument and the party to whom it was issued) through use of these instruments (Johannesen, 2014:40).

The increasing use of these instruments by multinational groups has caused governments to take action and has resulted in international papers being released on hybrid instruments (Buettner, 2014:5). The Organisation for Economic Co-operation and Development ('OECD') is an international organisation with 34 member countries that work together to address economic, social and environmental challenges of globalisation, including in the arena of taxation (OECD, 2012:2). The OECD has been providing solutions for tax authorities to tackle aggressive tax planning for many years. Specifically in relation to hybrid instruments, the OECD first mentioned mismatch situations in its 2010 report titled "Addressing Tax Risks Involving Bank Losses". In 2012, the OECD released a paper titled "Hybrid Mismatch Arrangements, Tax Policy and Compliance Issues" which addressed hybrid instruments and hybrid entities. The OECD also addressed hybrid mismatches in its 2013 reports titled "Addressing Base Erosion and Profit Shifting" and "Action Plan on Base Erosion and Profit Shifting". The 2013 reports were released in response to the problems of aggressive tax planning (which is considered to be tax avoidance) and the shifting of profits from high-tax jurisdictions to low-tax jurisdictions. These tax concerns reached high political levels and became a key issue on the agenda of many countries worldwide (OECD, 2013a:6; OECD, 2014b). To date, the OECD has released papers on each of the proposed action plans noted in the 2013 reports (OECD, 2014c; OECD, 2014d). One of the action plans is specific to hybrid mismatch arrangements and the working paper on this action plan was released earlier in 2014 for global comment, titled "BEPS Action 2: Neutralise the effects of hybrid mismatch arrangements (Recommendations for Domestic Laws)". An initial action plan deliverable was released later in 2014 titled "Neutralising the Effects of Hybrid Mismatch



Arrangements”, with the final version being published during the latter part of 2015. While hybrid instruments are a global concern, it is still in its early stages of being resolved, with the OECD only recently publishing recommendations and other leading bodies like the UN Tax Committee yet to release their recommendations. Furthermore, numerous countries are still to introduce legislation addressing this tax planning technique (PwC, 2014).

While South Africa is not a member of the OECD, it does have strong working relations with the OECD and has continued to remain involved in initiatives by the OECD (Ministry: Finance, Republic of South Africa & OECD, 2008; OECD, 2014e). Being a leading nation in Africa, South Africa plays a key role where base erosion and profit shifting in Africa is concerned. The many multinational groups operating in South Africa also adds to the relevance of the OECD’s base erosion and profit shifting project to the country. In terms of addressing tax avoidance techniques, National Treasury has already introduced various pieces of legislation over the years and continues to amend this legislation. Examples include legislation on controlled foreign companies contained in section 9D, transfer pricing rules contained in section 31, general anti-avoidance rules contained in sections 80A to 80L, hybrid instrument deeming provisions contained in sections 8E and 8F and provisions on the limitation of the deductibility of interest contained in sections 23M and 23N of the Income Tax Act 58 of 1962 (‘the Income Tax Act’). Some of the provisions were introduced and/or amended prior to any OECD base erosion and profit shifting reports or guidelines being released on them (Steyn, 2014). Specifically with respect to hybrid instruments, South Africa first introduced legislation on this in 1989, contained in section 8E, and amendments continued to be made to this legislation. Hybrid instruments remain an area of focus for the South African tax authorities, as indicated by the recent amendments that were made to

sections 8E and 8F and the introduction of section 8FA to the legislation. It is thus an area of importance for South African taxpayers.

## **Research problem**

### **Statement of the problem**

With the increasing global awareness on hybrid instruments, several countries have introduced specific tax rules addressing such instruments. In addition, various recommendations have been made within the international tax fraternity on curbing the use of these instruments. The South African tax legislation too contains rules on hybrid instruments, and over the years significant amendments have been made to these rules. For instance, section 8F on hybrid debt instruments has been amended to such an extent that the amended section 8F bears no resemblance to the previous section 8F. Furthermore, entirely new provisions on hybrid interest were introduced into the Income Tax Act in section 8FA. While legislation often needs to be improved and updated in order to keep up with globalisation and changes to the commercial environment in which entities operate, such changes need to be adequately considered from the perspective of both taxpayers and tax authorities.

International guidelines or best practice should also be taken into account. To a certain extent, principles and concepts surrounding cross-border transactions and operations that are contained within domestic legislation also need to be aligned with other countries in order to achieve a coherent approach against tax avoidance and remain globally competitive with respect to inward investment.

The purpose of this research report is to consider the domestic and global tax concerns of hybrid debt instruments; the global tax trends in addressing such concerns; and the development of South African legislation on hybrid debt instruments in light of these tax concerns and global tax trends. What constitutes a hybrid debt instrument; whether there is need for tax legislation addressing hybrid debt instruments; and how South Africa's stance compares to global practices and OECD recommendations are questions that are central to this report.

### **The sub-problems**

1. The first sub-problem is establishing what constitutes a hybrid debt instrument. It is generally considered to be a debt instrument that combines both debt and equity characteristics. This broad description makes it a flexible instrument. It also means that the instrument can be created with unique terms and conditions and each hybrid debt instrument can differ vastly from another. Different countries have adopted different approaches on how to classify such instruments. For South African tax purposes, a specific definition has been included in the Act in section 8F. This definition is relevant as it determines whether an instrument falls within the hybrid debt instrument provisions of the Act. National Treasury has gone further than just defining a hybrid debt instrument for tax purposes and has also included a definition in section 8FA of the Act for what they consider to be hybrid interest.
2. The second sub-problem is identifying the reasons for introducing hybrid debt legislation, which essentially revolves around the tax concerns and issues that such legislation is meant to address. If legislation is introduced in order to address a specific

problem, one first needs to establish what the problem is before one can establish whether that legislation is appropriate in terms of addressing that problem. Where hybrid debt legislation is concerned, there are domestic and international reasons for introducing such legislation, both linked to the claiming of interest deductions. From a domestic perspective, issues and concerns relating to the previous legislation on hybrid debt instruments created a need for amendments to the legislation. Globally, there has been increased focus on hybrid debt instruments and hybrid instruments in general have been identified by the OECD as a key pressure area. Many countries are concerned about the use of hybrid debt instruments in cross-border tax planning and tax arbitrage.

3. The third sub-problem is considering what tax policy approaches are available or recommended for hybrid debt instruments and whether the provisions contained in the South African tax legislation are aligned with these. South Africa introduced legislation on hybrid instruments many years ago, well ahead of any international recommendations. This legislation has been significantly amended and broadened over the years. With hybrid instruments being highlighted as a global tax concern, more research has been undertaken on potential policy approaches and more countries have started introducing tax laws addressing hybrid debt instruments. While each country has a sovereign right to introduce its own tax laws taking its own country-specific factors into account, experience can still be drawn from other countries. South Africa's legislation should therefore be considered in light of global developments. It must, however, be noted that recommendations were only recently released by the OECD in their final format. Furthermore, not all countries have introduced tax legislation on hybrid instruments. Tax policy is thus still in its early stages of development.

## **Scope and limitations**

This research report only covers hybrid debt instruments. It does not cover any other type of hybrid arrangement or financial instrument. Only the relevant aspects of South African legislation are taken into account, and specifically the current sections 8F and 8FA contained in the Income Tax Act. Only South African income tax implications are considered and not any other tax implications like value-added tax or securities transfer tax. While the practice of tax authorities in other countries is discussed, a detailed analysis of foreign legislation is not undertaken and a detailed comparison between South African legislation and the legislation of other countries is not performed. International tax guidelines are incorporated into the research report, although these are largely limited to guidelines published by the OECD. International tax principles, like territorial or source rules and controlled foreign corporation rules, which may be impacted by hybrid debt instrument rules are only discussed to a limited extent where required. Double taxation agreements and the implications thereof are not considered. Accounting principles fall outside the scope of this report.

## **Methodology**

Research has been undertaken as a literature review. The sources of information included tax legislation, government releases, books, journals, articles, publications, websites and any other publicly available document or piece of reliable information relevant to the research. Both South African and international sources have been used. The findings of this literature review were used to compile this report.

## **CHAPTER TWO – The legal nature and classification of hybrid debt**

### **Introduction**

Hybrid debt combines the characteristics of both debt and equity. The definitions of debt and equity and their distinguishing features thus need to be understood in order to appreciate the definition of hybrid debt. From a corporate perspective, the distinction between debt and equity is driven by legal principles and tax principles were traditionally based on these legal principles. This chapter therefore explores the legal classification of debt and equity, including related challenges, and the definition of hybrid debt.

### **Corporate funding – the debt/equity distinction**

In a corporate context, there are three main sources of capital available to companies; namely, internally-generated funds, debt and equity (Glen & Pinto, 1994:1). There are various factors that would influence a company's funding choice and each option has different implications on the company and its operations (Fan, Titman & Twite, 2012:23 and Glen & Pinto, 1994:4). Where external funding is required, the choice is between debt and equity (National Treasury, 2013c:27).

Debt is defined as funds borrowed by the company which the company is obliged to repay to the lender (Oxford English Dictionary and Merriam-Webster). Equity is an amount raised in capital markets by the company as a result of the issue of shares or common stock in the company, which gives the holder a right or interest in the company (Glen & Pinto, 1994:1 and Merriam-Webster). These are considered broad definitions of the terms. Distinguishing

between the two forms of funding is inherently difficult and instruments cannot easily be classified into these two categories (Krahmal, 2005:103). It is, however, important to make this debt/equity distinction as different regulatory, financial reporting and tax implications arise as a result of the classification.

Essentially, it is the terms and conditions attached to the funding instrument and the application of domestic laws that would determine its classification as debt or equity.

Domestic laws may include corporate law, civil law, insolvency law, accounting law or similar and each set of laws may employ its own criteria in determining such classification.

The labelling of an instrument under domestic law is considered to play a major role with respect to its classification for tax purposes (Schön *et al*, 2009:84). The decision for domestic law purposes often involves an evaluation of the instrument in order to identify debt and equity characteristics. In order to determine what are considered to be debt or equity characteristics, Green *et al* consider it useful to ascertain the core elements of ‘pure’ debt and ‘pure’ equity (2012:11). Some of these (legal) elements are listed in the table below. For the purposes of this report, the term “lender” refers to the person extending the debt funding to the company (i.e. the issuer of the debt instrument) and the term “shareholder” refers to the person contributing the equity funding and holding the equity instrument or shares in the company.

<b>Debt</b>	<b>Equity</b>
The lender does not have a say in the affairs of the company. They are the suppliers of capital rather than the owners of capital.	The shareholder has ownership and voting rights and thereby has a say in the affairs of the company.

<p>The return on the instrument is certain as the lender is entitled to receive fixed, ongoing returns by way of interest, irrespective of the performance or financial position of the company. This is a legally enforceable right of the lender.</p>	<p>Returns, received by way of dividends, are dependent on the profitability of the company. If a return is paid out, the amount could vary between minimal and substantial, depending on the performance of the company.</p>
<p>The capital amount of the instrument, which equates to the funding extended, is repayable as agreed between the parties to the instrument. However, repayment is limited to the capital amount only.</p>	<p>There is no obligation to repay the capital amount raised and no maturity is attached to the instrument. Should the company wish to repurchase the instrument or shares from the shareholder, the amount paid is generally based on the market value of the company and thus has no bearing on the capital amount raised.</p>
<p>The lender has a preferred ranking in the event of distributions made on liquidation of the company.</p>	<p>There is no guarantee of distributions to the shareholder in the event of liquidation of the company as the shareholder ranks in the last class where this is concerned.</p>

(Boltar J,1995:252-3; Brincker, 2011:B2.1; Dauds, 2007:28; De Mooij, 2012:496; Green *et al*, 2012:12; and Krahmal, 2005:106)



## **Debt/Equity (legal) classification from a practical perspective**

The above-mentioned elements are considered the main distinguishing characteristics in classifying an instrument as debt or equity. They are widely applied by various countries around the globe. Evidence of their application in practice can be found by reviewing the principles applied by countries in distinguishing between debt and equity. One such review can be found in an analysis performed by the Max Planck Institute for Tax Law and Public Finance ('the Max Planck Institute'). The legal systems of several countries were analysed; namely, Brazil, Germany, France, Greece, Holland, Austria, Switzerland and the United Kingdom. It therefore incorporated both developing and developed countries, including developed countries that were considered to have a well-established tax and legal system in place.

The analysis indicated that, for all examined countries, the classification of financial instruments as equity is primarily driven by "the legally binding association of persons under corporate or partnership law for a common (commercial) purpose" (Schön *et al*, 2014:149). Financial contributions by these persons, referred to as the partners or shareholders, under the partnership agreement or company statute to which they are party, are considered to be equity. The creditor, on the other hand, is "connected to the enterprise (company/partnership) via a loan agreement, which does not mandate the pursuit of a common purpose but rather the exchange of performance for consideration" (Schön *et al*, 2014:149).

The following general principles were noted in the analysis by Schön *et al* in respect of the partners or shareholders (i.e. the holders of equity):

- The holders of equity have joint control of the assets and the operations of the enterprise, which can be delegated to managers. They also have certain participation rights (like rights of management, voting and control), depending on the enterprise and type of involvement.
- The holders of equity share in the profits and losses of the business; have rights on liquidation of the enterprise; and are jointly liable to the creditors of the enterprise (to the extent of their capital contribution or to an unlimited extent).
- On insolvency, the holders of equity have the lowest ranking in terms of claims, with further differentiation within this category being possible.
- Distributions to the holders of equity are subject to the impact on creditors and level of indebtedness or leverage of the enterprise. The holders of equity do not have an enforceable legal right or a right to sue for payment of returns, rather it is dependent on the profits of the company (2014:149-150; 191).

The following converse principles were noted by Schön *et al* in respect of the creditors:

- The creditors do not have joint proprietary or corporate law rights to the assets and operations of the enterprise. This is the case even if it is possible to grant such rights on a contractual basis.
- The creditors have a fixed right to the repayment of interest and of the capital sum extended, which is often secured in some way and enforceable by law. The debt has a limited term.
- The creditors have a priority claim on insolvency of the enterprise, with each set of creditors being capable of further ranking differentiations.
- Payments to creditors are not subject to any limitations or prohibitions that are based on capital maintenance, solvency or similar (2014:149-150; 191).

The analysis by the Max Planck Institute thus confirms that the elements listed in the table above can be applied both theoretically and practically. This, however, holds true for instruments that clearly comprise ‘pure’ debt or ‘pure’ equity characteristics, which is not always the case. Legal deviations are allowed in practice, as evidenced by the Max Planck Institute analysis, which adds challenges to the classification of debt and equity in practice.

### **Debt/Equity (legal) classification practices in South Africa**

The terms “debt” and “equity” have not been specifically defined for South African corporate law purposes. Based on a history of established case law, where terms are not specifically defined, their ordinary dictionary meaning should apply. As indicated above, the dictionary meanings of these terms are fairly broad and in practice may not easily be applied to financial instruments. Some of the fundamental domestic law elements of debt and equity are as follows:

<b>Debt</b>	<b>Equity</b>
The lender has a creditor relationship with the company, making the lender’s rights contractual in nature. The instrument has a fixed tenure.	A legal relationship between the shareholder and the company must exist, which involves a complex of rights and duties. The shareholder remains a member of the company as long as the shareholder holds the equity instrument; and the term of the equity instrument is perpetual.

<p>The instrument is in any agreed form.</p>	<p>The instrument is in the form of a share certificate, as prescribed by the Companies Act 71 of 2008 ('the Companies Act').</p>
<p>The lender has a right to receive, over the life of the instrument, a return in the form of interest at a predetermined rate, calculated based on the issue price of the instrument and payable at fixed times. This right to interest does not depend on any declaration or on the profitability of the company, and payment is made without regard to these two aspects.</p>	<p>The shareholder participates in the profits of the company that are available for distribution as dividends. These dividends are subject to declaration by the company (by its directors) and subject to the liquidity and solvency of the company.</p>
<p>The lender usually holds security in lieu of the funds lent. Upon liquidation, the funding may be secured and the lender may hold a preferential claim, although this is subject to the claims of other creditors that hold higher ranking security.</p>	<p>The shareholder does not hold any security in respect of the instrument. The shareholder does not hold a preferential right upon liquidation of the company but has a right to equal participation in the remaining assets of the company after it has settled debts and liquidation costs.</p>

(de Koker & Brincker, 2010:8.2.3-8.2.4)

The domestic law criteria are thus in line with those applied globally. However, as is the case globally, legal deviations over the years have caused the lines between debt and equity to be blurred. Financial instruments are now placed on a continuum ranging from what was

traditionally considered to be ‘pure’ equity to what was traditionally considered to be ‘pure’ debt.

### **Classification challenges – deviations from ‘pure’ funding**

Financial innovation over time has resulted in instruments containing a mix of both debt and equity characteristics (Krahmal, 2005:103). This innovation makes the debt/equity classification a challenging task and one that is subject to interpretation (Brincker, 2011:B2.2; De Mooij, 2012:496). While the elements and principles contained above can still be used as guidelines, in practice the distinguishing lines can become quite vague. In addition, the legal systems of countries have developed differently in terms of addressing or allowing the deviation of financial instruments from the general principles of debt and equity (Schön *et al*, 2014:150). Differences in the application of law by countries also exists (Schön *et al*, 2014:157). This holds true for South Africa too. For instance, the Companies Act allows companies to design their own debt and equity instruments and combine debt and equity features (Lewis, 2013:1). In accordance with the Companies Act, certain classes of shares may have preferences, rights and limitations based on any objectively ascertainable fact (van der Zwan & Huisman, 2012:4). The different legal systems and legal application of countries thus contribute to classification challenges and to differing conclusions being drawn by countries on the classification of an instrument.

The Max Planck Institute illustrated the variations in legal systems using a silent partnership arrangement whereby both the silent partner and the general partner are the contributors of capital but the operations are run by the general partner with the silent partner not necessarily having any proprietary participation or decision-making rights. The silent partner could also

share in the profits but not losses of the enterprise. Based on their analysis, the status and legal rights of the partners and partnership differed depending on the laws of each specific country. In certain jurisdictions like England, a partnership was not considered an independent legal entity while in others it was considered a body corporate. In some jurisdictions, like Germany, partners could avoid participating in losses while in other jurisdictions, like France, such an arrangement was classified as a participating loan (Schön *et al*, 2014:150-151).

Despite all of the examined countries applying the same set of debt/equity classification principles, contrasting conclusions can be drawn by these countries on the classification of a particular instrument that deviates from some of the traditional characteristics of ‘pure’ debt and ‘pure’ equity. The greater the deviation from the traditional characteristics, the less relevant the traditional classification guidelines become. In practice, it is possible for deviations to occur to the extent that a holder of equity could have rights falling within the general principles of debt or to the extent that a contractual entitlement could be classified as equity.

As quoted by Johannesen, “In exchange for capital, corporations can offer investors any set of rights that can be described by words, subject to any conceivable set of qualifications, and in consideration of any conceivable set of offsetting obligations” (2012:2). Between the two spectrums of traditional debt and traditional equity lies what is termed as hybrid finance (Schön *et al*, 2014:165).

## **Hybrid finance definitions**

In addition to references within corporate environments to debt funding and equity funding, one will also find references to hybrid funding. The terms “hybrid finance”, “hybrid debt” or “hybrid instrument” do not appear to have globally accepted definitions. The ordinary dictionary meaning of “hybrid” is something that combines or is composed of two different elements (Oxford English Dictionary, Merriam-Webster). By applying this dictionary definition to external funding obtained by a company, hybrid finance would refer to finance that combines the elements of both debt and equity. Similarly, hybrid debt or a hybrid instrument would refer to one that contains the features of both debt and equity. This is in line with definitions for hybrid instruments and hybrid securities (with securities being an American term used synonymously for instrument) that can be found in online dictionaries like Investopedia, InvestorWords and RiskGlossary. It is also in line with the understanding of various international bodies, tax authorities, practitioners and academics, as referred to in this research report. A hybrid debt instrument is by inference a debt instrument that contains some equity characteristics and vice versa for a hybrid equity instrument. This inference conforms with National Treasury’s view that a hybrid debt instrument is debt in legal form but has equity features (National Treasury, 2004:24). This research report deals only with hybrid debt instruments, which are understood for the purposes of this research report to be debt instruments in legal form that have certain equity elements present within their terms and conditions.

## **Features of hybrid debt instruments in practice**

Due to the broad definition of a hybrid debt instrument, it can be created through a combination of many different terms or conditions. A simplistic overview of some of the terms and conditions of hybrid debt instruments that are currently used in practice is included below. In practice, contractual clauses contained within different hybrid debt instruments can vary extensively and these clauses can become extremely complex. Parties also tend to structure hybrid debt instruments in order to benefit from certain aspects of both debt and equity, thus adding to the complexity.

### Debt with deferral features

This is a debt instrument that contains a clause allowing the company to defer the payment of interest. The lender may have limited rights where deferred interest is concerned. The clause could also contain an option for permanent cancellation of the obligation to repay interest or deferred interest should certain conditions be met. Under these circumstances, the lender forfeits the right to claim payment. Alternatively, the interest or deferred interest may be capped to a maximum amount (Green *et al*, 2012:22).

### Variable rate instruments

These instruments allow for a variable rate of interest to be paid. The agreement often contains a formula for calculating the interest that is to be paid. The result of applying the specified formula is that no interest is paid during periods where the company does not make a profit and a considerable amount of interest is paid during periods where adequate profits are made. Similarly, the formula can be linked to the cash reserves of the company as opposed to profits made (Brincker, 2011:B2.3).



### Scale or ratchet debt

These instruments contain interest rates that change at specified tranches within the tenure of the debt. For instance, the interest rate could start at a negligible rate of 1%, thereafter increase to 5% for the next tranche and end with a 40% rate for the remaining tranche. The converse could also apply with high interest rates at the start that are later reduced (Brincker, 2011:B2.3).

### Subordinated debt

Subordination clauses relate to the ranking of the debt where the creditors of the company are concerned. The debt would rank behind some or all other creditors, depending on who the subordination is in favour of (ASX, 2014).

### Contingent or convertible capital

One type of contingent capital is debt that automatically converts to equity should certain conditions be met or events occur. Examples of such conditions or events would be if the company's profits fall below a certain amount or the company's debt ratio exceeds a certain threshold (Green *et al*, 2012:19;25). Alternatively, if the company has not made sufficient profits, the company could have the option to satisfy a creditor's claim on interest payments through the issue of shares (Schön *et al*, 2014:160). Another type of contingent capital is where the instrument can be substituted with one that has different terms attached to it (Green *et al*, 2012:19;25).

### Perpetual debt

Perpetual debt instruments do not contain an obligation to repay the capital amount of the loan funding. The debt remains in existence indefinitely and never has to be repaid, except on

liquidation (Brincker, 2011:B2.3).

### Participating loans

Under a participating loan arrangement, the lender has certain participation rights. The payment of compensation can be based on performance, financial results or an index. The lender may also have to participate in losses. Participation rights can also extend to the latent gains of the company or enterprise. The repayment of the capital amount of the debt can be modified based on the participation rights (Schön *et al*, 2014:160).

### **Conclusion**

Historically, corporations would choose between ‘pure’ debt and ‘pure’ equity funding, with each having its own commercial, legal and tax implications. Various legal features were used to distinguish between these two forms of funding. However, due to financial innovation over time, corporations have combined different features of debt and equity in order to create funding instruments that suit specific requirements and integrate the beneficial features of both forms of funding. This new form of hybrid funding has created classification challenges from both a legal and tax perspective. From a tax perspective, tax classifications play a crucial role in determining which tax rules are to be applied to the funding.

## **CHAPTER THREE – The tax classification of debt and equity and its related concerns**

### **Introduction**

The tax rules to be applied to a funding instrument are generally based on the tax classification of that funding instrument as debt or as equity (which has traditionally been based on the legal classification). Different tax rules are applied to each form of funding. Such classification hence determines the resulting tax implications for both taxpayers and tax authorities. This chapter discusses these tax implications and illustrates the importance of debt/equity classifications from a tax perspective using the South African tax treatments of debt and of equity.

### **Debt/Equity classification – relevance from a tax perspective**

The principal tax concern from a practical perspective is the classification of hybrid financial instruments as debt or as equity (Schön *et al*, 2014:188). The distinction between debt and equity has created numerous issues for countries from both a domestic and international tax perspective. It is the subject of many discussions within the tax world and international bodies, like the International Fiscal Association, have placed importance on this debt/equity topic (Schön *et al*, 2014:147). The OECD, the International Monetary Fund and the United Nations are also amongst the international bodies that have included the debt/equity issue on their agendas. Specifically for tax purposes, the debt/equity classification is of importance as

tax systems typically classify financial instruments as either debt or equity and different tax treatments arise as a result of the classification (Johannesen, 2012:2).

Where corporate tax is concerned, there is a double layer of taxation levied on equity as a result of both the company and shareholder being subject to tax (Schön *et al*, 2014:164). The company is subject to tax on its profits, and it is out of these after-tax profits that a return on equity (i.e. dividend) is paid. In addition, this dividend can be subject to further tax at shareholder level (i.e. dividends tax or similar), albeit at a reduced rate. Debt, on the other hand, does not create the ‘double layer’ tax concern due to the returns (i.e. interest) paid on debt funding often being deductible in computing the taxable profits of the company. It is thus the fact that a return on equity funding is not deductible for tax purposes while a return on debt funding is deductible that is key to the debt/equity issue (Schön *et al*, 2014:180;199 and De Mooij, 2012:490). According to De Mooij, the reasoning behind allowing a deduction for interest and not dividends is due to interest being considered a cost of doing business whereas equity returns reflect business profits (2012:496). This favourable tax treatment for debt creates a bias towards debt funding for companies (De Mooij, 2012:490). Where the parties to a financial instrument are tax resident, and hence subject to tax, in different countries, distortions may occur in taxing these cross-border instruments due to inconsistent tax treatments being applied by the different countries. This is explained in more detail in the next chapter.

While the tax treatment of debt differs to that of equity, it must be noted that tax is only one of the various factors influencing corporations’ choice between debt and equity funding. Several research papers have been published on the various factors that impact this choice, including one authored by Glen & Pinto and another by De Mooij. Johannesen pointed out

that some firms may use such instruments for non-tax reasons due to other beneficial characteristics present in the instruments. The extent of tax-driven financial innovation and the choice of financial instruments by multinational groups in the absence of taxes is, however, considered a difficult concept to quantify (Johannessen, 2014:46). This research report will not delve into the details of non-tax driven funding choices.

### **Debt versus Equity – South African income tax implications**

Like many other countries around the world, the South African tax system taxes debt and equity under two different sets of rules, generally based on their legal form (National Treasury, 2004:19). Once an instrument is analysed and characterised under South African law, the South African tax treatment will follow such characterisation (de Koker & Brincker, 2010: 8.6.11). Hence instruments qualifying as debt will be subject to tax rules that apply to debt, and likewise for equity instruments (National Treasury, 2004:19). In order to illustrate the differences in the tax rules applying to these two forms of finance, a simplistic overview of the South African normal tax implications of ‘pure’ debt and of ‘pure’ equity within a corporate context is included hereafter. Detailed explanations on these tax implications fall outside the scope of this report.

#### **Debt funding income tax implications**

The income tax implications listed below arise where interest-bearing loan funding has been extended on capital account by a South African tax resident company to another South African tax resident company (all section references are to the Income Tax Act and all

paragraph references are to the Eighth Schedule to the Income Tax Act on the determination of taxable capital gains and assessed capital losses).

#### Lender company implications

- Loan receivable – The funds extended will fall within the definition of “asset” under paragraph 1. Per paragraph 20(1)(a), a base cost equal to the amount of funds extended, being the expenditure actually incurred in respect of the creation of that asset, will be established (SARS, 2015b:763).
- Repayments – Capital repayments will either reduce the base cost of the loan receivable per paragraph 20(3)(b) or it will be considered a part-disposal subject to paragraphs 11(1)(b), 33 and 35 (SARS, 2015b:764,766). Redemptions usually occur at face value, hence no capital gain or loss should arise (i.e. the net effect of the repayment should merely be a reduction in base cost).
- Interest earned – The amount received will in all likelihood constitute “interest” as defined in section 24J of the Act and will hence be specifically included in gross income per section 24J(3). The quantum and timing of the inclusion in gross income will be determined with reference to the provisions of section 24J. Section 24J effectively spreads the interest (as defined) over the period or term of the financial arrangement by compounding the interest over fixed accrual periods using a predetermined rate referred to as the “yield to maturity” (which is effectively the rate on a day-to-day basis over the agreed term). Section 24J deems the holder of an instrument to have accrued amounts of interest in a relevant year of assessment, as calculated under section 24J principles (ENSafrica, 2015). Should the provisions of section 24J not apply to the debt, any interest received or accrued will be regarded as gross income in accordance with the gross income definition contained in section 1.

### Borrower company implications

- Loan liability – No income tax implications will arise as a result of the receipt of funds being a capital receipt (being fixed capital to be held with a degree of permanency in order to support the income-earning structure of the business, per various case law principles) (SARS, 2015b:17,21).
- Repayments – No income tax implications will arise (being expenditure of a capital nature, which is not in respect of an “asset” as defined) (Income Tax Act).
- Interest incurred – Interest incurred in the production of “income” (as defined), derived from the carrying on of a trade, should qualify for a tax deduction in terms of section 24J. The quantum and timing of the deduction would be determined with reference to the provisions of section 24J (whereby a yield to maturity basis will be applied, as described above). If the provisions of section 24J do not apply to the debt, the interest incurred could be claimed as a deduction under section 11(a), provided the necessary requirements are met (i.e. “income” as defined must be derived from the carrying on of a trade; the interest must be actually incurred in the production of that “income”; and the expense must not be of a capital nature) (ENSafrica, 2015 and Income Tax Act).

### Summary of the income tax implications associated with debt funding

Interest incurred by a borrower company that qualifies for deduction would result in a tax saving at the corporate tax rate of 28%. Interest income, on the other hand, would be included in the lender company’s gross income and would therefore attract income tax at the corporate tax rate of 28%. It is therefore apparent that, under normal circumstances, the combined net tax effect of the funding arrangement should be neutral as the tax saving achieved by the borrower company should equate to the tax suffered by the lender company.

## **Equity funding income tax implications**

The income tax implications listed below arise where funding has been extended by a South African tax resident company to another South African tax resident company by means of a purchase of ordinary shares in the company, which is to be held on capital account (all section references are to the Income Tax Act and all paragraph references are to the Eighth Schedule to the Income Tax Act on the determination of taxable capital gains and assessed capital losses).

### Shareholder implications

- Share acquisition – Shares fall within the definition of “asset” under paragraph 1 of the Eighth Schedule. Per paragraph 20, a base cost equal to the expenditure actually incurred in respect of the acquisition of that asset together with any qualifying expenditure will be established (note: special rules per paragraph 32 can be applied in computing the base cost of shares) (SARS, 2015b:39,176, 303).
- Share disposals – share buy-backs, sales or any other type of disposal will fall within paragraph 11(1)(a) (SARS, 2015b:76,641). The amount received on disposal will be treated as proceeds per paragraph 35 (SARS, 2015b:341,641). The difference between the proceeds and the base cost of the shares being disposed of will result in a capital gain or loss (SARS, 2015b:30). It is generally expected that the amount of proceeds would be influenced by the value of the shares at the time of disposal rather than the initial subscription amount, thus a capital gain or loss is expected to arise. Subject to any specific anti-avoidance provision like paragraph 19, the capital gain or loss will be used to determine the person’s taxable capital gain (through application of



paragraphs 3 to 10), and would effectively be subject to a tax rate of 18.6% (SARS, 2015b:699,61-71).

- Company distributions – distributions by the company in respect of a share will either be a dividend (refer below for implications) or a repayment of “contributed tax capital”, a defined term in section 1 (SARS, 2015b:611-612). Repayments of contributed tax capital will reduce the base cost attributable to the share, per paragraph 76B, with any excess giving rise to a capital gain (SARS, 2015b:618,621,624).
- Dividends – These amounts will fall within the gross income definition in section 1 on receipt or accrual. In most instances, dividends should qualify for exemption under section 10(1)(k). Per section 64F, the shareholder should not be subject to dividends tax at 15%, being a South African tax resident company (Income Tax Act).

### Company implications

- Equity injection – The issue of shares by a company would not be considered a disposal of an “asset” based on paragraph 11(2)(b) (SARS, 2015b:82,85). The amount will be recorded by the company as contributed tax capital (SARS, 2015b:614-616). No further tax implications should arise.
- Share buy-backs and company distributions – Repurchases by a company of its own shares and other forms of company distributions will either reduce the contributed tax capital balance relating to that class of shares or will be considered a dividend paid by the company (SARS, 2015b:613,616). Outside of administrative obligations, no negative income tax implications should arise.
- Dividends – The company will be subject to certain obligations in terms of the dividends tax rules contained in sections 64D to 64N. These obligations could range

from administrative in nature (where no dividends tax arises and only reporting obligations are placed on the company), to withholding obligations (where the dividend is subject to dividends tax), to being liable for dividends tax (in the instance of a dividend *in specie* which is subject to dividends tax) (Income Tax Act). Where dividends are paid to South African resident companies, no negative income tax implications should arise.

#### Summary of income tax implications associated with equity funding

A company receiving equity funding and paying returns on that equity funding will not enjoy any tax benefits associated with that funding and nor will it suffer any adverse income tax implications. The shareholder would not suffer any taxes on the dividends and (capital) distributions that are not in excess of the base cost of the shares. Any capital gains realised on (capital) distributions and share disposals would attract tax at an effective rate of 18.6%. The combined net effect of equity funding is likely to be an outflow of taxes due to tax suffered by the shareholder. Equity funding thus has the potential to give rise to positive tax revenues for tax authorities.

#### **Debt versus Equity – tax revenues earned by tax authorities**

Based on South African tax rules, there is a clear difference in the income tax treatment of debt and of equity from each party's perspective (i.e. lender/shareholder compared to borrower/company). The provider of the funds is likely to prefer equity funding as the returns are not taxable, while the recipient of the funds is likely to prefer debt funding due to the tax saving on the deductible returns. The overall impact on tax revenues earned by tax authorities (SARS where South Africa is concerned) is, however, a difficult concept to conclude on.

Based on the simplistic representation above, it could be argued that the net difference between these two forms of funding (where the parties to the instrument are South African tax residents) is not a significant one. However, in practice many other factors can influence the outcome. When incorporating additional dynamics, debt funding provides various opportunities for reducing the aggregate tax exposure of all taxpayers concerned.

One such dynamic is loss positions. As pointed out in the report by the Max Planck Institute, where companies are in loss positions, funding choices can be used to exploit these losses. Tax laws do not generally allow the vertical and horizontal offsetting of losses on revenue streams and between parties, like the shifting of losses from a company to its shareholders. Tax laws also do not generally provide a negative tax or tax benefit to taxpayers in loss positions (Schön *et al*, 2014:201). For these reasons, taxpayers often seek ways of utilising losses and hence apply tax planning to areas like funding choices.

Another dynamic is the involvement of parties that are not subject to tax (Schön *et al*, 2014:183). The reference to parties that are not subject to tax includes a party that is located in another tax jurisdiction and hence not subject to tax in the same tax jurisdiction as the party claiming the tax deduction; and tax-exempt or similar bodies that are located in the same tax jurisdiction but not subject to any tax, for example a public benefit organisation or government body.

Depending on the combination of the various dynamics, debt funding has a much greater potential to harm a tax jurisdiction through lost tax revenues. This loss of tax revenues is largely due to the fact that the borrower may qualify for an income tax deduction whereas the lender may not necessarily be subject to income tax on the interest income. This is especially

true for cross border funding as tax revenues may have to be shared with or even fully attributed to another tax jurisdiction. The global concern on hybrid funding hence relates more to cross-border hybrid instruments than to domestic hybrid instruments. Cross-border hybrid debt is discussed in more detail in the next chapter.

## **Conclusion**

Depending on whether an instrument is classified as debt or as equity for tax purposes, different tax implications would arise for the parties to the instrument, as debt and equity trigger distinctly different tax rules. This emphasises the importance of the tax classification of hybrid instruments as debt or as equity. In addition, the potential for returns on debt to be deductible, which would give rise to a tax saving for the party receiving the funds, together with the opportunities to utilise debt funding in tax planning techniques creates a preference for debt funding, especially in a cross-border context. This creates a concern for tax authorities regarding the utilisation of hybrid debt instruments.

## **CHAPTER FOUR – Cross-border hybrid debt and its related concerns**

### **Introduction**

While the bias towards debt funding exists both within a domestic and international context, cross-border hybrid debt instruments offer more opportunities for tax planning and hence pose a greater risk to tax authorities. This chapter explores the common tax planning techniques utilised by multinationals in cross-border funding instruments, thereby explaining the reasons for the global concern on hybrid debt funding.

### **Cross-border tax planning opportunities**

In addition to the difference in the tax treatment of debt compared to equity, from an international tax perspective, the assignment of taxation rights between jurisdictions is generally of significance. Where corporate funding is concerned, returns on debt are largely taxed in the state of residence of the lender (i.e. where the interest income is received and recognised) while equity returns are commonly taxed in the state where the operations are based (i.e. where the profits out of which the dividends are distributed is earned) (Schön *et al*, 2014:164,203). Hence the type of funding dictates which jurisdiction has the right to tax the return on the cross-border funding instrument. From a tax planning perspective, this creates an opportunity to manipulate the rates of return on funding and thereby shift profits between different tax jurisdictions. It also brings into play the relevance of the corporate tax rates of each jurisdiction as well as applicable withholding taxes that are levied on the different income streams (De Mooij, 2012:496). The higher the corporate tax rate, the more incentive there is to claim deductions in order to reduce taxable profits and to shift profits out of that

jurisdiction. High withholding tax rates on returns paid may reduce this incentive and may also impact the choice of the funding instrument. The use of leveraging and hybrid debt instruments as well as the creation of complex structures in order to secure tax benefits are explained in more detail below.

## **Leveraging**

Leveraging is essentially the funding of a company using debt (rather than equity). The more debt funding a corporation has, the more leveraged it is (Oxford English Dictionary). As a tax planning tool, multinational groups can choose to leverage subsidiaries (hosts or recipients of funding) located in countries with a high corporate tax rate in order to benefit from tax deductions on the interest of the loan funding extended (De Mooij, 2012:493-494). In this manner, a deduction for interest is obtained in a high-tax jurisdiction, thereby reducing the profits that are subject to tax in that jurisdiction and achieving a greater tax saving. On the other hand, multinationals can choose to provide equity funding to subsidiaries that are subject to a low tax rate on profits as there is a limited need to manage the tax exposure on profits in such a jurisdiction. The greater the disparity in corporate tax rates, the greater the incentive to manage the debt/equity funding ratio (De Mooij, 2012:493-494).

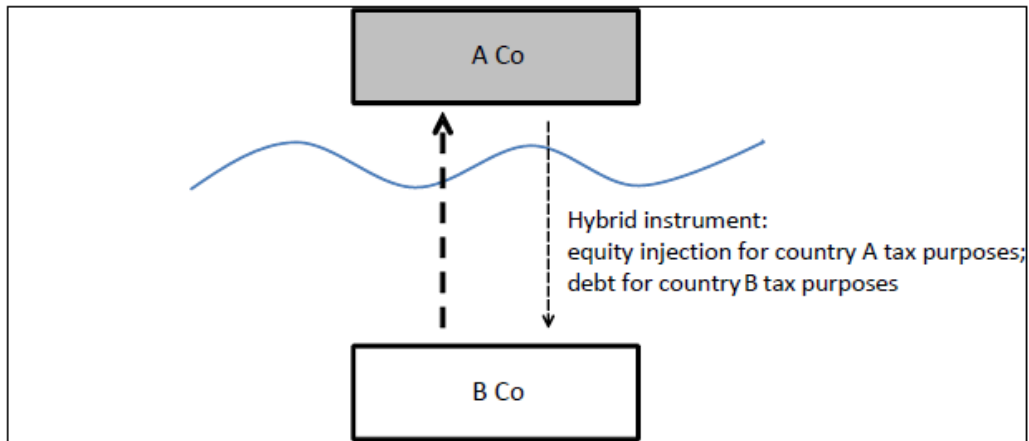
Tax benefits can be further enhanced by selecting a favourable counterparty jurisdiction for the funding returns to flow to. The tax suffered on income that flows to the funding company located in the counterparty tax jurisdiction (referred to henceforth as the home country) depends on the country-specific tax legislation. Generally, interest income is subject to tax while no or limited additional tax is suffered on dividend income (Johannesen, 2012:20). Multinationals can therefore select low-tax jurisdictions for interest income to flow to,

thereby reducing the tax suffered on such income streams (Fatica, Hemmelgarn & Nicodème, 2012:9 and OECD, 2013b:16). With dividend income, the income can be directed to jurisdictions that offer tax exemptions or credits for such income, resulting in no or little tax being suffered (OECD, 2013a:37,41). The tax benefit to the (corporate) group would therefore be the net effect of the tax impact in the host country and the tax impact in the home country (Fatica, Hemmelgarn & Nicodème, 2012:9 and De Mooij, 2012:492). The tax impact would include any withholding taxes levied by the host jurisdiction and withholding tax credits provided by the home jurisdiction.

Multinational groups can expand on leveraging benefits and reduce or eliminate any tax suffered on the funding arrangement by utilising hybrid finance like hybrid debt instruments. When used as a cross-border tax planning tool, hybrid debt instruments are commonly treated as debt in one country and equity in another country. The funding is extended between companies in tax jurisdictions that allow for a tax deduction to be claimed in the host country and no tax to be levied on the corresponding income in the home country (OECD, 2012:7). An example was used by the OECD to illustrate cross-border hybrid debt funding, which is reproduced below.

Example from OECD report (OECD, 2012:8-9):

A company resident in country B ('B Co') is funded by a company resident in country A ('A Co') with an instrument that qualifies as equity in country A but as debt in country B. If current payments are made under the instrument, they are deductible interest expenses for B Co under country B tax law. The corresponding receipts are treated as exempt dividends for country A tax purposes. As a result, a net deduction arises in country B without a corresponding income inclusion in country A.



The OECD expanded on the above example in a later report issued in 2014. In the updated example, country B grants a tax deduction for the payments made under the instrument and country A does not tax those receipts or grants some form of tax relief (an exemption, exclusion, indirect tax credit, or similar) for those receipts, hence achieving the same effect as the example above (OECD, 2014a:59). Since these structures often involve and affect many countries, a global impact does arise and global concerns are raised.

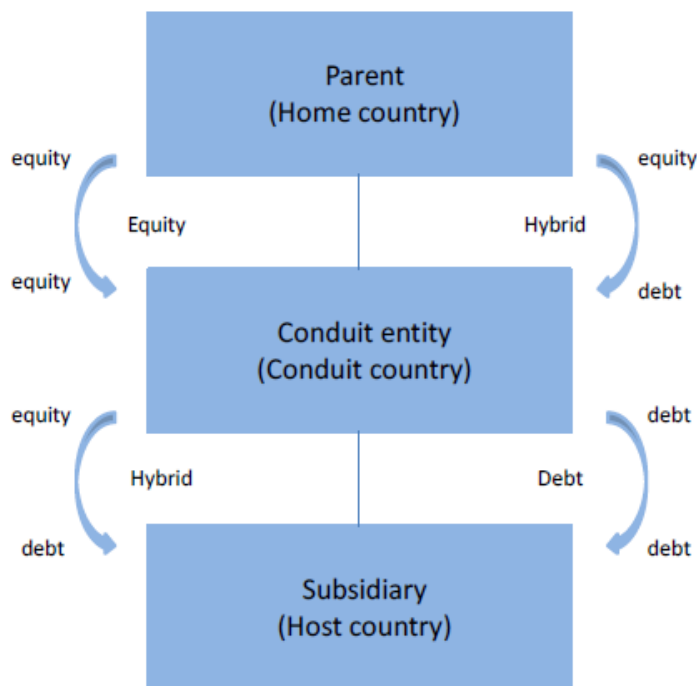
### **Layered group structures**

Johannesen has found that the use of hybrid instruments by parties located in different tax jurisdictions that view the instruments differently for tax purposes, is always feasible for one of the parties to the instrument and, in certain situations, is feasible for both parties (2012:4). Creating a multi-tier structure whereby more companies (often referred to as conduits) located in different tax jurisdictions, are included in the financing arrangement allows a multinational group to take advantage of differences in tax treatments by third or more countries (Johannesen, 2012:5). According to Johannesen, multinational groups are noted for involving multiple jurisdictions in their tax planning techniques, for instance the use of tax



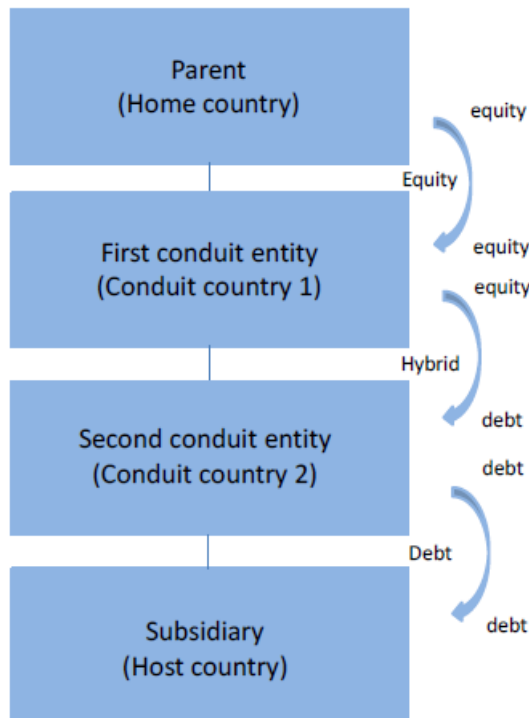
haven countries as finance headquarters for the group (Johannesen, 2014:44). Johannesen found that using a conduit financing structure has the ability to ensure that the hybrid instrument is treated as debt in the country of the ultimate user of that finance (host country) and as equity in the country of the original provider of finance (home country) (2012:26). Conduit structures thus virtually guarantee a tax benefit. The diagrams contained hereunder were used by Johannesen to illustrate such structures (2012: Figure 3 and Figure 4). Note that an example similar to Johannesen’s single conduit hybrid structure was also used by the OECD in their 2014 report (OECD, 2014a:59).

### The single conduit hybrid structure



**Note:** The figure illustrates the two ways in which a cross-border hybrid instrument can be embedded in a single conduit hybrid structure to create equity treatment in the home country and debt treatment in the host country. Either, the parent finances the conduit entity with a hybrid instrument, which is treated as equity in the Home country and as debt in the conduit country, and the conduit entity passes on the funds to the subsidiary as pure debt (right side). Or, the parent finances the conduit entity with pure equity and the conduit entity passes on the funds to the subsidiary in the form of a hybrid instrument, which is treated as equity in the conduit country and debt in the host country (left side).

### The double conduit hybrid structure



Note: The figure illustrates how a cross-border hybrid instrument can be embedded in a double conduit hybrid structure to create equity treatment in the home country and debt treatment in the host country. The parent finances the first conduit entity with pure equity. The funds are passed on to the second conduit entity in the form of a hybrid instrument, which is treated as equity in the first conduit country and as debt in the second conduit country. Finally, the second conduit entity passes on the funds to the subsidiary in the form of pure debt.

Layered structures involving hybrid debt instruments can be used as an effective tax planning tool, affecting multiple countries and hence giving rise to a global concern. According to the OECD, current tax rules applied by countries promote the use debt funding (OECD, 2013a:43). The OECD stated in their 2014 report that, while mismatches in the tax treatment of hybrid instruments could be due to various reasons, the most frequent is the debt versus equity classification by the jurisdictions (2014a:33-34).

### Global impact of hybrid tax planning mechanisms

In practice, various forms of cross-border hybrid arrangements can exist through the use of hybrid entities and hybrid instruments. Although hybrid arrangements other than hybrid debt

instruments fall outside the scope of this report, discussions on the global impact generally refer to the broader banner of hybrid arrangements and not specifically to hybrid debt instruments, hence the references below are to hybrid arrangements.

Many countries have had to contend with hybrid arrangements and these arrangements often achieve what the OECD refers to as double non-taxation in the countries concerned or they achieve a tax deferral which can be economically similar to double non-taxation. The OECD is concerned with any hybrid arrangement that results in a mismatch for tax purposes. The OECD describes such hybrid mismatch arrangements as arrangements that exploit the differences in the tax treatment between two or more countries, producing a mismatch in the tax outcomes in the respective countries and thereby lowering the aggregate tax burden of the parties to the arrangement (OECD, 2012:5,11 and OECD, 2014a:29). One such mismatch occurs when the proportion of a payment, measurable in money but excluding valuation differences, that is deductible in one jurisdiction does not correspond to the proportion of the inclusion in income by any other jurisdiction(s). Such a mismatch is typical of a hybrid debt instrument that is used as a tax planning tool. Hybrid debt instruments are one of several hybrid arrangements that the OECD is concerned with.

Where companies within a (corporate) group are located in different tax jurisdictions, the funding choice affects the total tax burden of the group (OECD, 2013a:43). Hybrid instruments reduce the overall tax revenue earned by tax authorities from the parties involved and hence, from a global cumulative perspective, create a tax loss for countries (OECD, 2012:11). Tax differentials between countries contribute to this cumulative tax loss as debt funding is often utilised in a high-tax country where interest deductions can be claimed while the corresponding income is either taxed at a low rate or not taxed at all (OECD, 2013a:43).

Currently, there is no data on the extent of the tax losses suffered as a result of hybrid arrangements (which includes various structures like hybrid entities and hybrid instruments). These arrangements are, nonetheless, considered to reduce overall global taxes by a considerable amount (OECD, 2012:5). Similarly, the magnitude on the use of hybrid arrangements cannot easily be quantified, which Johannesen attributes to the inability to infer quantification from financial statements or standard business surveys. Based on qualitative evidence, hybrid arrangements are considered to be widely used and considered to be a contributing factor to declining effective tax rates on cross-border investment (Johannesen, 2014: 40).

A direct critique of the global tax loss suffered as a result of these arrangements is that there is no such concept as a common or collective tax base amongst countries. Each country has its own individual and separate tax base and is free to make its own decisions on what and how to tax. It is inevitable that the different rules applied by countries will result in inconsistent tax treatments, however, this is a deliberate inconsistency and hence companies cannot be said to be 'exploiting' these inconsistencies (Macfarlanes, 2014:1). A possible response to this critique is that international tax principles are largely based on one jurisdiction forgoing tax revenues on the presumption that another jurisdiction would be imposing tax. Due to current tax arbitrage, these principles no longer hold true (OECD, 2013a:47). Despite being compliant with the laws of the relevant jurisdictions, hybrid arrangements achieve a result that may not have been intended by the jurisdictions (OECD, 2012:12). In addition, the OECD notes other concerns about such arrangements. These concerns include additional tax revenue being lost due to parties claiming deductions for costs on creating and implementing the hybrid instruments; multinational companies being placed at a competitive advantage earning higher (after-tax) profits compared to other smaller

enterprises; creating preferences for offshore investments or vice versa thus impacting on capital import and export neutrality; contributing to financial instability through, for instance, increased leverage and risk; and unfairness towards types of business that are not able to utilise such arrangements (OECD, 2012:11-12). Hence the concerns are much wider than the cumulative global tax effect.

Despite the differences in opinions on whether the concerns related to cross-border hybrid arrangements are valid or not, these arrangements are widely considered to be one of the mechanisms used to erode the tax base in affected countries and shift profits from high to low-tax countries. These arrangements have been recognised by the authors of several research papers as an important tax planning tool. This is especially true when layered and complex group structures are created by multinational groups to aid in tax planning techniques.

### **Practical examples of cross-border hybrid debt instruments**

Hybrid debt instruments can essentially be created using any combination of debt and equity characteristics. Theoretically, a myriad of different hybrid debt instruments can exist with vastly different terms and conditions. These instruments can be classified either as debt or as equity and inconsistencies in the classification of such instruments by different countries can create tax planning opportunities. A few of the hybrid debt instruments that have been used in practice are briefly described below.

#### US perpetual loan

Under the US tax regime, a perpetual loan is likely to be seen as equity. The US funder of

such a loan will thus treat the returns as dividend income and will be entitled to a foreign tax credit (Krahmal, 2005:109). If the recipient is located in a jurisdiction like France where the perpetual loan is treated as debt, the returns will qualify for deduction. Thus a US parent with a French subsidiary can reduce their combined tax burden through the use of a perpetual loan that achieves a French tax deduction with a favourable tax inclusion in the US (Johannesen, 2012:3).

#### Canadian preference shares

Mandatory redeemable preference shares are seen as equity in Canada for tax purposes and returns are treated as dividends, which may not be included in income for tax purposes where these dividends are paid from the exempt surplus of an affiliate company. In Luxembourg, however, these shares are considered to be debt and a deduction is allowed for returns on the shares. The arrangement between two affiliated companies thus achieves a tax deduction in Luxembourg with no tax inclusion in Canada. The same result can be achieved by using the US instead of Luxembourg and by using preference shares that are subject to a repurchase agreement (KPMG, 2014a:3).

#### Dutch participating loans

Profit participating loans are treated as equity under certain circumstances in the Netherlands and the returns are recognised as dividends, which may qualify for a profit participation exemption and hence not be subject to any tax in the Netherlands. Under previous South African rules (i.e. prior to sections 8F and 8FA being introduced), the profit participating loan could have been viewed as debt, in which case the returns would have qualified for a tax deduction (de Koker & Brincker, 2010:8.2.2-8.2.3). Thus a favourable tax result could have been achieved by a multinational group with companies in these two jurisdictions.

## **Conclusion**

Due to the difference in the tax treatment of debt compared to equity and, specifically, the potential for returns on debt to be deductible whereas returns on equity are distributed out of after-tax profits, there is a bias towards debt funding in a corporate context. Multinational groups are able to further reduce the net tax suffered on funding arrangements through the utilisation of hybrid debt instruments and multi-tier group structures with entities are located in favourable tax jurisdictions. In this manner, a deduction for debt returns in the hands of one party with no corresponding taxable income in the hands of the other party is achieved. From a global perspective, tax jurisdictions lose out on tax revenues, and hence the global concern for such arrangements and the question faced by tax authorities on how to best address this concern.

## **CHAPTER FIVE – Global policy recommendations on addressing the bias towards debt funding**

### **Introduction**

One of the reasons that hybrid debt instruments are being utilised as a tax planning technique is due to the tax distinction between debt and equity and the different tax implications that arise on the two forms of funding. This chapter contains comments and recommendations made on tax policy changes that may assist in reducing or eliminating the preference for debt funding, either through eliminating the distinction between the two forms of funding or through introducing special tax rules.

### **The need for a debt/equity distinction**

In 1958, Professors Modigliani and Miller demonstrated in their famous “Proposition I” that, in the absence of taxes, corporations would be indifferent between debt and equity financing as no value could be created by changes in a corporation's capital structure (Madison, 1986:468). According to Madison, the debt/equity distinction was one of the most frequently litigated issues in American tax law (1986:465). The issues surrounding this distinction have only grown over the years. It is now the subject of dynamic discussion within the tax fraternity. The foundation of this distinction and rationality behind the issues are being challenged. The vast differences between the tax rules applied by countries and the complexities of these rules are also being widely criticised (Schön *et al*, 2014:147).



Furthermore, the distinction is considered to have a detrimental influence on financing decisions (Schön *et al*, 2014:182).

A number of proposals have been made to eliminate this distinction altogether (Krahmal, 2005:106). For instance, De Mooij has concluded that, after taking legal, administrative and economic factors into account, there is little reason for the tax discrimination between debt and equity (2012:509). The legal criteria that are considered in the classification of debt and equity play a limited tax role and hence should not influence tax outcomes (Schön *et al*, 2009:87-88). It has been argued that income, as an economic value, does not need to be distinguished based on how it was earned i.e. from debt or from equity. This is in line with the Schanz-Haig-Simons tax system which is based on the net increase in wealth (explained in more detail further below) (Schön *et al*, 2014:163). Furthermore, in applying current tax rules in a purely domestic setting, the classification of an instrument as debt or as equity should not matter as the return on the instrument would be taxed at least once. According to Schön *et al*, “it makes sense to simply leave it to the financiers to opt for debt treatment or equity treatment. At least from the point of view of domestic tax law there is no logically superior solution”. It could even be argued that the taxation principles governing equity instruments represent an irregularity in the tax system where it involves a double layer of taxation. This implies that the tax treatment relating to debt is the more ‘legitimate’ or ‘compliant’ approach where tax laws are concerned (Schön *et al*, 2009:89-90).

The general concern with respect to eliminating the debt/equity distinction altogether is that there are a number of other distortions within the tax system which would impact the overall efficiency of such a change (Krahmal, 2005:106). Nonetheless, policy options which would result in debt and equity being treated in the same way for tax purposes have been suggested.

While the debate on such policies continues, various other proposals have been made that may aid in resolving the debt/equity conundrum, as discussed below.

### **Proposed policy options and special tax rules**

The policy options and special tax rules that have been proposed range from the commonly applied interest deductibility rules to the more radical options of reducing corporate tax rates in order to decrease the tax benefit derived from debt funding or changing the design of the tax system altogether (Fatica, Hemmelgarn & Nicodème, 2012:11-12). Some of these are discussed in further detail below.

### **Thin capitalisation and other interest deductibility rules**

Since the core of the problem appears to be the preference for debt funding as opposed to equity funding, one option would be to introduce a limit on the amount of debt funding that a company can have (commonly known as thin capitalisation rules). These rules essentially limit the deductibility of interest where the company is found to be excessively funded by debt. In addition, the denied interest can be recharacterised as dividends. Research papers indicate that thin capitalisation has been effective in reducing debt funding, and accordingly the level of the associated interest deduction (Fatica, Hemmelgarn & Nicodème, 2012:11). The interest limitations can be based on ratios or a given constraint like a percentage of EBITDA (a financial term which means earnings before interest, taxation, depreciation and amortisation) (Fatica, Hemmelgarn & Nicodème, 2012:11). These rules are also referred to as income stripping rules. They can assist both with excessive debt funding and excessive interest rates attached to that debt funding.

De Mooij has pointed out that the number of countries introducing these types of rules has grown tremendously over the years. However, in addition to reducing the proportion of debt funding by companies, the rules have also reduced investment. The rules also add to the complexity of tax laws. De Mooij considers such rules to be imperfect solutions to the problem, which create their own distortions (2012:502,509). Furthermore, the rules are directed towards protecting the tax base of the country of the recipient of the funds and not in resolving the debt/equity differentiation issue itself. They also create double taxation through the denial of deductions (where the corresponding income will remain fully taxable) (Schön *et al*, 2014:206).

### **Dividend relief techniques**

Dividend relief techniques eliminate the economic double taxation arising on equity returns, by recognising that tax has already been levied on these returns through the taxation of the profits of a company. The return / dividend is thus either fully exempt from tax in the hands of the shareholder or is taxed at a reduced rate. Alternatively, an imputation of the taxes already charged in the hands of the company declaring the dividend can be allowed in determining the tax arising on the dividend income for the recipient (Schön *et al*, 2014:183). However, based on the points made in the Max Planck Institute report, it must be noted that this approach essentially views the parties as a single unit i.e. it looks at the combined tax effect of the parties. It does not achieve tax neutrality between interest and dividends from the perspective of the individual parties (Schön *et al*, 2014:199). It therefore assists in reducing the debt bias but not in addressing the root of the problem, which is the differentiation itself.

## **Withholding taxes**

The international tax principle on the assignment of taxing rights between the home country (country of residence) and host country (source country) is regarded by some to be at the core of the base erosion and profit shifting issue on debt funding (Schön *et al*, 2014:203). As previously explained, in cross-border funding returns on debt are generally taxed in the country where the lender is tax resident (home country), whereas returns on equity are mainly taxed in the country where the borrower is tax resident (host country). This assignment creates an incentive to shift profits from high-tax to low-tax jurisdictions (by claiming deductions on interest in the high-tax country, and routing corresponding income to a low-tax jurisdiction where it is either not taxed at all or taxed at a low rate). Applying a withholding tax to the interest leaving the host country can reallocate the taxing rights to that host country. However, this only serves as a solution when the recipient is in a low-tax country (Schön *et al*, 2014:203). It could otherwise create issues of its own, like excessive tax being levied on the same income without adequate double-taxation relief being available.

While withholding taxes are levied on different income streams and can be levied on both interest and dividends, it is the rate of this withholding tax that is at the discretion of each country and can be used to adjust the tax revenue earned by that (host) country. For instance, a higher rate can be levied on interest while a lower rate is applied to dividends, as the underlying profits out of which dividends are declared would already have been subject to tax in the host country (Schön *et al*, 2014:204). Nevertheless, levying a withholding tax on both dividends and interest income once again means that returns on equity are subjected to a higher tax burden than returns on debt as a result of the combination of a non-tax deduction for returns on equity together with a withholding tax (Schön *et al*, 2014:211).

Similar to the interest deductibility rules, withholding taxes protect the tax base of the host country and do not resolve the debt/equity differentiation issue (Schön *et al*, 2014:206). High withholding tax rates also reduce a country's attractiveness as an investment location (Schön *et al*, 2014:211). In practice, withholding taxes are more prominent in developing countries than in developed, however the reasons for this are not necessary driven by the debt/equity issue (Schön *et al*, 2014:204).

### **Anti-avoidance rules**

The OECD considers general anti-avoidance rules an effective tool in addressing certain tax avoidance arrangements, like those with artificial features. The rules are considered difficult to apply as a direct link often needs to be established between the transaction and tax avoidance. Amongst the recommendations are specific anti-avoidance rules in the host country that deny a deduction where the corresponding income is not subject to a minimum level of taxation in the home country, or that deny a deduction where the main purpose of the transaction is to obtain a tax advantage (OECD, 2012:13-14 and Johannesen, 2014:41).

Johannesen notes that, despite being considered a suitable solution, these rules exist in a limited number of countries (2014:46). This may be due to the difficulty experienced in applying such rules due to their reference to foreign tax law treatment, as pointed out by the OECD (2012:14). According to Johannesen, in order to be effective these rules need to treat conduit entities as transparent and look through the chain of conduits in order to ascertain the final or net outcome of the finance structure. Anti-abuse rules can be developed that enable the tax authorities to treat transactions between multiple related parties as a transaction between two entities only, thereby eliminating the flow-through transactions (Johannesen, 2014:45). He also indicates that controlled foreign company rules are one mechanism of

addressing conduit structures (2014:45). However, these rules all add to the complexity of tax laws and the application thereof.

### **Uniform tax treatment for debt and equity**

Eliminating the debt/equity distinction for tax purposes, by treating debt and equity in a similar way, is considered to be one of the more radical policy options. There are various suggestions on the design of tax systems that achieve this. Two alternate designs are discussed below, the one being an allowance for corporate equity ('ACE') and the other being a comprehensive business income tax ('CBIT'). Under the first system, a deduction is granted for returns on equity. Hence dividends would be treated in the same manner as interest. The second system denies the deduction of interest. Interest is thereby treated in the same manner as dividends. Both systems achieve a uniform treatment for debt and equity returns (Fatica, Hemmelgarn & Nicodème, 2012:12).

The ACE system taxes investments in a similar manner as a cash-flow tax and thus has the advantage of creating neutrality between funding options (Fatica, Hemmelgarn & Nicodème, 2012:13). In addition, it removes the economic double taxation that arises on corporate profits whereby the income is subject to tax in both the hands of the company and in the hands of the shareholder on distribution as a dividend (Schön *et al*, 2014:180). While detailed mechanics of the ACE systems is outside the scope of this report, it may be valuable to note that the system does provide for additional deductions which reduce the tax base and, consequently, tax revenues for countries. Countries may therefore have to increase their tax rates in order to compensate or establish their own solution to the loss in tax revenues. Being the direct opposite of ACE, the benefit of the CBIT system is that it increases tax revenues

for authorities and, in so doing, facilitates a reduction in the tax rate. Since corporate investment, choices on the location of companies and profit-shifting are presumed to be partially linked to corporate tax rates, reducing tax rates should have a favourable effect for countries. This is, however, a simplistic conclusion and many other factors need to be taken into account. The potential negative effect on companies also needs to be factored into the analysis (Fatica, Hemmelgarn & Nicodème, 2012:12-13).

According to De Mooij, while both systems eliminate the tax discrimination between debt and equity, the economic properties and implications of these two systems is distinctly different. He pointed out that the CBIT is more in line with the Schanz-Haig-Simons tax system (which is explained below) (2012:501). De Mooij has undertaken a detailed analysis of these two systems and has also noted countries that have introduced variants of such systems. For instance, Belgium, Brazil, Latvia and Italy allow a notional deduction on certain equity (De Mooij, 2012:506). The Dutch tax authorities were also considering providing a fixed deduction to Dutch companies on their profits (van Gelder, 2013:147). This equity allowance does come at a cost i.e. the loss in tax revenues (De Mooij, 2012:506). Another option is to develop a system that combines aspects of the ACE and CBIT systems, focusing on the advantages of the two systems and avoiding the disadvantages of both systems. Despite the considerable benefits that can be obtained by doing this, very few countries have actually implemented such a system (Fatica, Hemmelgarn & Nicodème, 2012:15-16).

According to Schön *et al*, deviations from a uniform tax system that have developed over time within domestic and international tax systems has resulted in the need for a distinction between debt and equity. Hence, while it may appear reasonable to eliminate the debt/equity distinction for tax purposes through such systems, it is very difficult to do so in practice (Schön *et al*, 2014:216).

## **Schanz-Haig-Simons tax system**

The purpose of the Schanz-Haig-Simons system is to achieve a uniform and synthetic tax system. Under this system, it is the net increase in wealth and a comprehensive concept of income that is the focal point. Hence it is the actual increase in wealth that matters and not the specific income stream that gives rise to it i.e. whether it is through interest income or a profit share/dividend. The difference between interest and a profit share only matters when considering the risk profile and volatility of the income stream, although this impacts its quantity and not its quality as income. This line of thinking can be compared to the approach where capital gains are not differentiated based on the type of asset that was sold. In other words, the tax rules remain the same irrespective of whether the asset was classified as a debt instrument or an equity instrument. A tax system of this nature is based from the outset on financial neutrality.

There are various ways of implementing such a tax system. A detailed discussion on these various options falls outside the scope of this report. In brief, a cash-flow method combined with a consumption-style income tax is one option. This results in income that is reinvested in order to generate additional income not being taxed while income that is utilised for private consumption is subject to tax. This treatment is applied consistently irrespective of the type of income i.e. whether it arises from debt or from equity (Schön *et al*, 2014:163-164).

“Income” for this purpose is based on the traditional understanding of the term, which looks at unconstrained access thereto. Hence a person must have the ability to determine the use of an amount before it can be attributed to that person as their income. This ability is linked to actual decision-making powers rather than mere formalities (Schön *et al*, 2014:199-200). Up until the date of the release of the report by the Max Planck Institute, no country had



implemented a comprehensive consumption tax or a system similar to the principles of the Schanz-Haig-Simons tax system (Schön *et al*, 2014:179). It thus remains a theoretical option on eliminating the debt/equity distinction and completely changing the manner in which taxes are levied.

## **Conclusion**

Of the various policy options and specific tax rules that have been recommended, the most radical but arguably most effective solution would be to entirely eliminate the debt/equity distinction for tax purposes and tax the two forms of funding in exactly the same manner. This will eliminate both the challenges faced in classifying instruments as debt or as equity instruments and the preference for debt funding. In practice, this policy change is unlikely to happen. Certain jurisdictions have, nonetheless, introduced specific rules that try and reduce the tax differential between debt and equity funding. The use of a notional deduction for equity returns is one example of such a rule. The more ‘acceptable’ approach, however, appears to be the introduction of special rules that deter the use of debt funding, like interest limitation rules or interest withholding taxes. These options do not assist with the classification challenge, however, they do assist in reducing the debt bias. Nonetheless, they still remain imperfect solutions which could create issues or distortions of their own.

## **CHAPTER SIX – Global policy recommendations on the use of hybrid debt funding**

### **Introduction**

The policy options and special tax rules discussed in the previous chapter relate more to eliminating the bias towards debt funding and eliminating the debt/equity distinction itself. An additional option is to introduce special rules that specifically address hybrid debt instruments, which are instruments that cannot clearly be classified as debt or as equity and could hence be viewed differently by different jurisdictions. By addressing hybrid debt instruments directly, there may not be a need to eliminate the bias towards debt funding or the distinction between debt and equity funding. The main recommendations on hybrid debt instrument rules have been made by the OECD. These recommendations are discussed below.

### **The OECD's project on hybrid funding**

Per the OECD, globalisation has benefitted many economies and supported the development of many countries. Globalisation does, however, impact the tax systems of countries and can lead to negative effects on the tax revenues of countries. This creates a need for an adequate set of international tax rules and a coherent approach by countries. While each country has a sovereign right to design their own tax policy, the collaboration of countries is required in order to design policies that counteract the negative effects of globalisation and address the gaps and overlaps created by differences in the tax policies of countries. The idea behind complementary and coherent rules would be to prevent both double taxation and double non-

taxation (OECD, 2013b:7-9,15). This is supported by various researchers like Schön *et al* and Johannesen who have noted nationally and internationally uniform criteria as an especially important goal and have reiterated the need for an internationally co-ordinated approach (Schön *et al*, 2014:217 and Johannesen, 2014:41). The OECD has made recommendations for rules on hybrid instruments, which comprise of model treaty provisions for double taxation agreements and domestic law provisions. This research report only covers domestic law recommendations.

Based on input by numerous countries around the world, including both developed and developing countries as well as OECD member countries and non-member countries; consultations with other stakeholders like business representatives, trade unions, civil society organisations and academics; and feedback from the general public; the OECD released a detailed report on hybrid instruments during the latter part of 2014 and then issued a comprehensive final version of this report in October 2015 (OECD, 2014a:3 and OECD, 2015:3). The report was titled “Neutralising the Effects of Hybrid Mismatch Arrangements” (‘OECD’s hybrid report’) and was issued in response to action 2 of the OECD’s “Action Plan on Base Erosion and Profit Shifting”. The OECD’s hybrid report covered various forms of hybrid mismatch arrangements. Only the recommendations on hybrid debt instruments are discussed below.

### **Scope and purpose of the OECD recommendations**

The recommendations in the OECD’s hybrid report are aimed at tax mismatches. For OECD purposes, a tax mismatch occurs where there is a difference in the tax treatment of an arrangement under the laws of two or more tax jurisdictions, thereby achieving double non-

taxation (which also includes long-term deferral of taxes) (OECD, 2015:11). For hybrid debt instruments, this occurs where payments under that instrument are characterised differently by different tax jurisdictions, thereby resulting in mutually incompatible tax treatments of that same payment by the tax jurisdictions involved (OECD, 2012:7 and OECD, 2014a:29-31). A typical example is a payment qualifying for a deduction in one jurisdiction (like interest paid) which is not taxable in the other jurisdiction (like exempt dividends). Tax differences arising as a result of the valuation of money, like foreign currency fluctuations, are not considered a mismatch (OECD, 2015:18).

The OECD's hybrid report targets only tax mismatches that utilise a hybrid element to achieve such a mismatch. However, the OECD acknowledges that it is impossible to identify and define all such mismatches due to the wide variety of financial instruments used in practice and the different ways that they are taxed by countries. The focus of the OECD's hybrid report is therefore on aligning the treatment of payments under financial instruments with the treatment in the counterparty jurisdiction, thus eliminating the mismatch but without impacting the commercial outcomes (OECD, 2015:11,18).

The OECD has listed some of the objectives of their recommendations in the report. These objectives include neutralising the mismatch rather than reversing the tax benefit that arises under the laws of the jurisdiction; avoiding double taxation through rule co-ordination between countries; minimising disruption to existing domestic law and providing sufficient flexibility for rules to be incorporated into the laws of each jurisdiction; and minimising administrative burdens and compliance costs for taxpayers and tax authorities. The recommended measures require co-operation and co-ordination between jurisdictions, an

approach that is needed to order to adequately and efficiently address hybrid mismatches and other base erosion and profit shifting techniques (OECD, 2015:93-94).

## **OECD recommendations**

The recommendations are organised in a hierarchy, with a primary rule and a secondary or defensive rule. This hierarchy is in order to prevent double taxation from occurring through application of the rules. Double taxation could arise where, for instance, more than one jurisdiction applies the hybrid debt rules to the same hybrid debt instrument (OECD, 2015:11-12). Hence a jurisdiction need not apply the hybrid debt rules where the counterparty jurisdiction is already applying a hybrid debt rule that neutralises the tax mismatch (OECD, 2015:18). The rules therefore link the domestic tax treatment by a jurisdiction to the foreign tax treatment in the counterparty jurisdiction.

The primary and secondary rules relating to hybrid debt instruments are explained under chapters 1, 2 and 8 of the OECD's hybrid report. The domestic law design principles are contained in chapter 9 (which includes the objectives discussed above as well as implementation challenges). Certain terms are defined in chapters 10, 11 and 12 of the OECD's hybrid report. Some of the points discussed in the chapters are summarised below. A detailed discussion on definitions is excluded.

### **Hybrid financial instrument recommendation**

Recommendation 1 in chapter 1 of the OECD's hybrid report is the main recommendation with respect to financial instruments. As a first measure, the OECD recommends adjusting

tax deductions in the payer jurisdiction. Payments under a hybrid financial instrument that result in a hybrid mismatch should be denied as a deduction in the payer jurisdiction to the extent that it is not included in the ordinary income of the payee within a reasonable period of time (OECD, 2015:23,25). As a second measure, where the payer jurisdiction does not neutralise a mismatch that arises, the payee jurisdiction should include the payment in ordinary income (OECD, 2015:23). The combined adjustments under the primary and secondary rules should not, however, result in double taxation (OECD, 2015:32).

The OECD has not defined the term “hybrid financial instrument”. The OECD states that this is due to the wide variety of financial instruments and the various ways in which they can be classified and treated for tax purposes, which make it impossible to capture all situations where a hybrid mismatch may arise. The OECD has therefore left it to each jurisdiction to define a “hybrid financial instrument” but has provided recommendations on the definition of a “financial instrument” (OECD, 2015:25). The term “payment” is defined and may include future or contingent obligations to make payment. In considering deductions, equivalent tax relief like tax credits are to be taken into account (OECD, 2015:27). Any exemptions, exclusions, tax credits or similar that is available in the payee jurisdiction must also be taken into account when determining whether the amount is included in ordinary income. The rules are, however, based on expected tax outcomes in the counterparty jurisdiction hence the actual tax treatment need not be determined by the taxpayer or tax authorities (OECD, 2015:28). It must be noted that the rules do not require reclassification of the payment for tax purposes. For instance, if it is treated as interest in the payer jurisdiction, it remains interest and need not be reclassified as a dividend (OECD, 2015:32). It is merely the mismatch that is eliminated.

Complexities in applying the rules may arise in practice. For instance, the OECD's hybrid report indicates that where the counterparty is transparent (for tax purposes) or has a taxable presence in more than one jurisdiction, the laws of multiple jurisdictions may need to be considered order to determine whether a mismatch arises and apply the rules (OECD, 2015:41). Furthermore, where the payment is taken into account in multiple jurisdictions or in jurisdictions other than the payer and payee jurisdictions, the treatment in all jurisdictions would essentially need to be taken into consideration. A deduction in any jurisdiction is sufficient to trigger the rule, while an adequate inclusion in income in any jurisdiction is sufficient to discharge application of the rules (OECD, 2015:41). Other factors like foreign branch rules, territorial regimes (where all foreign source income is exempt), no-tax jurisdictions, exempt or reduced-rate entities and similar also need to be taken into account as they would not trigger a mismatch (OECD, 2015:30-31,43). In addition, the rules have a defined scope as well as a list of exceptions (OECD, 2015:24). Arrangements like hybrid transfers, where jurisdictions take inconsistent views on who the owner of the return is, or substitute payments, which are payments made for financial or equity return, are included in the scope (OECD, 2015:26). These may add to complexities as they require further analysis and understanding of arrangements by tax authorities.

### **Financial instrument recommendation**

Recommendation 2 in chapter 2 of the OECD's hybrid report is a recommended improvement to domestic law. It is a specific rule that operates in addition to the primary and secondary rules above (OECD, 2015:16). In terms of this rule, dividend exemptions and other dividend relief techniques provided as relief against double taxation on corporate profits should be denied to the extent that the dividend payment is deductible in the payer

jurisdiction. Such relief should ideally only be available for dividends declared out of taxed profits. Similarly, tax credits or relief for foreign tax withheld on payments under a hybrid transfer should be restricted to the net taxable income of the taxpayer under the arrangement. Hybrid transfers often result in economic benefits being shared between jurisdictions and hence the tax credits should be proportionate (OECD, 2015:45-47).

### **OECD imported mismatch recommendation**

Recommendation 8 in chapter 8 of the OECD's hybrid report deals with imported mismatches, which would not otherwise be captured under recommendations 1 or 2 above. It involves a first payment that is deductible in the payer jurisdiction and which gives rise to ordinary income in the payee jurisdiction, and a second deductible payment (hybrid mismatch) which is set-off against that income. The income can therefore be viewed as 'funding' the hybrid deduction or as being 'sheltered' by the imported mismatch arrangement (OECD, 2015:86). Under this rule, the payer jurisdiction should deny a deduction for a payment to the extent that the payee directly or indirectly utilises the corresponding income of that payment in set-off against a payment made by the payee under a financial instrument which gives rise to a hybrid mismatch (OECD, 2015:83). These imported mismatches essentially arise through the use of more than one financial instrument or arrangement and through payments that are made in different financial years. It could also involve third jurisdictions or multi-tier structures and multiple parties. The different steps within an arrangement and the different parties involved will have to be investigated. The rule thus requires co-ordination between jurisdictions and can be complex to apply (OECD, 2015:83-84,86-87). According to the OECD, the problem of imported mismatches only exists due to a lack of effective hybrid mismatch rules. Hence if all jurisdictions introduce the rules



recommended by the OECD, the effect of hybrid mismatches will be neutralised in the jurisdiction where it arises and the importation of mismatches into other jurisdictions will be prevented. The rule on imported mismatches will thereby become an additional safety mechanism (OECD, 2015:85).

### **Implementation challenges relating to the OECD recommendations**

Amongst the different challenges that may arise in introducing special hybrid mismatch rules, complexity and co-ordination appear to be the main ones. As mentioned above, some of the rules are complex and hence further guidance on them may be required. Each jurisdiction would also have to take into account its existing legislative and tax policy framework and ensure effective integration and application of the rules within this framework (OECD, 2015:94,96). While the recommendations above are on changes to be made to domestic legislation and the rules should apply on a stand-alone basis in each jurisdiction (i.e. irrespective of whether the counterparty jurisdiction has hybrid mismatch rules), the linking of the domestic rules to foreign rules makes co-ordination and co-operation between jurisdictions important (OECD, 2015:18,95). Without consistent application by jurisdictions, taxpayers may suffer negative consequences like double taxation (OECD, 2015:94). The OECD indicates that the use of the hierarchy of the rules should prevent double taxation and avoid the need for a tie-breaker clause (OECD, 2015:96). However, consistent application is still essential for this to hold true and, should a counterparty jurisdiction apply its own set of hybrid mismatch rules, double taxation may still occur. The OECD's hybrid report has not specifically addressed such instances under its domestic law recommendations on hybrid financial instruments, but has rather emphasised the importance of a co-ordinated approach by all jurisdictions in addressing the global concern for hybrid mismatches (as opposed to

unilateral measures by each jurisdiction) (OECD, 2015:99,102). A co-ordinated approach not only prevents double taxation but will assist in reducing compliance costs for both taxpayers and tax authorities (OECD, 2015:99).

The OECD's hybrid report notes additional measures like the development of agreed guidance on the recommendations; review of implementation by jurisdictions; information exchange between jurisdictions; making information available to taxpayers; and considering the interaction with the recommendations by the OECD under other 'actions' of the OECD's "Base Erosion and Profit Shifting Action Plan" (OECD, 2015:93). An important point for jurisdictions to note is that the objective of the OECD's hybrid report is to neutralise hybrid mismatches and not to establish whether the tax base of a jurisdiction has been eroded and to recoup that lost tax revenue (OECD, 2015:95). The combined recommendations act as a comprehensive and coherent package to achieve this objective and selective application may result in tax planning opportunities as well as undue compliance burdens on taxpayers (OECD, 2015:94-95). The combined rules should also reduce the distinction between debt and equity funding in cross-border transactions (OECD, 2015:99).

In order to assist with understanding the recommended rules, the OECD has included in its hybrid report 37 examples on the hybrid financial instrument recommendation, 3 examples on the financial instrument recommendation, 16 examples on the imported mismatch recommendation and a few other examples on design principles and definitions (OECD, 2015:171-174). While the recommendations have merit, the introduction of new rules by countries is a time-intensive exercise. In addition, the recommendations amount to considerable changes in tax policy for many countries and it may prove to be a challenge for countries to draft such rules (KPMGa, 2014:6). According to Deloitte, the examples in the

OECD report indicate that the rules “necessarily will be complex” (2015:1). EY has also commented on the complexity of the recommendations in the OECD report. EY has further stated that, due to the complexities and difficulties that countries may face in implementing the OECD recommendations, it is unclear as to what extent countries will adopt the recommended rules (2015:10-11). Although some countries have started introducing their own rules on hybrid instruments, it remains to be seen how many countries globally implement the OECD recommendations. Despite the introduction of hybrid debt rules in tax jurisdictions and the recommendations made by the OECD, there remains criticism on taking such an approach. One of the questions raised relates to why a particular jurisdiction should deny a deduction that qualifies for deduction in all respects, including meeting transfer pricing requirements and not falling within anti-avoidance rules, purely based on it being paid to a recipient in a jurisdiction that takes a different tax view (Macfarlanes, 2014:2). It is a valid question that appears to have remained unanswered.

## **Conclusion**

The OECD recommendations involve linking the domestic tax rules on hybrid debt instruments to the foreign tax treatment. Essentially, the deduction for a payment (e.g. interest) should only be granted by the domestic tax jurisdiction to the extent that the corresponding income is subject to tax in the foreign tax jurisdiction. Alternatively, no exemption should be granted on the income if it was deductible in the counterparty jurisdiction. Similarly with dividend exemptions or other dividend relief mechanisms, these should only be granted where the corresponding payment was not deductible in the counterparty jurisdiction. The linking of domestic tax rules to foreign tax rules can be complex and difficult to apply in practice. The level of co-ordination between jurisdictions

that is required to effectively apply the rules may prove to be too challenging and onerous for many jurisdictions. Nonetheless, introducing special rules for hybrid debt instruments may reduce the debt/equity classification concerns associated with such instruments as the domestic tax implications are linked to foreign tax rules (as opposed to being entirely based on the tax classification of such instruments). It may also reduce the need for further debt funding related rules.

## **CHAPTER SEVEN – Tax policies currently applied by other jurisdictions**

### **Introduction**

Based on the discussion in the previous chapters, there appears to be two tax issues where hybrid debt instruments are concerned; the first being its classification as debt or as equity, due to the difference in tax implications; and the second being its use as a tax planning tool, especially in cross-border funding arrangements. This, in turn, raises two policy questions; (i) whether a specific tax definition for debt and equity is required in order to categorise all instruments as either debt or equity, thereby eliminating the uncertainty on the tax classification of hybrid debt instruments; and (ii) whether specific rules are required for hybrid debt instruments, especially where cross-border tax planning is concerned, as tax concerns may not be addressed through specific tax definitions. Thus far, policy recommendations have not directly addressed the classification issue. This may be due to it not being possible to capture all types of hybrid debt instruments within a specific definition. Policy recommendations have thus centred more on reducing the debt/equity distinction and the preference for debt funding. The OECD has taken a further step and recommended special rules on the tax treatment of hybrid debt instruments. This chapter will provide an overview of the stance that other countries have taken and the policy options that can be found in practice.

### **Debt/Equity tax classification trends**

According to Johannesen, tax laws need a set of rules in order to differentiate between debt and equity (2012:2). Traditionally, it was an instrument's legal form that dictated whether it

was classified as debt or equity for tax purposes. The analysis performed by the Max Planck Institute was also based on the legal systems of various countries. With the growth in concerns on hybrid instruments being used as a tax planning tool, there is an increasing focus on the debt/equity classification from a tax perspective and on deviations from the traditional legal form approach.

Generally, a shift in the tax world has been taking place towards an evaluation of the substance or economic essence of a transaction rather than its legal form. This shift also impacts the tax classification of hybrid finance and, with this shift, the tax authorities of various countries have developed their own approaches in resolving the hybrid finance tax dilemma (Johannesen, 2012:2). Part of the analysis performed by the Max Planck Institute was on the consistency of the classification rules from a tax perspective compared to a legal perspective for the countries under review. The various countries that were reviewed differed in their domestic rules. Most of the countries did not lean towards reclassifying funding that was considered debt for corporate law purposes as equity for tax purposes. In addition, shareholders from a corporate law perspective were considered to be the investors of equity, notwithstanding any preferential or limiting contractual arrangements (be it on the returns, participation or rights). Hence tax classifications were still fairly aligned with legal classifications (Schön *et al*, 2014:187-190).

The dependence of tax classification on legal classification is still being debated and many of the countries were introducing tax-specific rules at the time of the review by the Max Planck Institute. However, since there is significant variation between countries in the approach taken, the potential for the same instrument to be treated as debt in one country and equity in

another country continues to exist (Johannesen, 2012:2). A more detailed discussion on the tax classification approach taken by specific countries is included below.

## **Australia**

The Australian Tax Office issued a guide with a list of criteria that are to be assessed in evaluating whether a financial instrument is classified as debt or equity. Prior to the guide being released, it was an instrument's legal form that largely dictated its tax treatment. An instrument meeting both the debt and equity tests per the guide is considered to be debt for tax purposes. The debt test comprises of five fundamental elements, namely, that a scheme must exist; the scheme must be a financing arrangement; a financial benefit must be derived; the obligation for the company to provide future financial benefits must not be contingent; and it must be substantially more likely than not that the cumulative financial benefits provided must be equal to or more than the cumulative financial benefits derived. The elements of the equity test are that a share must be issued; the returns on the share or interest must be dependent on the company's economic performance; returns must be at the discretion of the company; or the interest obtained by the party providing the funding must convert to a share or interest that contain the previous two elements (Brincker, 2011:B2.1 and The Treasury, 2015:9-10). Other aspects like profit elements within debt, participation in losses, the entitlement to fixed returns on a share and the repayment of capital are also reviewed (Schön *et al*, 2014:202).

Australia is one of the many countries around the globe that places great emphasis on the economic substance of a transaction. The debt/equity guide takes that into account. Since the guide was issued a number of years ago, the growth in the number and complexities of hybrid

instruments has resulted in the Australian Government undertaking a project in 2013 to re-evaluate the debt/equity distinction. As part of this project, tax rules applied by different countries, international developments and tax arbitrage involving Australia and other countries were reviewed (The Treasury, 2014:15,19,139). A discussion paper was released on the findings of this project in 2014 and a final report in 2015. Changes were to be made by the Australian tax authorities based on these findings.

### **The Netherlands**

In the Netherlands, it is the civil law classification that usually dictates the tax treatment of debt and equity. However, it is not unknown for debt to be categorised as equity and an interest deduction denied for tax purposes. Situations have also arisen where the converse has taken place and equity was regarded as debt (Van Gelder, 2013:140). Based on Dutch case law, the repayment obligation within a financial instrument is an essential attribute of debt. Three exceptions to this rule have been noted in practice; namely, sham loans, loss financing loans and participating loans. Specifically for participating loans, it can be reclassified from debt to equity if certain criteria are met. These criteria are linked to the profit-dependence of returns, the ranking or subordination feature and a long or perpetual tenure period (Van Gelder, 2013:140 and (Schön *et al*, 2014:193). Where other financial instruments are concerned, limited consideration is given to the subordination feature (Schön *et al*, 2014:195).

Judgements have been made by the Dutch courts whereby the legal form of a transaction is reclassified for tax purposes in light of the economic result and the objective of the applicable tax provisions. Under the sham transaction doctrine, the facts of the court case at hand will be



taken into account and it must be shown that the actual intention of the parties differed from the apparent intention of the transaction (Van Gelder, 2013:144).

Generally, the classification of a financial instrument in another jurisdiction does not influence the characterisation in the Netherlands for tax purposes, although the foreign treatment of a cross-border instrument may, in certain instances, be taken into account (Van Gelder, 2013:147).

## **United Kingdom**

The approach adopted in the United Kingdom is that of following the legal nature of an instrument. The United Kingdom allows for a fair degree of flexibility in structuring equity funding arrangements and shares are rarely treated as debt for tax purposes. Similarly, debt with equity characteristics, like perpetual bonds, is still treated as debt (Schön *et al*, 2009:86,90-91). However, special tax provisions do exist which restrict the deductibility of profit-dependent returns. In line with the substance over form approach, the economic substance of the return is evaluated as to whether it represents financial remuneration for the use of money for a certain period of time; how it compares with market-related rates; whether it is fixed; and the probability of returns not being produced. Other factors like options for deferral of payment are also taken into account, while features like subordination generally do not play a role (Schön *et al*, 2014:190-195).

In the United Kingdom, hybrid rules have been introduced that take the foreign tax treatment into account. However, this relates more to the tax treatment of returns than the classification thereof, which is discussed further below.

## United States

The courts in the United States have, over the years, dealt with many legal cases on the debt/equity classification and guidance was provided by the tax authorities through some of these legal cases (Krahmal, 2005:104-105). A multi-factor test was developed to determine whether an instrument should be classified as debt or as equity (Schön *et al*, 2014:172). The list of factors include the presence or absence of a fixed maturity date; the source of funds used to make payments; the right to enforce payments of returns and capital; participation rights; the risk attached to the funds extended, including whether the funds are secured; what the funds were used for; the subordination ranking of the financial instrument; the debt/equity structure of the company; the company's ability to obtain external funds; and the intention of the parties (Krahmal, 2005:105 and Lewis, 2013:1-2). Of these factors, a few are considered to be vital indicators of whether the instrument is debt or equity while others, like the subordination feature, play a lesser role in the evaluation. Legal enforceability or a right to sue strongly indicates a debt relationship, as do security and a fixed maturity date (Lewis, 2013:1-2 and Schön *et al*, 2014:191). With respect to maturity dates, options to defer repayment dates are also considered important, particularly in situations where there is uncertainty as to the actual repayment. Profit-dependent returns that require a board resolution generally indicate the instrument is equity, but there can be exceptions to this rule (Schön *et al*, 2014:192,194).

It must be noted that the guidance issued by the United States Internal Revenue Service does indicate that an instrument having both debt and equity characteristics should be classified as equity rather than debt (Brincker, 2011:B2.1). This indicates a preference for equity classification by the United States tax authorities. Thus, contractual holdings are easily

classified as equity and convertible loans can be classified as equity at the outset, for instance, where the economic risk of a loss in the value of an underlying share is borne by the investor (Schön *et al*, 2014:192,196). Like many other countries, the United States also places emphasis on the substance of a transaction rather than its form (Krahmal, 2005:106).

Similar to the Netherlands, the classification of cross-border instruments is not dependent on foreign country treatment. It may, nonetheless, be examined where there is a loss to the domestic fiscus (Krahmal, 2005:108-114).

## **Singapore**

The Inland Revenue Authority of Singapore, in recognising that hybrid instruments exhibit both debt-like and equity-like features, issued a guide for taxpayers setting out the taxation thereof and the steps for determining classification as debt or equity. The first step noted in this guide is the examination of the legal rights and obligations created by the instrument and identification of potential ownership interests. Thereafter, instruments are evaluated on a case-by-case basis where the full facts and circumstances at hand, as well as a combination of various factors, are taken into account. Factors include the nature of the interest acquired and whether a shareholding and residual interest is obtained; participation rights; voting rights; the obligation to repay the principal amount of the funding irrespective of the financial position of the company; whether returns are contingent and cumulative; the investor's right to enforce payment; the classification by other regulatory authorities within Singapore; and the ranking for repayment on liquidation or dissolution. For cross-border instruments, the classification by the foreign country will also be considered and any mismatches evaluated.

The tax authorities do offer taxpayers the option of obtaining an advance ruling on the tax treatment of specific hybrid instruments (IRAS, 2014: 4-9).

### **Other European countries**

In other countries like Austria, France, Germany and Switzerland, an arguably more favourable tax treatment is adopted. For French tax purposes, the legal form appears to dictate its tax treatment. Shares are considered to be equity and obligations as debt, usually regardless of whether the instruments contain any hybrid terms (Schön *et al*, 2009:25-26,85). Contractual holdings are generally treated as debt in France and the payments made thereon are deductible, with special treatment being applied in exceptional cases (Schön *et al*, 2014:190). The Austrian classification for tax purposes largely depends on the financier's participation in the entity's profits, gains and goodwill. The risks involved and legal position of the financier is more relevant for corporate and accounting purposes rather than tax. An instrument can thus be classified differently for legal and tax purposes, with the tax classification appearing to follow a more 'simplistic' approach (Schön *et al*, 2009:17-18). For Swiss tax purposes, instruments that are debt in form are treated as debt and Swiss accounting principles are followed. Debt is usually only reclassified in certain situations, like where the entity is considered to be thinly capitalised (i.e. having excessive debt compared to equity) in terms of Swiss tax rules. (KPMG, 2014b:10). Payments on contractual holdings are generally deductible with special treatment applying in exceptional situations (Schön *et al*, 2014:190). However, the substance of an instrument can be taken into account and can influence its classification (Schön *et al*, 2009:85). Under German tax law, a greater emphasis is placed on the economic substance rather than the legal form. The means by which the financier is compensated plays a decisive role (Schön *et al*, 2009:42). In all countries, convertible bonds

are initially treated as debt and subsequently treated as equity (after conversion), with varying rules applying to the interest fluctuations. Subordination is usually not a consideration at all. While profit participation is a consideration in all countries, a greater significance is placed on this by the German and Austrian tax authorities. Profit-participating bonds or loans are generally treated as debt. However, if the participation rights include a right to participate in the proceeds on liquidation, then the instrument can be treated as equity. German tax law also contains special provisions where the participation of losses is concerned. In both France and Germany, perpetual bonds are considered to be debt. Where an instrument contains deferral options, the implication depends on whether the requirement to pay falls away entirely or whether it is merely deferred to a later point in time (Schön *et al*, 2014:195,202 and Schön *et al*, 2009:25-26,91). Instruments can thus easily be classified as debt for tax purposes in the above countries. The authorities in Germany are, however, considered to be more closely connected with economic content of an arrangement.

It is clear from the above sample countries that variations between countries in the tax classification of debt and equity do exist in practice and hence contribute to hybrid mismatch arrangements, as indicated by the OECD. Multinationals can utilise these variations in designing funding arrangements like hybrid debt instruments. Further policy options may therefore be needed in order to address this gap. A few countries have started introducing special provisions in their tax legislation on the tax treatment of hybrid instruments. The general trend in these countries is discussed below.

## **Hybrid debt tax treatment trends**

In 2012, the OECD released a paper which presented the concerns and issues of hybrid mismatch arrangements and suggested policy options that tax authorities could implement (2012:13). At that stage, a few countries had started introducing specific rules targeting cross-border hybrid instruments and the OECD noted the success in this regard (2012:14). The rules implemented by the countries were found to be effective and had reduced the incidence of mismatch arrangements being exploited by taxpayers (OECD, 2012:23-24). Over time, more countries have started introducing such rules. The approaches taken by countries broadly entail rules that deny deductions for payments which are not taxable in the hands of the recipient or rules that deny exemptions on income in certain situations. Examples of countries that have implemented such rules, as well as the problems they have faced in respect of such rules, is contained hereafter. In addition to the countries mentioned below, other countries like Hungary, Singapore, Switzerland and Poland either have or are in the process of introducing hybrid-specific tax rules (PwC, 2014).

### **Denial of deductions**

A number of European countries have special rules denying interest deductions in particular instances. From a Danish tax perspective, if certain requirements are met, including the treatment of Danish debt as equity in the foreign (counterparty) tax jurisdiction, the instrument would be treated as debt for Danish tax purposes and the interest deduction denied. Furthermore, the payment would be subject to dividend withholding tax instead of interest withholding tax, which may be levied at a different rate. Specific legislation was also introduced by Denmark on tax arbitrage using fiscally transparent entities. These rules also

deny Danish tax deductions where there is no income inclusion in the foreign (counterparty) country for tax purposes (OECD, 2012:17-21). The United Kingdom took a similar approach by introducing a set of rules for denying deductions. Returns qualifying for a tax deduction in the United Kingdom without a corresponding or acceptable tax charge in the recipient's tax jurisdiction are captured by these rules and the tax deduction for such returns is consequently denied. Further factors are, however, taken into account before denying this deduction, like whether the main purpose was to achieve a domestic tax advantage (Van Gelder, 2013:147). The United Kingdom seems to focus more on whether it is part of a scheme to obtain a 'more than minimal' local tax advantage (OECD, 2012:17-21). Other European countries with limitations on interest deductibility include the Netherlands, France and Sweden (van Gelder, 2013:145). In France, special rules apply to related party loans whereby an interest deduction can be limited if the interest income is considered to be subject to insufficient tax (PwC, 2014:52). Sweden has rules on the deductibility of interest which take into account the tax on the corresponding income and the existence of business reasons for the debt (PwC, 2014:71). A non-European example of a country with similar rules is Mexico. The Mexican tax authorities deny deductions of certain payments, like interest, where these are made to tax transparent entities or where it is disregarded or not included in the income of the recipient (PwC, 2014:60).

### **Denial of exemptions**

Some European countries have special rules denying dividend exemptions in particular instances. Countries like Austria, Denmark, Germany, Italy and New Zealand deny exemptions on income for which a deduction could be claimed in the foreign (counterparty) tax jurisdiction. These mainly apply to dividends received on an equity investment in a

foreign tax jurisdiction (OECD, 2012:17-21 and PwC, 2014:55). The Netherlands applies certain tests which can result in dividend exemptions being denied in the hands of the Dutch taxpayer, namely, comparing the tax treatment in the foreign tax jurisdiction to the Dutch tax treatment and evaluating whether the assets of a foreign subsidiary consists mainly of hybrid financing receivables (van Gelder, 2013:145). The United Kingdom has legislation on taxing certain receipts that would otherwise not be subject to tax. Particular criteria are evaluated, like the existence of a scheme and the receipt of a non-taxable amount that was deductible for the payer (Davis Tax Committee, 2014:39).

### **Common problems**

While success amongst countries was noted, problems were also being faced by the countries in enforcing their hybrid instrument tax rules. Some of these were that the rules needed to be constantly monitored and amendments made to address structures that circumvent the rules; the reference to foreign tax treatments created difficulties in application; tie-breaker clauses were needed to resolve disputes where both countries took the foreign tax treatment into account; and the rules created administrative burdens (OECD, 2012:23-24). It was therefore a learning process. Knowledge needed to be shared between countries and additional disclosures were required on these arrangements (OECD, 2012:25). While the OECD did mention a harmonised tax treatment by countries, it is interesting to note that at that stage (in 2012) the OECD acknowledged that a harmonised approach was not likely to happen (OECD, 2012:13). Nonetheless, the OECD has emphasised a harmonised approach in both its 2014 and 2015 reports. OECD member countries have since agreed to work together in implementing consistent and co-ordinated rules. In addition, the OECD has stated that it will develop a comprehensive framework for monitoring the implementation of recommendations



by countries, and all interested countries are able to participate on an equal basis (EY, 2015:11).

## **Conclusion**

Countries have become more wary of the tax classification of debt and equity. There is a distinct move towards considering the substance of an instrument rather than its legal form. Various guidelines are being established and followed by the different countries. In addition, tax-specific rules addressing hybrid instruments is proving to be fairly successful amongst countries and, despite the problems experienced, is gaining more momentum. While the specific rules differ between countries, the broad approach taken is comparable with the recent OECD recommendations. However, it is largely European countries that have or are looking to introduce such rules, which strengthens the concern that the OECD recommendations could prove to be a challenge for many countries.

## **CHAPTER EIGHT – Tax policies adopted by South Africa**

### **Introduction**

Like many other countries around the world, South Africa is faced with the same debt/equity tax classification concerns regarding hybrid instruments and the same concerns on tax planning techniques that utilise such instruments. A hybrid debt instrument grants the borrower of the funds the ability to claim deductions on the returns paid on the instrument, without a corresponding inclusion in the income of the lender. Within both a domestic and cross-border context, tax planning techniques can be applied whereby the corresponding income is not subject to tax or is subject to a minimal level of tax. With cross-border arrangements, these tax planning techniques may become more difficult to detect, and, in addition, further tax planning techniques can be employed. Profits can thereby be shifted out of South Africa, resulting in lost tax revenues. One of the steps taken by National Treasury to address this risk was the introduction of specific hybrid debt legislation. This chapter discusses the background to the introduction and amendments made in respect of this legislation, the mechanics of the legislation and how the legislation (broadly) compares to international recommendations and trends.

### **Background to the introduction of hybrid debt legislation**

National Treasury recognised in 2004 that an instrument characterised as debt may display the characteristics of equity and that such (hybrid) instruments were being used internationally for a number of years, often to exploit the difference between debt and equity

(National Treasury, 2004:19). National Treasury therefore believed that there was an urgent need to improve anti-avoidance legislation on hybrid instruments (SARS, 2004:8).

The tax rules on hybrid instruments at the time were based on case law and various sections of the Income Tax Act, namely, the gross income definition contained in section 1; section 8E on hybrid equity instruments; the general deduction formula (falling within section 11 read together with section 23); and the general anti-avoidance provisions in section 103.

Section 8E was the only specific legislation on hybrid instruments but was limited to certain hybrid equity instruments only. It was considered far too narrow. Furthermore, there were no rules recharacterising interest as dividends where disguised dividends were concerned. There was also concern about manipulation of financial instruments and arrangements in order to reduce overall taxes (National Treasury, 2004:19). As such, it was announced in the 2004 National Budget by the then Minister of Finance that legislation which would characterise hybrid instruments based on their underlying economic substance would be introduced (SARS, 2004:8).

The proposal by National Treasury on hybrid debt instruments was that a section be introduced which specifically limited the deductibility of interest for persons other than natural persons on instruments that were equity in substance. In this manner, tax avoidance using such instruments would be countered. The focus of the legislation that National Treasury intended to propose included *inter alia* debt with a principal that was effectively never repayable and rules addressing concerns on domestic hybrids compared to foreign hybrids (SARS, 2004:8). While the latter concerns were not detailed by National Treasury, it appeared to relate to section 24J, which is the section that governs the taxation of interest in respect of interest-bearing arrangements. National Treasury proposed amendments to section

24J, stating that this was due to the manipulation of financial instruments and the use of hybrid instruments within complex financing structures. The tax avoided as a result of these structures was estimated at many billions of Rand (National Treasury, 2004:20).

Amendments to section 8E on hybrid equity instruments were also proposed in order to expand its scope (National Treasury, 2004:23).

National Treasury thereafter released a set of proposed rules on hybrid debt instruments. Very specific forms of hybrid debt instruments were targeted, which were essentially redeemable or convertible-type instruments. It was therefore a very narrow and limited scope. Despite various issues identified, the proposed rules were legislated and included as section 8F in the Income Tax Act by section 10(1) of Act 32 of 2004 (referred to hereafter as the 'initial' section 8F).

Due to the concerns relating to the initial legislation and its limited ambit, an announcement was made in the 2011 National Budget that specific legislation would be introduced concerning debt with indefinite or indeterminable maturity dates and yield calculations (SARS, 2011:18). National Treasury appeared to have become increasingly concerned about manipulation of maturity dates and distortion of interest calculations by taxpayers.

Considerable amendments were proposed to section 8F by National Treasury in 2012.

Various forms of hybrid debt instruments were covered by the 2012 proposals. The purpose of the rules was changed slightly whereby not only the return on a hybrid debt instrument but the instrument itself was to be recharacterised, deeming it to be a share other than an equity share (National Treasury, 2012a:27). The underlying shares would thus be deemed to be the debt principal and the returns or interest yield would be deemed to be the dividend and capital distributions on the instrument (National Treasury, 2013b:3). A proposal was also made to

insert a new section in the Income Tax Act, section 8FA, which dealt with hybrid interest and reclassified such interest as dividends *in specie* (National Treasury, 2012a:28). These proposals were made after the release of the OECD's first document mentioning hybrid mismatch arrangements in 2010, the focus of which was bank losses, but around the same time as the release by the OECD of its 2012 paper on hybrid mismatch arrangements. South Africa was thus at the forefront of tax legislation changes.

The draft proposals released by National Treasury in 2012 were later removed from the final Taxation Laws Amendment Bill, 2012 due to the rules being overly broad and unnecessarily complex, negatively impacting commercial transactions not driven by tax (National Treasury, 2013b:3). The proposals were reconsidered and a new draft issued in 2013, which took into account public comments that National Treasury had received on the 2012 proposals (National Treasury, 2013b:2-3). The impact of the 2013 proposed rules remained largely the same as the 2004 version of section 8F whereby only the return on a hybrid debt instrument (i.e. interest) was recharacterised as a dividend and the nature of the instrument itself (i.e. corpus) was not affected, unlike initially proposed in 2012 (National Treasury, 2013e:29-30). In addition, the rules on hybrid interest were slightly narrower than those initially proposed in 2012 (National Treasury, 2013f:20). Certain exemptions from the hybrid debt and hybrid interest rules were also listed in the 2013 proposal (National Treasury, 2013e:30). While further public comments were submitted to National Treasury, minimal amendments to the 2013 proposal were subsequently made. Two of the comments that were accepted by National Treasury were that the effective date of the proposed rules should be moved forward to allow taxpayers to restructure their affairs in view of the proposals; and that the proposed rules were restricted to debt owed by resident companies and there was no clear reason as to why it did not apply to branches of foreign resident companies (National Treasury,

2013c:17). A number of other comments were either partially or fully rejected (National Treasury, 2013d:9-11). The draft legislation was promulgated in 2013 and introduced into the Income Tax Act by section 12(1) of the Taxation Laws Amendment Act of 2013 (referred to hereafter as the 'current' section 8F). While the ambit of the legislation was widened by the amendments, the scope was still limited to specific forms of hybrid debt instruments.

National Treasury commented in 2013 that the amendments were in light of an increasing concern, both within South Africa and globally, for tax schemes undertaken by taxpayers (National Treasury, 2013b:1). At this stage, the OECD had released their comprehensive report on base erosion and profit shifting, in which hybrid instruments were identified as a key pressure area (OECD, 2013a:47). The use of these instruments was increasing and it was quickly becoming a global tax concern. Adding to a statement made by the OECD that profit shifting is a significant source of base erosion, National Treasury pointed out that a substantial amount of base erosion occurs in South Africa due to excessive deductions being claimed, normally by way of interest, royalties, service fees and insurance premiums, with the corresponding income flowing to low- or no-tax countries. Their biggest concern was that of excessive interest deductions and hybrid debt was identified as one of the areas that needed addressing (National Treasury, 2013b:1). National Treasury recognised hybrid debt instruments as instruments with a label of debt but that have substantive equity features. They considered the label of debt to be purely for tax reasons, i.e. to obtain a tax deduction on the returns and to benefit from cross-border tax arbitrage. The legislation was thus part of an initiative to curb excessive interest deductions (National Treasury, 2013b:2).

## **Initial legislation on hybrid debt – section 8F**

The initial section 8F (promulgated in 2004) was comprised of subsections (1) and (2), with subsection (1) containing the definition of a hybrid debt instrument and subsection (2) containing the tax implications that apply to such an instrument. The mechanics of section 8F was as follows:

- The recipient of funds under a funding instrument (borrower) needed to evaluate the instrument and determine whether it fell within one of the categories specified under section 8F(1), in which case it would be classified as a hybrid debt instrument.
- If the instrument was classified as such, then section 8F(2) resulted in interest on that hybrid debt instrument being denied as a deduction in the hands of the borrower.

The initial section 8F is included in Appendix A for reference purposes. Since the ambit of the legislation is considered the main concern, this is discussed first and thereafter further concerns of the legislation.

### **Ambit of initial legislation**

The initial section 8F was considered too narrow in its scope and the rules could easily be averted. Only specific types of instruments fell within the definition of a “hybrid debt instrument”, namely, convertible loan transactions; convertible preference shares; convertible debt; and revenue stream swaps (Brincker, 2011:B2.4). Furthermore, the legislation was restricted to a three year test, which is the same time period applied in section 8E on hybrid equity instruments. The rules were hence considered inadequate and mostly ineffective in counteracting the inconsistency between the commercial and the tax nature of hybrid

instruments. Moreover, case law principles were seldom being applied in recharacterising instruments based on their substance (Mitchell *et al*, 2012:16 and van der Zwan, 2014:52).

The four types of instruments that fell within the “hybrid debt instrument” definition are as follows:

1. The first type referred to debt that a company, being the recipient of the loan funding, had a right to discharge within three years from the date of issue of that instrument through the conversion into or exchange for a share in that same company. Alternatively, the debt could be discharged by a share in another company, provided that other company was a connected person in relation to the recipient company at the time (Brincker, 2011:B3.3).
2. The second type was very similar to the first, except that the word “repayment” was used in place of “convertible into or exchangeable for”. In addition, it expressly provided for a full or partial settlement of the debt. Brincker pointed out that the situation of a cash repayment by the company followed by an immediate subscription for shares in the company by the lender was not dealt with by the legislation (2011:B3.3).
3. The third type dealt with a repayment of the debt, whereby the company had a right to repay that debt within three years from the date of issue and, in addition, had a right to force the lender to subscribe for or acquire shares in that company or in a “connected person” of that company. Brincker stated that instruments where the lender, as opposed to the company, had a right to the subscription or acquisition of shares was not dealt with (2011:B3.3).
4. The last type was similar to the first type except that it was the lender that had to have held a right to have the debt discharged in the manner described. It also contained a further requirement, namely, that it had to be determined at the date of issue that the value of the share at the time of conversion or exchange was likely to exceed the value of the debt



instrument by at least twenty percent. Listed instruments issued by listed companies were excluded. According to Brincker, the legislation was restricted to conversion or exchange and did not include a subscription or acquisition of shares. Brincker stated further that it also did not apply where it was not possible to determine the future value of the share (at the time of conversion or exchange). Brincker added that if the debt was convertible at the fair market of the shares, it would be treated as debt until conversion or exchange (2011:B3.3).

It is understood from the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004 that the reasoning behind introducing such a definition was that debt that is convertible or exchangeable into equity is equivalent to debt that gives the lender the benefit of an equity upside (National Treasury, 2004:25). In effect, it provides protection against declines in the market as the equity is issued at the face value of the bond, while at the same time allowing the lender to participate in equity increases. The lender is thus entitled to fixed income and also shares in equity movements, although the lender can be exposed to equity losses (Brincker, 2011:B3.1). The legislation specifically targeted hybrid instruments that combine the expected time value returns with the exposure to changes in the equity value of a company (National Treasury, 2004:19). In addition, National Treasury's view is that convertible debt is generally issued with the aim of converting it into equity rather than redeeming it at maturity (National Treasury, 2004:25). These types of instruments were thus of special concern to National Treasury as they lacked a key characteristic of debt, which is the repayment requirement (National Treasury, 2004:19). The three year test was due to instruments that are convertible into equity within a three year period being placed by National Treasury at the equity end of the debt/equity spectrum (Brincker, 2011:B3.1).

As a result of the limited application of the rules, it was expected that additional legislation would be introduced at a later stage (Brincker, 2011:B2.4).

### **Other concerns of the initial legislation**

Although various issues were identified at proposal stage, National Treasury continued to promulgate the legislation in 2004 without any changes. For instance, the term “instrument” referred to in the section was not defined and it had to be assumed that the term had the same meaning as defined in section 24J, despite section 24J definitions being limited to section 24J only (Brincker, 2011:B3.2-3.3). Two of the more significant concerns, the one-sided application of the legislation and the effective date of application, are explained in more detail below.

#### One-sided application

The hybrid debt instrument rules effectively denied the interest deduction for the borrower, deeming the interest to be a dividend subject to secondary tax on companies (a special tax that applied to companies on their dividend declarations, prior to the introduction of dividends tax). The corresponding interest income, on the other hand, was still treated as taxable interest income in the hands of the lender (National Treasury, 2004:24). It was thus only a partial recharacterisation and a double penalisation as it denied a deduction for the payment but still taxed the corresponding income. Hence two layers of tax was being levied on the income, one at borrower level through application of secondary tax on companies and the second at lender level through normal income tax rules. This appeared to be a distinct choice by the legislator to not treat the tax position of the recipient and the funder in a uniform manner (Brincker, 2011:B2.4).

### Effective date of application

Brincker pointed out that there was confusion as to the date and scope of applicability of the proposed legislation. According to the Income Tax Act, the legislation came into operation on 26 October 2004 and applied in respect of any instrument issued or transferred to an issuer during any year of assessment commencing on or after that date. Firstly, it was unclear as to whether the year of assessment referred to that of the funder or the recipient or both. Next, the words “issued to an issuer” did not make logical sense. Lastly, existing instruments and instruments where the terms had been changed were not dealt with, although the latter was dealt with under the “date of issue” definition (Brincker, 2011:B3.1). For instruments already in existence, it appeared that the rules only applied to interest that was paid or payable after the instrument became a hybrid debt instrument, thus interest already paid (prior to the rules becoming applicable) was not affected (Brincker, 2011:B3.2-3.3). However, this was not explicitly dealt with in the legislation.

### **Addressing the concerns of initial legislation**

National Treasury acknowledged that hybrid instruments combine debt and equity features and that the economic substance of an instrument may differ from its tax characterisation. National Treasury views debt as redeemable with a yield based on the time value of money. It has payment obligations that exist regardless of the profit or cash flow position of the debtor. Equity is typically non-redeemable with a yield dependent on the profits of the company and payment obligations are discretionary or can be deferred without legal implications (National Treasury, 2013c:27). With these and other principles in mind, National Treasury released a set of draft proposals for significantly amended hybrid debt legislation. Hence the proposals were meant to address the concerns of the legislation at that time, including the narrow scope;

the restrictive time period of three years; the one-sided application of the rules; and the uncertainty relating to the effective date of application.

The current sections 8F and 8FA (promulgated in 2013) are considered to address the weaknesses of the previous legislation on hybrid debt instruments. There appears to be limited opportunity to manipulate instruments in order to avoid falling within the sections. The instrument as a whole and the yield are both assessed more comprehensively. There is no longer a one-sided implication as the current rules apply consistently to both parties to the instrument (National Treasury, 2013e:29-30). There is no reference to the creation of the instrument in the effective date and the wording is much clearer (the sections apply to interest incurred on or after the effective date of 1 April 2014 and it applies to all existing instruments).

### **Current legislation on hybrid debt – sections 8F and 8FA**

The Income Tax Act thus currently contains two sections on hybrid debt, sections 8F and 8FA (as opposed to the single section previously contained in the Income Tax Act). The current section 8F (promulgated in 2013) is laid out in a similar manner compared to the initial section 8F (promulgated in 2004). It contains the relevant definitions, the implication of falling within this section and the exclusions to this section. Section 8FA is also laid out in this way. The first section, section 8F on hybrid debt instruments, deals with the instrument itself (i.e. the *corpus*) and its related returns. The second section, section 8FA on hybrid interest, deals solely with returns on an instrument (i.e. nature of the yield). Section 8FA is not specific to hybrid debt instruments and can apply to any instrument (National Treasury,

2013b:3). For the purposes of these sections, “instrument” means any form of interest-bearing arrangement or debt.

Sections 8F and 8FA contain deeming provisions that recharacterise the return on the instrument. The instrument itself is not recharacterised. Both the instrument and any potential side arrangements were taken into account in drafting the legislation (National Treasury, 2013c:29).

### **Hybrid debt instrument – ambit of section 8F**

Like the initial section 8F, only specific instruments were targeted by the hybrid debt instrument rules. The specific instruments targeted by National Treasury is apparent from the amended definition ascribed to the term “hybrid debt instrument”, contained in the current section 8F titled “Interest on hybrid debt instruments deemed to be dividends *in specie*”.

Section 8F can be referred to in Appendix B.

A hybrid debt instrument is created in the following three situations:

1. Non-market value related conversions – The first situation occurs where, in the particular year of assessment, the company has a right to or is forced to partially or fully convert or exchange an interest-bearing arrangement under which it owes an amount of money for shares, unless the market value of those shares equates to the amount owed at the time of conversion or exchange. A conversion based on the value of the debt rather than a fixed number of shares should not be caught under this category (van der Zwan, 2014:52).
2. Solvency-based repayments – The second situation occurs where the obligation to pay any amount owing under the interest-bearing arrangement is dependent on the solvency of the

company (i.e. the market value of all assets should equal or exceed the market value of all liabilities). It was indicated by van der Zwan that a court decision noted that, even in the absence of specific repayment terms, where the lender was aware that borrower was not able to repay a loan, the lender could not reasonably have expected repayment and hence there is an implicit condition in the repayment terms, which is that the borrower has the ability to pay. This principle should, however, not impact this second solvency-based trigger of a hybrid debt instrument (2014:52). With respect to subordination clauses, these should be avoided or reworded in order to prevent subordinated loans from being captured under this category (Jackson *et al*, 2015).

3. Connected person redemptions beyond a reasonable time frame – The third situation occurs where the amount owing under an interest-bearing arrangement is owing to a connected person and the discharge of all liabilities under such an arrangement does not have to take place for a period up to thirty years, calculated either from the date of issue or the end of that year of assessment (van der Zwan, 2014:52). Redemption within a reasonable time frame is considered by National Treasury a key feature of debt and the lack of such a feature indicates that the instrument is more equity-like, especially where the funding has been extended by a related party that forms part of the same economic unit (2013c:29). Where the instrument can be converted to or exchanged for another financial instrument (other than a share) at the option of the company, the two instruments must be deemed to be one and the same for the purposes of the thirty year trigger. Extension clauses within loan agreements have not been dealt with, creating scope for avoiding this trigger. Instruments payable on demand are excluded from this last type of hybrid, which should assist with many instruments avoiding the implications of the hybrid debt rules (van der Zwan, 2014:52 and Jackson *et al*, 2015). According to van der Zwan, a well-

established common law principle is that the lack of specific repayment terms within a loan agreement essentially makes it repayable on demand (2014:52-53).

The current definition is considered by van der Zwan to be an improvement on the previous one as there is limited opportunity to manipulate instruments in order to avoid the consequences of the sections. The features that trigger a hybrid debt instrument are much wider and are predominantly not linked to a timeframe, as was the situation with the three year rule of the previous definition (van der Zwan, 2014:50,52). Nonetheless, the rules only target the specific types of hybrid instruments that were of concern to National Treasury. There may be other hybrid debt instruments that are being used in practice which demonstrate a number of equity characteristics but fall outside of the ambit of section 8F. At the same time, a broader definition than what currently applies may capture too many instruments and be too onerous for taxpayers. It may also result in differences in interpretation and application between taxpayers and SARS. The ambit of the rules may therefore be adequate.

### **Hybrid interest – ambit of section 8FA**

As part of the two-pronged approach taken by National Treasury, section 8FA titled “Hybrid interest deemed to be dividends *in specie*” was also introduced, which contains a new tax term “hybrid interest”. Section 8FA can be referred to in Appendix B. Based on the “hybrid interest” definition, any interest which is not based on a specified rate or on the time value of money is considered to be hybrid interest. Additionally, an increase in the rate of interest which is based on increased profits (i.e. profit-dependent returns) is also considered to be hybrid interest.

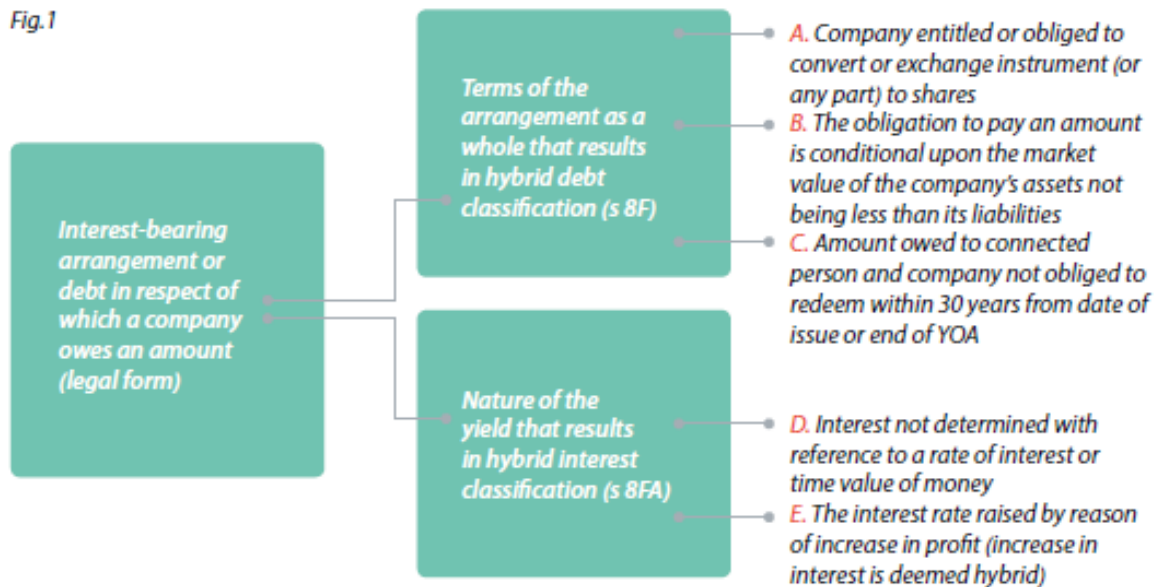
According to van der Zwan, the wording of the definition creates opportunities for interpretation. For instance, there is uncertainty as to whether the interest must be calculated solely using a specified interest rate or time value of money in order to avoid section 8FA, or whether other factors could be included in the calculation. Since it is not expressly stated, it could be interpreted that interest calculated using a specified rate / time value of money together with other factors would not be hybrid interest. Another uncertainty is whether the interest must be divided into the components of its calculation. It could be argued that a proportionate approach be taken and the portion that is calculated using a specified rate or the time value of money would not be hybrid interest while the remaining portion would be (van der Zwan, 2014:54-55). The legislation may therefore need further consideration by National Treasury and supporting guidelines. Regarding the second part of the hybrid interest definition, one option of avoiding the provisions of section 8FA from being triggered is for parties to determine a rate of interest that the company will be able to consistently pay based on its estimated earnings, as opposed to linking repayments to the company's earnings (Jackson *et al*, 2015).

### **Summary of ambit of sections 8F and 8FA**

The scope of sections 8F and 8FA has been summarised by van der Zwan in the figure hereunder. He recommended a revision of the terms of existing instruments, where required, in order to avoid falling within the scope of these sections (2014:52,55).



Fig.1



### Application by the courts – substance over form

Despite the terms “hybrid debt instrument” and “hybrid interest” being specifically defined in sections 8F and 8FA of the Income Tax Act, some practitioners like Lewis have warned taxpayers about the substance over form principle that is applied by the courts (Lewis, 2013:2). Courts are not bound by labels given to agreements or subjective views, instead the courts will base their decision on the true nature of the rights and obligations agreed to between the parties i.e. the ‘real’ rather than ‘disguised’ agreement (de Koker & Brincker, 2010:8.6.30 and Roodt, n.d.). Examples of court cases where the substance over form doctrine was applied include *Erf 3183/1 Ladysmith & Another v CIR* 1996 (3) SA 942 (A), *CCE v Randles Bros & Hudson Ltd* 1941 AD 369 and *Zandberg v Van Zyl* 1910 AD 302.

It has been recommended that care be taken with regards to the terms and conditions of the instrument; its true nature should be established (Lewis, 2013:2). The rights and obligations

contained within an agreement must therefore correspond with the true intention of the agreement (de Koker & Brincker, 2010:8.6.32). In disguised arrangements where the parties never intended to enforce the rights and obligations as they are presented, the form is ignored and the real intention is given effect to. This is referred to as the sham doctrine and applies more so where there is dishonesty or deception by the parties (de Koker & Brincker, 2010:8.6.28-8.6.30). Based on the substance over form principle and its application by the courts, a debt instrument can thus be reclassified as equity by the courts without regard to the ambit of section 8F and 8FA, when having regard to the principles set out in case law in respect of the application of the substance over form or sham doctrines. Reclassification is hence not restricted only to situations where specific sections of the Income Tax Act apply.

### **Tax implications of falling within sections 8F and 8FA**

Sections 8F and 8FA have the effect that interest (i.e. return on the instrument) that is incurred during a year of assessment by a company (referred to hereafter as the ‘borrower company’) in respect of a “hybrid debt instrument” or in respect of “hybrid interest” is deemed to be a dividend *in specie* declared and paid by that borrower company on the last day of the borrower company’s year of assessment and is no longer deductible in the determination of the borrower’s taxable income. Correspondingly, the interest (i.e. return on the instrument) that accrues to the person that extended the funds (referred to hereafter as the ‘lender’) is deemed to be a dividend *in specie* declared and paid to such lender on that same day. All companies are subject to these implications, including foreign companies (Income Tax Act).

The borrower company is therefore not entitled to any deduction in respect of interest for South African tax purposes (Clegg & Stretch, 2014:24.20.2). The disallowance applies to interest arising on an instrument from the date that instrument becomes a “hybrid debt instrument” or the interest becomes “hybrid interest”. The rules apply until the definitions of “hybrid debt instrument” or “hybrid interest” cease to be met (Clegg & Stretch, 2014:24.20.2-24.20.3). This implies that an instrument needs to regularly be tested in order to establish whether it is captured by section 8F. This understanding is in line with the view by National Treasury that debt must be continually tested to determine if it is commercially real or artificial in nature (2013c:29). The term “issue” is also referred to in section 8F, specifically, in the definition of “hybrid debt instrument”. It means the “creation of a liability to pay an amount in terms of that instrument”. Based on this definition, the disallowance applies from the date that the company becomes indebted (de Koker & Williams, 2014:17.72C). However, this is specific to the third category of instruments that are captured by section 8F, which contains the 30 year maximum redemption period.

In addition to the disallowance of the interest, the borrower company would need to account for a dividend *in specie*. Dividends, including dividends *in specie*, are subject to the dividends tax provisions contained in sections 64D to 64N. Where a dividend *in specie* has been declared and paid by a South African tax resident company (i.e. the borrower in this instance), that South African tax resident borrower company will be liable for dividends tax in terms of section 64EA(b). Dividends tax applies at a rate 15% per section 64E, unless an exemption or reduced rate per section 64FA applies. One of the potential exemptions that could apply is the resident company exemption, if the beneficial owner of the dividend (i.e. the lender in this instance) is a South African tax resident company. A reduced rate usually applies in terms of an applicable double taxation agreement and hence could apply where the

recipient, being the beneficial owner of the dividend, is a non-tax resident. According to SARS, the dividends tax levied in this instance (i.e. on an amount that is deemed to be a dividend *in specie*, the liability for which falls in the hands of the paying company) will not qualify for a reduced rate under an applicable double taxation agreement. There is some debate on whether a reduced rate could apply, however, this discussion involves double taxation agreements and hence falls outside the scope of this report. Through application of section 64K(1)(b), the South African tax resident borrower company must pay the dividends tax over to SARS on the last day of the month following the end of the year of assessment (as the dividend *in specie* is deemed to be declared and paid on the last day of the year of assessment for section 8F purposes). Certain required declarations and documentation must also be submitted to SARS per section 64K (BDO, 2014:3-4; SARS, 2015a:76-78,110-111; and Income Tax Act).

The lender is also subject to sections 8F and 8FA and will similarly treat the interest as a dividend *in specie*. The lender will not recognise interest income but dividend income, which is specifically captured under paragraph (k) of the gross income definition and will hence have to be included in the gross income computation of the lender. The lender should qualify for an exemption under section 10(1)(k)(i) for that dividend income, which is commonly referred to as the 'local dividend exemption', unless one of the exceptions to the exemption applies. These tax implications will apply to the lender irrespective of whether the lender is a South African tax resident or not, and irrespective of whether the borrower is a South African tax resident or not (SARS, 2015a:76-78 and Income Tax Act).

For non-tax residents, sections 8F and 8FA will only be relevant where these non-tax residents are subject to the provisions of the Income Tax Act (i.e. where they fall within the

South African tax net) and are required to compute their taxable income for South African tax purposes. Should non-tax residents be party to the instrument, the tax implications in the foreign jurisdiction would also need to be taken into account. The payment(s) captured under the deeming rules of sections 8F and 8FA may still be considered to be interest by the foreign jurisdiction and foreign tax implications relating to interest may still arise (in addition to the implications of sections 8F and 8FA). The impact of withholding taxes, double tax agreements and foreign tax credits would also have to be considered, where applicable. Further discussion on this falls outside the scope of this report.

With respect to the definition of “interest” for the purposes of sections 8F and 8FA, a point to be noted is that it is defined as “interest as defined in section 24J”. The definition of the term “interest” as contained in section 24J(1) (set out in Appendix B) essentially includes any interest or related finance charges, discount or premium payable or receivable; and certain amounts payable by a borrower to the lender in terms of a lending arrangement. Section 24J also contains principles on calculating the quantum of the interest that is to be included or deducted by taxpayers in their taxable income computations (ENSafrica, 2015). According to ENSafrica, it is not clear whether the provisions of section 8F and 8FA apply to recharacterise amounts of interest equal to the stated interest in respect of the relevant instrument, or the amounts of interest as determined in accordance with section 24J. It is also not clear how recharacterised amounts are taken into account for purposes of determining, *inter alia*, accrual amounts and adjusted gains and losses in terms of section 24J. ENSafrica anticipate complications when applying sections 8F or 8FA in conjunction with section 24J (2015).

Per section 8F(3) and section 8FA(3), the provisions of sections 8F and 8FA do not apply in the following instances:

- an instrument or debt in respect of which all amounts are owed by a small business company (as defined);
- a tier 1 or tier 2 capital instrument referred to in the regulations issued in terms of section 90 of the Banks Act, where it has been issued by a bank or controlling company in relation to that bank;
- certain instruments that are subject to approval as contemplated in the specified section of the Short-term Insurance Act, in terms of which amount are owing by a short-term insurer and similarly with long-term insurers; and
- an instrument that contains a linked unit in a company, where those linked units are at least 20% held by a long-term insurer, a pension fund, a provident fund, a REIT or a short-term insurer and were acquired before 1 January 2013, and at the end of the previous year of assessment at least 80% of the value of the assets of that company is attributable to immovable property.

From the analysis above it is apparent that the purpose of the provisions of sections 8F and 8FA is to recharacterise the return on disguised equity as a dividend, with the result that both the issuer and the holder of the instrument are taxed as if the instrument represented equity. Sections 8F and 8FA thereby assist in reducing excessive interest deductions, which was noted as a concern by National Treasury. However, it is important to note that the results of these sections are not entirely aligned with the recommendations by the OECD.

Summary on tax implications and considerations for the parties to an instrument captured by sections 8F or 8FA

	<b>South African tax resident lender (company)</b>	<b>Non-tax resident lender (company)</b>
<b>South African tax resident borrower (company)</b>	<ul style="list-style-type: none"> <li>• No tax deduction on interest expense for borrower.</li> <li>• Dividends tax liability arises for borrower; however, resident company exemption should be available.</li> <li>• Dividend income included in gross income of lender; however, local dividend exemption should be available.</li> </ul>	<ul style="list-style-type: none"> <li>• No tax deduction on interest expense for borrower.</li> <li>• Dividends tax liability arises for borrower.</li> <li>• Dividend income included in gross income of lender; however, local dividend exemption should be available.</li> </ul>
<b>Non-tax resident borrower (company)</b>	<ul style="list-style-type: none"> <li>• Potential tax deduction on interest expense for borrower in foreign jurisdiction.</li> <li>• Potential foreign withholding tax on interest paid to lender (no foreign tax credits will be available for lender if the income is exempt).</li> <li>• No dividends tax liability.</li> </ul>	<ul style="list-style-type: none"> <li>• Not relevant for South African tax purposes as it should only involve foreign tax jurisdictions.</li> </ul>

	<ul style="list-style-type: none"> <li>• Dividend income included in gross income of lender; however, local dividend exemption should be available.</li> </ul>	
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**Policy approach in comparison with other countries and OECD recommendations**

National Treasury has focused on protecting South Africa’s tax base by denying interest deductions on instruments that it considers a commonly used tool for achieving unwarranted interest deductions through the disguising of equity instruments as debt or equity returns as interest. National Treasury adopted the approach of specifically defining the terms “hybrid debt instrument” and “hybrid interest” for South African tax purposes. The South African approach thereby targets particular instruments and restricts the application of hybrid debt legislation to those particular instruments only. National Treasury also chose not to include any references in the legislation to foreign (tax) laws. This differs from the approach taken by countries like Australia and the United States, where guiding factors are used to assist with the debt/equity classification of hybrid instruments rather than a strict rule. It also differs from countries like the United Kingdom and Singapore, where the foreign tax treatment of a hybrid instrument is considered in determining the domestic tax treatment. Linking the domestic tax implication to the foreign one is in line with the OECD domestic law recommendations made on hybrid debt instruments.



By targeting specific instruments only, there is the disadvantage of narrowing the ambit of the application of the South African hybrid debt reclassification rules and therefore risking many hybrid debt instruments not being captured by the legislation. The advantage is that there is much less room for subjectivity and interpretation, which helps to reduce the potential for challenges by taxpayers and the administrative burden on tax authorities. Overall, a definition targeting specific instruments releases both National Treasury and taxpayers from the difficult task of trying to classify each funding instrument as debt or as equity based on its agreed terms and conditions. Similarly, excluding foreign references in legislation is also an administratively easier and less burdensome approach, as confirmed by the experience of other countries in the 2012 report of the OECD (2012:23-24). It does not mean that National Treasury is completely adverse to referencing foreign tax treatment in its tax legislation, as this was done with the provisions on foreign dividends (initially, a reference to the foreign tax law treatment was included in the “foreign dividend” definition in section 1 of the Income Tax Act in order to assist with the consistent global treatment of hybrid equity instruments and the reduction of tax arbitrage, and later it was moved to section 10B which deals with foreign dividend exemptions) (National Treasury, 2010:85 and National Treasury, 2012c:144). It is therefore possible that a similar approach be taken in future on interest deductions.

Another point to note is that National Treasury specifically targeted instruments that it considered to be equity in nature but which were classified as debt by taxpayers. The OECD, on the other hand, has targeted all instruments that give rise to a tax mismatch between two or more jurisdictions. The OECD’s objective is hence slightly different and more directed at double non-taxation and the reduction of global tax revenues. The OECD has previously stated (in their 2014 report) that other tax measures that countries introduce on the

deductibility of interest, like limitations on the quantum of interest deductions based on specified rules, may obviate or reduce the need for introducing hybrid debt rules as recommended by the OECD (2014:64). These other tax measures would, for instance, assist in reducing excessive debt funding or excessive interest deductions. South Africa has several such measures in place and many of these additional rules are in line with the various policy recommendations that have been made globally. One example is thin capitalisation rules, which have been in place in South Africa for a number of years. These rules are contained in section 31 and the latest amendments to these rules were enacted in 2013. Previously, a safe harbour ratio applied to the debt/equity funding ratio of companies. A market value approach currently applies. A second example is the interest deductibility rules in section 23K, 23M and 23N. Section 23K was legislated in 2011 and applied specifically in relation to reorganisation and acquisition transactions, as defined in the section. Section 23K ceased to apply from 1 April 2014. It was replaced by section 23N. In addition, a new section 23M was introduced which limits interest deductions in respect of debts owed to persons not subject to South African normal income tax or withholding tax. Section 23M applies from 1 January 2015. A third example is withholding taxes on dividends and interest. Withholding tax on dividends, the rules for which are contained in sections 64D to 64N, came into effect as of 1 April 2012, while withholding tax on interest only came into effect from 1 January 2015. Sections 50A to 50H apply to interest withholding tax. Both withholding taxes currently apply at a 15% rate, subject to specified exemptions. The rates can be reduced under a double taxation agreement entered into between South Africa and any other country, per sections 50E(3) and 64G(3). A fourth example is the partial relief provided for equity income through an exemption system, whereby dividends declared by South African tax resident companies can be exempt from normal income tax by application of section 10(1)(k) (subject to certain exclusions). A fifth example is the controlled foreign company rules contained in section 9D,

which prevents taxable income from being shifted out of the South African tax net to other no- or low-tax jurisdictions through the use of foreign subsidiaries. Section 9D is considered to be a complex set of rules. A last example of additional rules in place in South Africa is the general anti-avoidance rules contained in sections 80A to 80L. These general anti-avoidance rules are not specific to transactions, instruments or entities. They are able to capture a wide range of tax avoidance situations. All of the afore-mentioned provisions assist in addressing the preference of debt funding compared to equity funding, excessive interest deductions and cross-border tax arbitrage.

Considering the number of different provisions contained in the Income Tax Act aimed at capturing tax planning and tax avoidance techniques, it is useful to note that the Davis Tax Committee, a tax review committee set up in 2013 by the then Minister of Finance, pointed out that rules governing the deductibility of interest should be developed holistically and without introducing too many sections in the Income Tax Act. The Davis Tax Committee also recommended that broader anti-avoidance rules be introduced which capture more transactions, rather than the numerous specific anti-avoidance provisions that are currently in place (many of the above-mentioned sections are anti-avoidance provisions). The committee recommended a principles-based approach rather than the ‘transaction-by-a-transaction’ approach currently in place. A similar comment was made on sections 8F and 8FA, which were considered to be quite complex and unclear. Simplified rules directed at legal principles rather than specific transactions was recommended (Davis Tax Committee, 2014:40,58-59). Specific to sections 8F and 8FA, the Davis Tax Committee is of the view that these sections should be linked to the tax treatment in the counterparty jurisdiction. Such a linking rule would take into account the existence of tax leakage through use of the instrument, which the current sections do not consider, and would also prevent potential tax abuse (Davis Tax

Committee, 2014:58-59). While the committee's observation was that tax avoidance using hybrid instrument mismatches is limited to certain 'niche' transactions in South Africa, the committee has recommended an emphasis on mismatches rather than an 'attack' on particular types of instruments or terms. There is currently no indication on whether further amendments will be made to these sections by National Treasury.

The Davis Tax Committee has cautioned against South Africa making unilateral changes as these could make South Africa less 'tax-friendly' than other jurisdictions and could thereby reduce South Africa's attractiveness as an investment location. The committee confirmed that international best practice is preferred (Davis Tax Committee, 2014:19). The aforementioned points were made by the Davis Tax Committee in its 2014 interim report on base erosion and profit shifting, which mirrored the base erosion and profit shifting report issued by the OECD in 2013. The same action plans were used, but adapted to South Africa's economic climate (Mazansky, 2015). Various South African and international stakeholders were consulted on adapting the action plans and addressing the tax issues raised by the OECD from a South African perspective, taking country-specific factors into account (Davis Tax Committee, 2014:1,18). The committee reviewed South Africa's legislation in light of international developments, and made recommendations on potential improvement areas. This process was done under the broader purpose of the committee, which is to "inquire into the role of South African tax system in the promotion of inclusive economic growth, employment creation, development and fiscal sustainability" (Davis Tax Committee, 2014:1).

## **CHAPTER NINE – Report summary and conclusion**

Over the years, globalisation and economic development have resulted in multinational groups structuring their operations across different countries, giving them ability to utilise tax planning techniques and take advantage of tax differentials between jurisdictions. Aggressive tax planning is considered to have eroded the tax base of many countries and resulted in profits being shifted from high- to low-tax jurisdictions. The increasing use of hybrid instruments as a tax planning technique has created concern amongst many jurisdictions. Debt instruments, in general, provide taxpayers with the ability to claim interest deductions, thereby reducing the profits that are subject to tax. Returns on equity, on the other hand, are declared out of after-tax profits and hence trigger distinctly different tax rules compared to returns on debt funding. In addition, with debt funding, the corresponding income (interest) can be shifted to other jurisdictions, resulting in lost tax revenues. Hybrid debt instruments pose a further risk to global tax revenues as they can be structured in a manner whereby the corresponding income is not subject to any taxes in any jurisdiction. Numerous research papers, including documents by the OECD, have been released on the use of hybrid instruments and the potential mechanisms to address the tax base erosion resulting from the use of such instruments.

Typically, the concern around the use of hybrid debt instruments is that taxpayers achieve the tax benefit of obtaining a tax deduction in one jurisdiction without a corresponding inclusion of the income for tax purposes in the counterparty jurisdiction, resulting in an overall reduction in taxes paid and a tax loss from a global perspective. The tax benefit arises mainly due to the discrepancy in the tax classification of the hybrid debt instrument by the two

respective jurisdictions i.e. the host jurisdiction (where the recipient of the funds is located), which classifies the instrument as debt and the counterparty jurisdiction (home jurisdiction, where the provider of the funds is located), which classifies it as equity. Since hybrid debt instruments comprise of a combination of debt and equity features, its classification as debt or as equity does become a challenge for jurisdictions. An instrument that contains both debt and equity characteristics could easily fall within either category, depending on the type and extent of these characteristics. Furthermore, the economic substance of the instrument may differ from its legal form and it is the legal form of an instrument that has traditionally been used for tax classification purposes. While jurisdictions are moving towards a substance over form approach, inconsistencies amongst countries remain an issue.

Numerous tax policy recommendations have been made globally. These range from entirely eliminating the debt/equity distinction for tax purposes and taxing the two forms of funding in exactly the same manner to merely reducing the tax differential between debt and equity funding through special tax rules. In practice, countries appear to favour less radical approaches and have adopted what could be termed as indirect methods to addressing the use of hybrid debt instruments. These indirect methods reduce the bias towards debt funding in general, rather than specifically target hybrid debt instruments. Examples of indirect methods include thin capitalisation rules, withholding tax on interest, notional deductions for dividends or other equity returns, and similar. More direct methods of curbing the use of hybrid debt instruments for tax arbitrage purposes have also been employed by various countries. For instance, some countries have adopted the approach of establishing specific tangible guidelines or criteria for determining whether an instrument should be classified as debt or as equity for tax purposes. Where an instrument is treated as debt, certain countries apply further legislation which could deny the interest deduction, depending on the foreign

tax treatment of the corresponding interest income. Including such foreign tax references in domestic legislation is in line with OECD recommendations.

The OECD recommends that, as a primary rule, the domestic tax deduction for hybrid debt instruments be linked to the foreign tax treatment, whereby the deduction for returns on the instrument is only granted by the domestic tax jurisdiction to the extent that the corresponding income is subject to tax in the foreign tax jurisdiction. Should the primary rule not be applied, a secondary or defensive rule can be applied by the counterparty jurisdiction whereby the income is subject to tax (i.e. no exemption is granted) if it was deductible in the paying jurisdiction. Similar rules are recommended for the granting of dividend exemptions or other dividend relief mechanisms. While these are direct methods of curbing the use of hybrid debt instruments, the rules require a significant amount of co-operation and co-ordination between jurisdictions. It also requires monitoring by a supervisory body like the OECD in order to be effectively and efficiently applied by all jurisdictions. Since inconsistencies in the tax classification and treatment by countries do exist and do give rise to tax planning opportunities, the OECD maintains that a globally co-ordinated approach is required. However, unilateral approaches (like the indirect methods mentioned above) may continue to be more attractive to some jurisdictions like South Africa.

South Africa has followed a slightly different approach compared to the OECD recommendations, with National Treasury specifically defining terms like “hybrid debt instrument” and “hybrid interest” within the tax legislation, thereby narrowing the ambit of the legislation applicable to hybrid instruments. Although providing a specific definition does limit the number and type of instruments that are considered to be hybrid debt instruments,

National Treasury has targeted the most common instruments used by taxpayers in taking advantage of the debt/equity tax distinction. Under South African legislation dealing with hybrid debt instruments, a deduction is denied in respect of returns on instruments falling within the “hybrid debt instrument” definition and returns that are considered to be “hybrid interest”. The returns are consequently treated as dividends *in specie* for tax purposes. A specific definition with a definite denial of interest on such instruments, although restrictive, reduces the burden on the tax authorities on trying to categorise every instrument that does not clearly fall within the categories of ‘pure’ debt or ‘pure’ equity and that should be treated as a hybrid debt instrument. National Treasury has also chosen not to link the South African tax treatment of cross-border hybrid debt instruments to the respective foreign tax treatment that applies to those same instruments. This limits the complexities and administrative burden of the legislation in trying to establish the foreign tax treatment of returns on that instrument.

South Africa also has numerous other provisions in the Income Tax Act that protect the South African tax base and address excessive deductions and tax avoidance. Many of the policy recommendations made internationally have been implemented by South Africa, like applying limitations on the deductibility of interest, imposing withholding taxes and applying anti-avoidance rules. The combination of all these provisions is likely to be more than adequate in addressing the global tax concerns surrounding hybrid debt instruments. South Africa is therefore aligned with many of the global developments in tax. Measures like setting up the Davis Tax Committee have assisted National Treasury in comparing South African tax legislation to international best practices and identifying areas for improvement. Through these measures, international recommendations, like that of the OECD, are considered from a South African perspective and adapted in order to incorporate South African specific factors.



The proactive attitude of National Treasury and the pace at which it has improved on its tax legislation puts South Africa ahead of numerous other countries around the globe. Going forward, National Treasury should be wary of introducing unilateral measures to address global tax concerns. National Treasury should ensure it maintains a competitive tax policy which encourages foreign direct investment and promotes economic growth.

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**8F. Limitation of deduction of certain interest payments.**—(1) For purposes of this section, unless the context otherwise indicates, any word to which a meaning has been ascribed in section 24J bears the meaning so ascribed, and—

**“date of issue”** in relation to an instrument means—

- (a) the date on which it is issued; and
- (b) the date on which that instrument becomes convertible into or exchangeable for a share at any time in the future;

**“hybrid debt instrument”** means an instrument, where—

- (a) that instrument is at the option of the issuer convertible into or exchangeable for any share in that issuer or any connected person in relation to that issuer within three years from the date of issue of that instrument;
- (b) the issuer in relation to that instrument is entitled to repay that instrument in whole or in part within three years from the date of issue of that instrument by the issue of shares by the issuer or any connected person in relation to the issuer to the holder of the instrument;
- (c) the issuer in relation to that instrument is entitled to repay that instrument in whole or in part within three years from the date of issue of that instrument and is entitled at the time of that repayment to require the holder of that instrument to subscribe for or acquire shares in the issuer or any connected person in relation to the issuer; or
- (d) that instrument, other than a listed instrument issued by a listed company, is at the option of the holder convertible into or exchangeable for any share in the issuer or any connected person in relation to the issuer within three years from the date of issue and it

is determined on the date of issue that the value of that share at the time of conversion or exchange is likely to exceed the value of the instrument by at least 20 per cent.

(2) No deduction shall be allowed in terms of this Act in respect of any amount paid or payable by an issuer in terms of a hybrid debt instrument, which is paid or becomes payable after that instrument becomes a hybrid debt instrument.

[S. 8F inserted by s. 10 (1) of Act No. 32 of 2004 with effect from 26 October, 2004 and applicable in respect of any instrument issued or transferred to an issuer during any year of assessment commencing on or after that date.]

**8F. Interest on hybrid debt instruments deemed to be dividends *in specie*.**—(1) For purposes of this section—

“**hybrid debt instrument**” means any instrument in respect of which a company owes an amount during a year of assessment if in terms of any arrangement as defined in section 80L—

- (a) that company is in that year of assessment entitled or obliged to—
  - (i) convert that instrument (or any part thereof) in any year of assessment to; or
  - (ii) exchange that instrument (or any part thereof) in any year of assessment for, shares unless the market value of those shares is equal to the amount owed in terms of the instrument at the time of conversion or exchange;
- (b) the obligation to pay an amount in respect of that instrument is conditional upon the market value of the assets of that company not being less than the market value of the liabilities of that company; or
- (c) that company owes the amount to a connected person in relation to that company and is not obliged to redeem the instrument, excluding any instrument payable on demand, within 30 years—
  - (i) from the date of issue of the instrument; or
  - (ii) from the end of that year of assessment:Provided that, for the purposes of this paragraph, where the company has the right to—
  - (aa) convert that instrument to; or
  - (bb) exchange that instrument for,a financial instrument other than a share—

(A) that conversion or exchange must be deemed to be an arrangement in respect of that instrument; and

(B) that instrument and that financial instrument must be deemed to be one and the same instrument for the purposes of determining the period within which the company is obliged to redeem that instrument;

**“instrument”** means any form of interest-bearing arrangement or debt;

**“interest”** means interest as defined in section 24J;

**“issue”**, in relation to an instrument, means the creation of a liability to pay an amount in terms of that instrument;

**“redeem”**, in relation to an instrument, means the discharge of all liability to pay all amounts in terms of that instrument.

(2) Any amount of interest that during a year of assessment—

(a) is incurred by a company in respect of a hybrid debt instrument is, on or after the date that the instrument becomes a hybrid debt instrument—

(i) deemed for the purposes of this Act to be a dividend in specie declared and paid by that company on the last day of the year of assessment of that company; and

(ii) not deductible in terms of this Act; and

(b) accrues to a person to whom an amount is owed in respect of a hybrid debt instrument is deemed for the purposes of this Act to be a dividend in specie that is declared and paid to that person on the last day of the year of assessment of the company contemplated in paragraph (a).

(3) This section does not apply to any instrument—

(a) in respect of which all amounts are owed by a small business corporation as defined in section 12E (4);

(b) that constitutes a tier 1 or tier 2 capital instrument referred to in the regulations issued in terms of section 90 of the Banks Act (contained in Government Notice No. R.1029 published in Government Gazette No. 35950 of 12 December 2012) issued—

- (i) by a bank as defined in section 1 of that Act; or
- (ii) by a controlling company in relation to that bank;

[Proposed amendment: The word “or” at the end of para. (b) to be added by s. 13 (1) (a) of TLA Act of 2013 with effect from 1 January, 2016 and applicable in respect of amounts incurred on or after that date.]

(c) of any class that is subject to approval as contemplated in the—

- (i) Short-term Insurance Act in accordance with the conditions determined in terms of section 23 (a) (i) of that Act by the Registrar defined in that Act, where an amount is owed in respect of that instrument by a short-term insurer as defined in that Act; or
- (ii) Long-term Insurance Act in accordance with the conditions determined in terms of section 24 (a) (i) of that Act by the Registrar defined in that Act, where an amount is owed in respect of that instrument by a long-term insurer as defined in that Act; or

[Proposed amendment: The expression “; or” of a full stop at the end of para. (c) to be substituted by s. 13 (1) (b) of TLA Act of 2013 with effect from 1 January, 2016 and applicable in respect of amounts incurred on or after that date.]

(d) that constitutes a linked unit in a company where the linked unit is held by a long-term insurer as defined in the Long-term Insurance Act, a pension fund, a provident fund, a REIT or a short-term insurer as defined in the Short-term Insurance Act, if—

- (i) the long-term insurer, pension fund, provident fund, REIT or short-term insurer holds at least 20 per cent of the linked units in that company;
- (ii) the long-term insurer, pension fund, provident fund, REIT or short-term insurer acquired those linked units before 1 January 2013; and
- (iii) at the end of the previous year of assessment 80 per cent or more of the value of the assets of that company, reflected in the annual financial statements prepared in

accordance with the Companies Act for the previous year of assessment, is directly or indirectly attributable to immovable property.

[Proposed amendment: Para. (d) to be deleted by s. 13 (1) (c) of TLA Act of 2013 with effect from 1 January, 2016 and applicable in respect of amounts incurred on or after that date.]

*Section 8F was substituted by s. 12 (1) of TLA Act of 2013 with effect from 1 April, 2014 and applicable in respect of amounts incurred on or after that date.*

**8FA. Hybrid interest deemed to be dividends in specie.**—(1) For the purposes of this section—

**“hybrid interest”**, in relation to any debt owed by a company in terms of an instrument, means—

- (a) any interest where the amount of that interest is—
  - (i) not determined with reference to a specified rate of interest; or
  - (ii) not determined with reference to the time value of money; or
- (b) if the rate of interest has in terms of that instrument been raised by reason of an increase in the profits of the company, so much of the amount of interest as has been determined with reference to the raised rate of interest as exceeds the amount of interest that would have been determined with reference to the lowest rate of interest in terms of that instrument during the current year of assessment and the previous five years of assessment;

**“instrument”** means any form of interest-bearing arrangement or debt;

**“interest”** means interest as defined in section 24J;

**“issue”**, in relation to an instrument, means the creation of a liability to pay or a right to receive an amount in terms of that instrument.

(2) Any amount of interest which during a year of assessment—

- (a) is incurred by a company in respect of hybrid interest must, on or after the date that the interest becomes hybrid interest—
  - (i) be deemed for the purposes of this Act to be a dividend in specie declared and paid by that company on the last day of that year of assessment; and
  - (ii) not be deductible in terms of this Act; and
- (b) accrues to a person to which an amount is owed in respect of the hybrid interest must be deemed for the purposes of this Act to be a dividend in specie that is declared and paid to that person on the last day of that year of assessment of the company contemplated in paragraph (a).

(3) This section does not apply to any interest owed in respect of—

- (a) a debt owed by a small business corporation as defined in section 12E (4);
- (b) an instrument that constitutes a tier 1 or tier 2 capital instrument referred to in the regulations issued in terms of section 90 of the Banks Act (contained in Government Notice No. R.1029 published in Government Gazette No. 35950 of 12 December 2012) issued—
  - (i) by a bank as defined in section 1 of that Act; or
  - (ii) by a controlling company in relation to that bank;

[Proposed amendment: The word “or” at the end of para. (b) to be added by s. 15 (1) (a) of TLA Act of 2013 with effect from 1 January, 2016 and applicable in respect of amounts incurred on or after that date.]

- (c) an instrument of any class that is subject to approval as contemplated—
  - (i) in the Short-term Insurance Act in accordance with the conditions determined in terms of section 23 (a) (i) of that Act by the Registrar defined in that Act, where an amount is owed in respect of that instrument by a short-term insurer as defined in that Act; or
  - (ii) in the Long-term Insurance Act in accordance with the conditions determined in terms of section 24 (a) (i) of that Act by the Registrar defined in that Act, where an



amount is owed in respect of that instrument by a long-term insurer as defined in that Act; or

[Proposed amendment: The expression “; or” of a full stop at the end of para. (c) to be substituted by s. 15 (1) (b) of TLA Act of 2013 with effect from 1 January, 2016 and applicable in respect of amounts incurred on or after that date.]

(d) an instrument that constitutes a linked unit in a company where the linked unit is held by a long-term insurer as defined in the Long-term Insurance Act, a pension fund, a provident fund, a REIT or a short-term insurer as defined in the Short-term Insurance Act, if—

- (i) the long-term insurer, pension fund, provident fund, REIT or short-term insurer holds at least 20 per cent of the linked units in that company;
- (ii) the long-term insurer, pension fund, provident fund, REIT or short-term insurer acquired those linked units before 1 January 2013; and
- (iii) at the end of the previous year of assessment 80 per cent or more of the value of the assets of that company, reflected in the annual financial statements prepared in accordance with the Companies Act for the previous year of assessment, is directly or indirectly attributable to immovable property.

[Proposed amendment: Para. (d) to be deleted by s. 15 (1) (c) of TLA Act of 2013 with effect from 1 January, 2016 and applicable in respect of amounts incurred on or after that date.]

*Section 8FA was inserted by s. 14 (1) of TLA Act of 2013 with effect from 1 April, 2014 and applicable in respect of amounts incurred on or after that date.*

Extract of section 24J(1):

**24J. Incurred and accrual of interest.**—(1) For the purposes of this section, unless the context otherwise indicates—

...

**“interest”** includes the—

- (a) gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement;
- (b) amount (or portion thereof) payable by a borrower to the lender in terms of any lending arrangement as represents compensation for any amount to which the lender would, but for such lending arrangement, have been entitled; and

[Para. (b) substituted by s. 27 (1) (a) of Act No. 53 of 1999 with effect from the date of promulgation of that Act, 24 November, 1999.]

- (c) absolute value of the difference between all amounts receivable and payable by a person in terms of a sale and leaseback arrangement as contemplated in section 23G throughout the full term of such arrangement, to which such person is a party,

irrespective of whether such amount is—

- (i) calculated with reference to a fixed rate of interest or a variable rate of interest; or
- (ii) payable or receivable as a lump sum or in unequal instalments during the term of the financial arrangement;

[Definition of “interest” substituted by s. 19 (1) (a) of Act No. 28 of 1997.]

...