SHARES WITH DIVIDEND YIELDS BACKED BY THIRD-PARTIES OR BY INTEREST-BEARING DEBTS

(DRAFT DATE: 03 AUGUST 2011)

[Applicable provisions: sections 8E and 8EA]

I. Background

A. Debt versus shares

Debt and share instruments have a number of differences in their features and their consequences.

- In commercial terms, debt represents a claim on a specified stream of cash flows. In its purest form, this claim in the form of interest is payable despite the financial performance of the debtor. Shares, on the other hand, represent a contingent claim by shareholders on dividends directly or indirectly based on company profits.

- In tax terms, debt payments are typically deductible by the payor with the same payments being includible as income by the payee. With the advent of the new dividends tax, dividend payments in respect of shares are not deductible by the payor but are potentially subject to a 10 per cent charge falling on the payee.

Depending on the circumstances, a tax advantage may exist for taxpayers to attach a label to a debt or share instrument that differs from the underlying substance.

B. Legislative anti-avoidance rules

Setting aside the potential impact of commercial law, two sets of legislative tax rules exist that seek to address differences in respect of debt or share instruments when the label of those instruments differ from their substance. Stated dividends in respect of shares will be deemed to be interest if instruments labelled as shares contain certain debt features. Conversely, stated interest in respect of debt will not be deductible if instruments labelled as debt contain certain share features.

In the case of dividends, interest treatment applies for stated dividends in respect of non-equity shares (i.e. certain preference shares) with a second statutory set of rules existing for equity shares (typically ordinary shares). In terms of non-equity shares, puts, calls and related purchase/sale rights in respect of those shares will trigger interest treatment for the share yield if these rights are exercisable within three years. In practice, tax practitioners

largely avoids these rules by utilizing instruments with terms expiring after the three year rule.

II. Reasons for change

A number of transactions have been identified involving the use of shares (typically preference shares) designed to disguise otherwise taxable interest as tax-exempt dividend income. In these transactions, various types of shares are collateralised by third parties (i.e. parties other than the issuer) through put options, call options and other similar sale/purchase rights or commitments. This third-party backing is designed to protect the instrument's yield so that the instrument provides security features similar to debt. For instance, if the issuer of shares is unable to pay the promised dividends, the holder of the shares may have a right to demand that a third party must acquire the shares.

In essence, dividends in respect of shares backed by this form of third party backing raise similar concerns to the concerns raised in respect of dividend cessions. The shareholder lacks any meaningful stake in the issuer of the shares because the shareholder is ultimately looking to third parties for payment. It should be further noted that these shares are generally classified as debt for financial accounting purposes. In extreme circumstances, these shares operate at the tail-end of various schemes whereby a company within a group pays deductible interest, followed by another company within the same group receiving preference share dividends indirectly funded by the deductible interest.

A related concern is the use of shares backed-by debt. In the transactions of concern, the dividends at issue have a yield that mirrors interest with the source of those dividends being derived from interest-bearing debt.

III. Proposal

A. Ordinary treatment without timing requirements

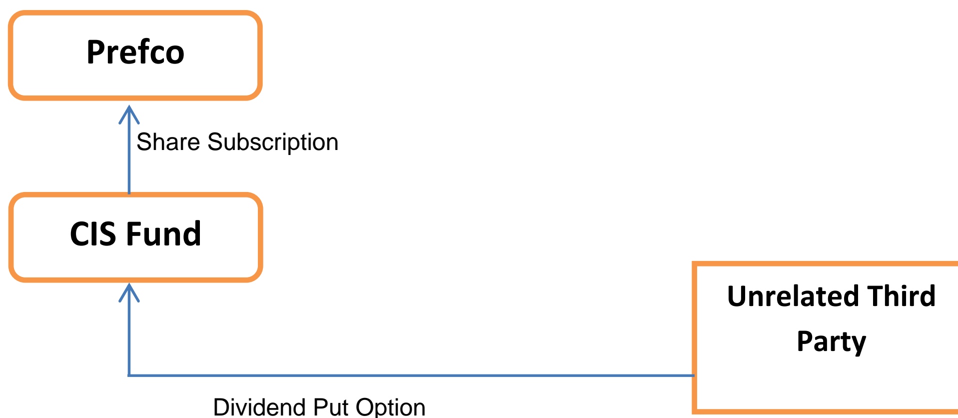
In view of the above, shares with dividend yields backed by third parties will generate ordinary revenue in respect of those dividends. This ordinary revenue treatment will cover various forms of third-party backed dividends, all of which will apply without regard to any three year or other timing requirements. This anti-avoidance rule applies to both domestic and foreign dividends.

More specifically, a third-party backed share will exist if an "enforcement right" or "an enforcement obligation" applies due to the lack of a specified dividend yield from that share. Turning to the definitions of enforcement right and enforcement obligation:

- *Enforcement right:* An enforcement right means any fixed or contingent right that provides the holder of the share with a right to require any person other than the issuer: (i) to acquire the share from the holder, (ii) to make any guaranteed, indemnifying or similar payment to the holder in respect of the share, or (iii) to procure, facilitate or assist with any share acquisition or indemnifying payment contemplated in (i) and (ii).

- *Enforcement obligation:* An enforcement obligation means any fixed or contingent obligation that requires the issuer of the share to require any person other than the issuer: (i) to acquire the share from the holder, (ii) to make any guaranteed, indemnifying or similar payment to the holder in respect of the share, or (iii) to procure, facilitate or assist with any share acquisition or indemnifying payment contemplated in (i) and (ii).

EXAMPLE:



Facts: CIS Fund subscribes for preference shares issued by Prefco in respect of preference shares issued. The dividends payable by Prefco are effectively guaranteed through a put option in favour of CIS Fund that exercisable on the occurrence of certain credit events (e.g. failure by Prefco to pay specified levels of dividends). In effect, the put option requires Unrelated Third Party to acquire the preference shares if the dividends fall short of a required amount.

Result: In the event of a specified credit event, CIS Fund has a right of recourse against a third party and not Prefco. Consequently the dividends in respect of the third party backed preference shares are deemed to be ordinary income in the hands of CIS Fund.

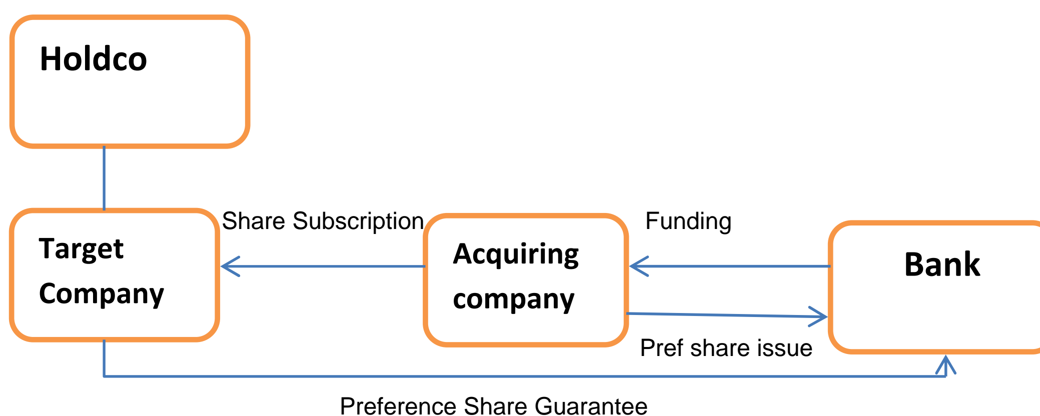
B. Exception for hybrid share funding to acquire ordinary shares of an operating company

Despite the concerns outlined above, share funding (typically in the form of preference shares) is often used to fund the acquisition of shares of a target company. This practice has emerged because taxpayers cannot deduct interest on debt used to acquire shares. If preference shares are utilised to fund share acquisitions, the net impact of the funding is generally neutral to the fiscus. This form of preference share funding is also common in the case of preference share funding for black economic empowerment.

Within this limited context, certain third party backed shares will not give rise to ordinary revenue treatment. This exception will apply if the share funding is used by the issuer to acquire shares of a (target) company. In this scenario, third party enforcement rights (or obligations) can be disregarded if:

- Those rights (or obligations) are against a company within the same group as the issuer;
- Those rights (or obligations) are against the target company;
- Those rights (or obligations) are against a company within the same group of companies as the target company.

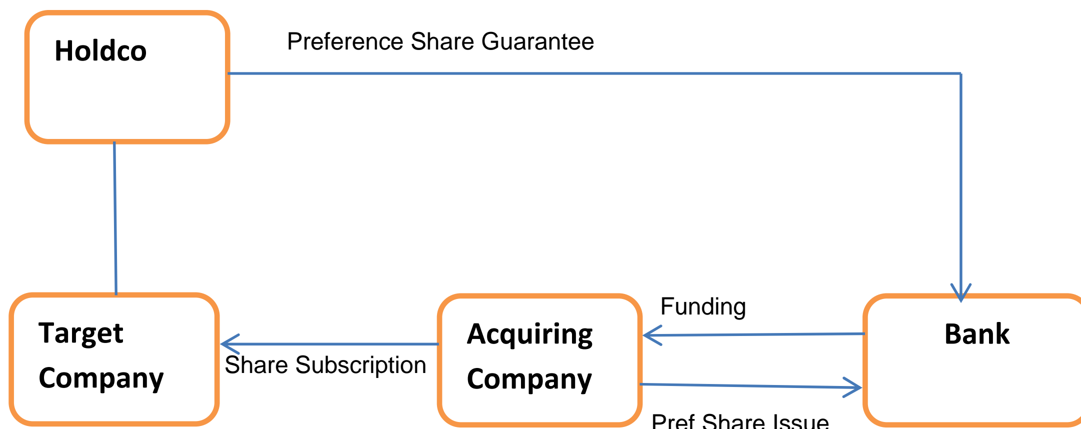
EXAMPLE 1:



Facts: Acquiring Company acquires ordinary shares in Target Company with funding from Bank. Target Company derives most profits through mining operations. Acquiring Company issues preference shares to Bank as a funding mechanism with the preference shares providing a yield of prime minus one per cent. As security for the amount advanced, Target Company agrees to indemnify the bank for any short-fall in the preference share yield of prime minus one per cent.

Result: Even though a third party (i.e. Target Company) will indemnify any shortfall in the preference share dividend yield, the dividend yield from Acquiring Company will not generate taxable income (i.e. will retain its dividend character). The indemnifying commitment can be ignored because the funding is used to acquire Target Company's shares and the indemnity comes from Target Company.

EXAMPLE 2:



Facts: Holdco owns all the shares of Target Company. Acquiring Company acquires ordinary shares in a Target Company with funding from Bank. Acquiring Company issues preference shares to Bank as a funding mechanism. As security for the loan amount, Holdco issues a guarantee in favour of Bank that is exercisable upon default by the Acquiring Company on its preference share obligations.

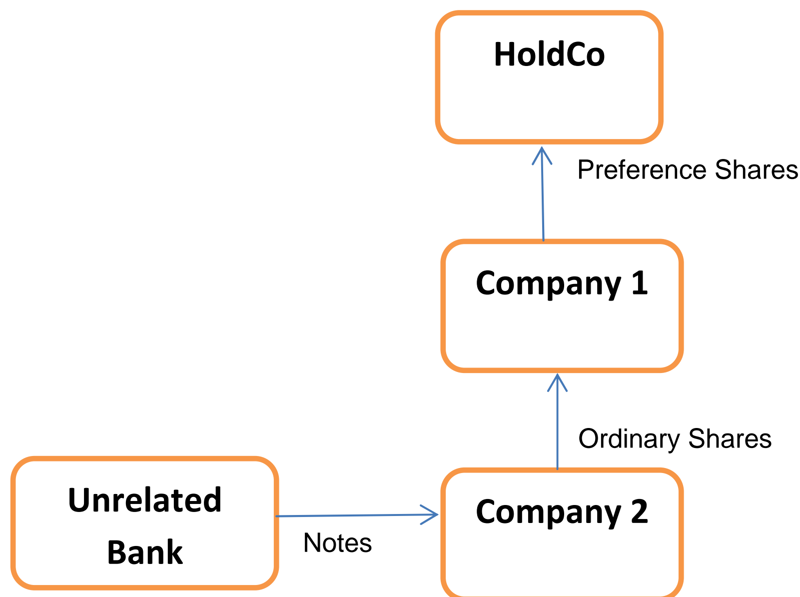
Result: Funding received by Acquiring Company is utilised to acquire shares in a Target Company. Holdco guarantees performance by Acquiring Company on the preference shares issued. Consequently, the deeming rules do not apply, and the dividends received by Bank retain their dividend nature.

C. Hybrid share dividends backed by debt

Special purpose companies should not be allowed as a mechanism to artificially convert taxable interest into exempt dividends. In order to prevent this form of avoidance, dividend income will be recharacterised as interest income under the following circumstances:

- The dividends should generate a yield based on a specified amount of interest or based on the capital used to acquire the shares; and
- The dividends should be derived directly or indirectly mainly from interest-bearing notes.

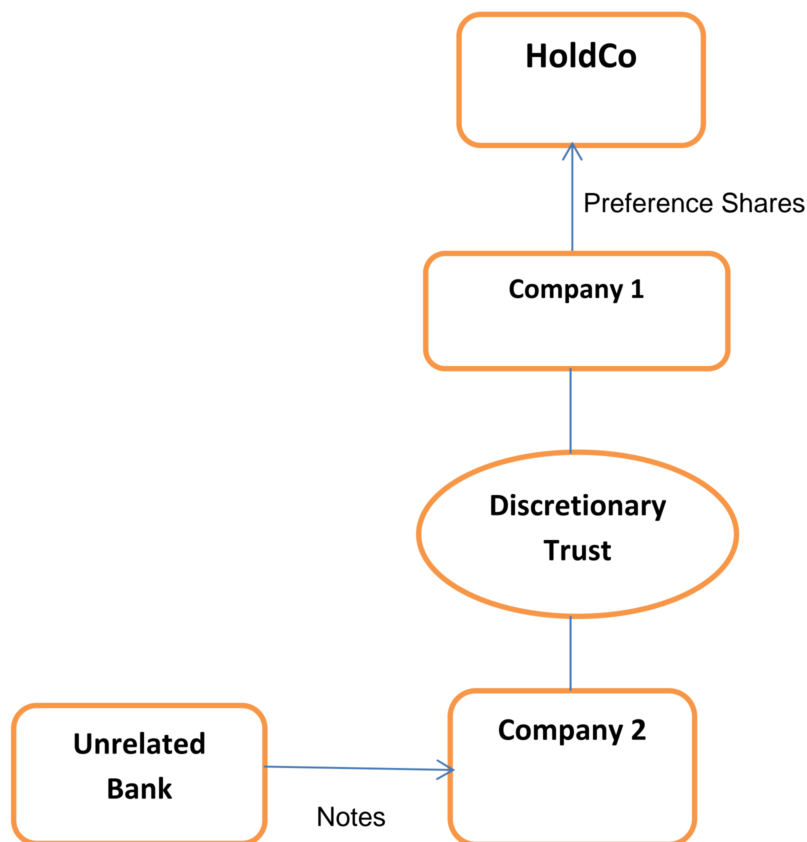
EXAMPLE 3:



Facts: Company 1 holds all ordinary shares in Company 2. Company 2 holds interest bearing notes from a bank. The notes bear interest of prime plus two per cent. Company 1 issues preference shares to HoldCo as a funding mechanism with the preference shares providing a yield of prime.

Result: The preference share yield is indirectly derived from the interest bearing notes. Consequently, the preference share yield is deemed to be interest in the hands of Holdco.

EXAMPLE 4:



Facts: HoldCo acquires preference shares from Foreign Company 1 which provide a yield at prime. Company 1 owns a Discretionary Trust. The Discretionary Trust in turn owns Foreign Company 2. Foreign Company 2 holds NCDs from an unrelated Bank which yield prime plus 2 per cent interest. Company 2 distributes dividends to Discretionary Trust, which in turn distributes dividends to Company 1, which in turn pays out preference share dividends to HoldCo.

Result:

The preference share yield is indirectly derived from the interest bearing notes. Consequently, the preference share yield is deemed to be interest in the hands of Holdco.

IV. Effective date

The proposed amendment applies to dividends received or accrued on or after 1 April 2012.