Annexure C

DRAFT EXPLANATORY MEMORANDUM: ANTI-HYBRID DEBT INSTRUMENT RECHARACTERISATION RULES

[Applicable provisions: section 8F and new section 8FA]

Date: 29 April 2013

I. Background

A. Overview

In the area of corporate financing, there are three basic sources of finance – equity, debt and retained profits. For commercial purposes, debt and equity are the key sources of external finance. As a general matter, debt is redeemable with a yield based on the time value-of-money (e.g. interest), and payment obligations exist without regard to the performance of the debtor company (i.e. payments are required without regard to profits or cash available). On the other hand, equity is typically non-redeemable with the yield (i.e. dividends) depending on the performance of the company (i.e. profits), and payment obligations are discretionary or can be deferred without giving rise to legal claims.

For tax purposes, interest on debt is generally deductible in the hands of the payor (e.g. if incurred in the production of income) and included as ordinary revenue in the hands of the recipient. On the other hand, dividends are not deductible by the payor nor are they includible in the hands of the shareholder. However, dividends may be subject to the Dividends Tax.

B Hybrid Instruments

Current law contains anti-avoidance rules that deal with hybrid debt instruments (i.e. debt instruments with equity features) as well as hybrid equity instruments (equity instruments with debt features). In the case of hybrid debt instruments, the anti-avoidance rules seek to re-characterise interest as dividends in the hands of the payor. However, the instrument otherwise remains a debt instrument for all other purposes of the Income Tax Act (including interest treatment for amounts received by the payee).

This recharacterisation potentially occurs when: (i) the debtor is obliged to convert the instrument to shares, (ii) the issuer has an option to convert the debt instrument to shares, (iii) the issuer can force the holder to reinvest in shares, or (iv) the holder has a deep-in-the money right of conversion. However, for this recharacterisation to apply, the conversion obligation or right must be exercisable within a three-year period from date of issue.

II. Reasons for change

When determining the debt versus equity character of an instrument, it is widely believed that most of the tax law follows form. This focus on form seemingly provides taxpayers with the freedom to choose a label for an instrument with consequential tax benefits without regard to (economic) substance. This freedom poses a risk to the *fiscus* because certain taxpayers consistently choose a combination of features that bring about unintended tax benefits. The key driver for this form of tax planning is the issuer's desire to obtain an interest deduction for payment to financiers (as opposed to non-deductible payments of dividends).

When making payments to exempt persons, taxpayers have even a greater tendency to classify share-type instruments as debt in order to obtain an interest deduction, knowing the recipient is exempt. In this instance, the debt label is commercially neutral for the taxpayer, but the result is negative for the *fiscus* because there is no matching of deductions with inclusions.

While anti-avoidance rules exist as outlined above for debt conversions, artificial classifications go beyond the use of mere conversion features. For instance, an instrument lacking a maturity date for repayment is a strongly questionable form of debt. Moreover, even the conversion focus presently existing within the hybrid debt rules is too narrow – being limited to a three-year period.

III. Proposal

A. Overview

In order to reduce the scope for the creation of equity that is artificially disguised as debt, a two-fold regime is proposed for domestic company issuers. One set of rules focuses on features relating to the nature of the instrument itself (i.e. the corpus); the second set of rules focuses on the nature of the yield. In making these rules, it is understood that the features distinguishing debt from equity are varied and are often contextual. Nonetheless, the proposal takes aim at domestic companies that issue stated debt instruments so as to artificially generate interest deductions if clear-cut equity features exist when viewed in isolation.

In term of the anti-avoidance rules relating to the instrument (i.e. the corpus), the proposal focuses on debt-labeled instruments that (i) have features indicating that redemption for cash is unlikely within a reasonable period; or (ii) have features that enable a conversion into shares. These features will be tested on a continuous basis (i.e. not once off at the date of issue but at any time thereafter).

In terms of the anti-avoidance rules focusing on yield, the debt yield must be based on time value of money (e.g. a rate of interest) – not other factors. Lack of payment due to company insolvency is also a problem.

The effect of the application of both these anti-avoidance rules is that some or all of the yield will be treated as dividends. If the focus relates to the debt instrument itself, the full yield associated with the instrument will be treated dividends. If the focus relates solely to the yield, only the yield at issue will be treated as a dividend.

Lastly, the proposed regime will contain some exceptions to simplify administration and ensure that South Africa is not left in an uncompetitive situation. These exceptions include exceptions for certain forms of regulatory capital issued by regulated intermediaries as well as for debt owed to resident natural persons by certain “for profit companies”..

B. Instrument recharacterisation (section 8F)

1. <u>Features</u>

A key feature of debt is the holder’s ability to redeem the capital amount loaned within a reasonable period. Instruments without this key feature operate more like equity (i.e. shares), and the yield on these instruments will accordingly be treated as dividends. In order to avoid this deemed share treatment, the debt instrument (i.e. the corpus) must be fully redeemable in cash within 30 years from the year of assessment at issue (taking into account the terms of the instrument itself or any side arrangement).

The debt recharacterisation rules also target certain mechanisms commonly used to avoid required redemption. Hence, conditions allowing for the issuer to repay the debt in the form of equity (e.g. the shares of the issuer or group member) will also cause a recharacterisation. Moreover, the obligation to repay will be disregarded if conditional upon the solvency of the debtor. Like the 30-year redemption rule, these anti-avoidance rules take into account not only the instrument itself, but side arrangements as well.

As stated above, the test for whether a debt is commercially real or artificial must be tested continuously – not merely from the date of issue or modification. If the conditions of the debt change, the debt becomes subject to the avoidance rules at the time of the change (and not before).

2. <u>Impact of recharacterisation</u>

If an instrument is recharacterised as outlined above, stated interest in relation to the instrument will be treated as a dividend declared by the payor as well as dividends in the hands of the payee as long as the instrument retains its hybrid features. As a result, it will also be specifically provided that the payor will no longer obtain any deduction for the stated interest. The stated interest will be treated as a dividend (potentially subject to the Dividends Tax depending on circumstances), and the interest accrual and incurral rules (e.g. section 24J) will no longer be applicable to the hybrid debt instrument.

C. Yield recharacterisation (section 8FA)

In some circumstances, the debt/equity recharacterisation will focus on the yield of the instrument without looking to the whole. Under these rules, the recharacterisation will deem the particular yield at issue to be a dividend (nothing more). In order to breach this standard, the yield at issue (taking into account all agreements) must have one of the following features:

- The yield must not be determined with reference to a specified rate of interest (e.g. instead being based on company profits) or time-value-of-money principles; or

- The timing of payment must not be subject to the solvency of the issuer of the instrument.

In terms of yield, stated interest in relation to the instrument will be treated as a dividend declared by the payor as well as dividends in the hands of the payee. It will also be specifically provided that the payor will no longer obtain any deduction for the stated interest. The stated interest will be treated as a dividend (potentially subject to the Dividends Tax depending on circumstances), and the interest accrual and incurral rules (i.e. in section 24J) will no longer be applicable in respect of a hybrid debt instrument. The instrument itself will retain its debt characterisation (unless otherwise tainted) and other payments will have to be tested separately for debt/equity recharacterisation.

D. Exemptions from reclassification

The anti-hybrid rules will be subject to certain exemptions as a matter of policy. In particular, exemptions will exist for debt owed to resident natural persons by private companies and personal liability companies as well as certain regulated debt issued by banks and insurers.

1. Relief for debt owed to resident natural persons

Private companies and personal liabilities companies (i.e. profit companies that are not public or state-owed) under the Companies Act (2008) will be eligible for relief if the debt is owed to natural persons that are South African residents. It is understood that the use of debt with share-like features is a common practice for small businesses for a variety of reasons and that the only significant tax benefit is use of the interest exemption for natural persons.

2. Relief for regulated bank capital

Banks often issue various forms of capital, including Tier I (straight equity) and Tier II (debt with equity features) capital. Increased pressure is being placed on the banks to increase these forms of capital via the international banking Basel standards. While it is understood that certain forms of Tier II capital will probably be in violation of the hybrid recharacterisation rules, these rules will be waived for Tier I and Tier II capital so as not to place further pressure on the cost of banking capital given the global regulatory uncertainties in this regard. It is also understood that tax systems of other countries similarly exempt these forms of debt from potential recharacterisation on similar policy grounds.

3. Relief for regulated insurer capital

Short-term and long-term insurers are required to maintain a sound financial condition by maintaining adequate levels of assets to cover their regulated liability and capital requirements. As a safeguard mechanism, the redemption of certain subordinated debt instruments issued by short-term and long-term insurers is subject to approval by the Registrar of short term and long term insurance (respectively). These forms of debt operate roughly similar to Tier I and Tier II debt and will accordingly be exempt from the hybrid debt instrument reclassification rules (but not the hybrid interest rules).

IV. Effective dates

The proposed hybrid instrument recharacterisation rules will come into effective in the case of amounts accrued or incurred on or after 1 January 2014.