NATIONAL
TREASURY

REPUBLIC OF SOUTH AFRICA

EXPLANATORY MEMORANDUM

ON THE

TECHNICAL CORRECTIONS 8E AND 8EA, 2012

13 March 2012

[W.P. –- '12]

REVISED VERSION OF THE HYBRID EQUITY AND THIRD-PARTY BACKED SHARE PROPOSALS

[Key provisions: section 8E and section 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 payer 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 payer but are potentially subject to a 15 per cent charge falling on the payee (subject to exemptions). Depending on the circumstances, a tax incentive may exist for a taxpayer to attach a label to a debt or share instrument that differs from the underlying substance.

B. Legislative background

1. Pre-2011 legislation

Prior to 2011 (and setting aside the potential impact of tax and commercial jurisprudence), two sets of legislative tax rules existed that sought to address differences in respect of debt or share instruments when the label of those instruments differs from their substance. Stated dividends in respect of shares were deemed to generate interest income if instruments labeled as shares contained certain debt features. Conversely, stated interest in respect of debt instruments was not be deductible if instruments labeled as debt contained certain share features. The legislative rules contained one major limitation however. Many of the features tainting the instrument at issue had an impact only if the feature applied three years from date of issue. Therefore, many taxpayers simply delay the triggering event for tainted features beyond the three-year period.

2. Legislation in 2011

The 2011 legislation sought to strengthen the anti-avoidance rules if share instruments (typically preferred shares) were loaded with debt-like features. These anti-avoidance rules came in two forms. Firstly, the legislation targeted share issues where the dividends in respect of those shares were guaranteed by unrelated third parties. These third party guarantees effectively meant that the holder of the share had no direct or indirect meaningful stake in the risks associated with the issuer. Secondly, the legislation targeted share issues where the dividends in respect of those shares were fully secured by financial instruments (i.e. the secured financial instrument served as the basis for the dividend yield as opposed to a mix of assets associated with the issuing company as a whole).

II. Reasons for change

A. Hybrid Equity Instruments

Under the 2011 proposal, treatment of certain shares as tainted hybrid equity instruments due to the use of secured debt-based instruments remains appropriate theoretically. As discussed above, these preference shares merely operate as a conduit for underlying debt instruments with the holder looking solely to the debt as collateral. Nonetheless, concerns have been raised that the initial amendment is overly broad. Firstly, the amendment does not provide any caveat for preference shares issued as a financing tool to acquire substantial interests in a target operating company (in the context of black economic empowerment and otherwise). This limitation effectively overrides the relief contained in the anti-avoidance rules for third-party backed shares. The rule prohibiting “indirect” securities (and even the definition of a prohibited financial instrument) is too wide, thereby creating uncertainty for many standard commercial practices that pose little risk to the fiscus.

B. Third-party-backed shares

Under the 2011 proposal, treatment of certain shares as tainted shares due to guarantees by third parties is theoretically sound. The initial amendment also recognises the need for an exception in the case of preference shares issued as a financing tool to acquire substantial share interests in a target operating company (in the context of black economic empowerment and otherwise). That said, the nature of the relief appears to be narrow, failing to account for a variety of transactions. The rules specifically catering for multi-tier preference share schemes also failed to reach the technical relief initially desired. Lastly, adjustments were required to cover certain emerging avoidance gaps..

III. Proposal

A. Overview

The proposed regime is again two-fold with both legs essentially aiming at the same concern – holders of debt-like shares that rely on third party balance sheet wholly unrelated to the issuer. In the case of security arrangements, the holder of the debt-like share (typically labeled as a preference share) is looking to debt-bearing financial instrument issued by a third party to indirectly support the preference dividend yield of the issuer. In the case of third-party backed shares, the holder of a debt-like share (again typically labeled as a preference share) is looking to the credit of a third party guarantee (or obligation) to indirectly support the preference dividend yield of the issuer.

Holders of instruments receiving dividend yields in respect of either set of tainted shares must treat the dividend yield as ordinary revenue (with the yield falling outside of the dividends tax regime). Both provisions also contain an exception for preference share schemes where the funding received for the preference share issue is ultimately applied to directly or indirectly acquire a pure equity stake in an active operating company. These exceptions mean that preference share funding can continue as a means for acquiring the shares of active operating companies (including black economic empowerment transactions).

B. Hybrid shares secured by interest-bearing instruments

1. Basic anti-avoidance rule

The anti-avoidance rule for hybrid shares secured by interest-bearing instruments has a two-pronged trigger. Under the first prong, the dividend yield in respect of the share must be calculated directly or indirectly with reference to a specified rate or interest or the time value of money. Under the second prong, the share must be secured by a financial instrument (i.e. an interest-bearing instrument or one determined with reference to time-value of money principles). Alternatively, the second prong will be satisfied by a negative pledge that achieves the same effect as a direct security (i.e. an arrangement preventing disposal of the financial instrument other than the mere restriction on distributions of the financial instrument by the issuing company).

If both prongs of the anti-avoidance rule described above are satisfied, the dividend yield is deemed to qualify as interest income. The anti-avoidance rule equally applies to domestic and foreign dividends. The purpose of this rule is to prevent intervening hybrid share conduits that act as a means of converting interest income into a dividend yield at the holder level. Concerns also exist that the holder of the preference share is really looking to the credit of a third-party issuer of the underlying debt and not the issuer itself (i.e. not having any meaningful interest in the issuer of the share).

EXAMPLE 1:
Facts*:* Holder Company subscribes for preference shares from Issuer Company. The preference shares are redeemable in five years by Holder Company, and the dividend yield on the shares is based on JIBAR. The only assets held by Issuer Company are bonds. The Bank has a security interest in the bonds.

Result: The redeemable preference shares are subject to the anti-avoidance rule. The dividends payable are based on a JIBAR rate, and the shares are secured by interest bearing arrangements. Therefore any dividends generated by the preference shares are treated as interest.

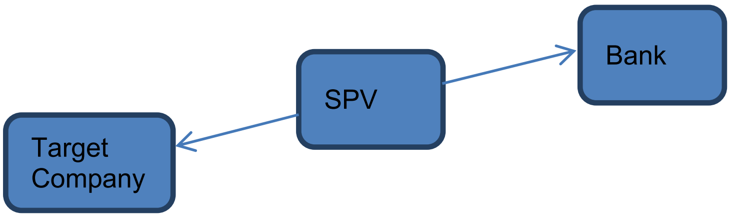
2. Exceptions

As stated above, hybrid shares secured by debt-like financial instruments may avoid the anti-avoidance rule if the consideration for the issue of the hybrid shares is applied directly or indirectly for the purpose of acquiring operating company shares. This exception recognizes the need for preference share financing in respect of share acquisitions because South African tax law does not generally allow for deductible interest when debt is employed to finance a share acquisition.

At its core, the exceptions to the anti-avoidance rule require that the consideration for the share issue somehow relate to the acquisition of equity shares (e.g. ordinary shares) in an active operating company. Under the first exception, the consideration for the hybrid shares issued must be directly or indirectly applied to acquire equity shares in an operating company. Under the second exception, the consideration must be for retiring bridging loans initially used for the same purpose. Under the third exception, the consideration must be for refinancing hybrid shares if the initial hybrid shares were used directly or indirectly to finance the acquisition of equity shares in an operating company. In the case of refinancing arrangement, the consideration for the newly issued hybrid shares cannot exceed the balance outstanding in respect of the original shares (as well as the accrued interest thereon).

Note: No relief from the anti-avoidance rule exists if the preference share consideration is used to acquire ordinary shares in an operating company that is part of the same group of companies as the issuer. This limitation is meant to avoid possible artificial cash injections to a related member of the group.

EXAMPLE 2:



Facts: A special purpose vehicle (SPV) issues preference shares to Bank in exchange for R50 million. The term of the preference share issue is five (5) years. The return on the preference shares is calculated on JIBAR plus 2%. SPV applies the consideration from the preference shares issue to acquire ordinary shares in Target Company. Target Company is actively engaged in the manufacturing sector. Target Company's ordinary shares serve as security for the bank in respect of the preference share yield. The dividends in respect of the Target Company's ordinary shares are paid into SPV's bank account. As part of the bank conditions for the arrangement, the bank account funds are also secured in favour of Bank.

Result: The use of ordinary shares as security does not taint the SPV preference share issue because the ordinary shares do not qualify as a debt-bearing financial instrument or a financial instrument with a time-value of money yield. On the other hand, the use of the bank account as security may be problematic because the bank account generates a debt-like yield. Nonetheless, the use of a bank account as security does not taint the preference share issue because the consideration for the preference shares was used to acquire equity shares in an active operating company.

EXAMPLE 3:
Facts: Assuming the same facts as Example 1, except that five years have passed. At this point, the preference shares have a face value of R30 million outstanding. Given the large balance outstanding, the parties agree to refinance the initial five-year arrangement. New preference shares are issued to Bank for R30 million with SPV paying the R50 million to redeem the initial preference share issue. Bank again requires the preference share issue to be secured by the ordinary shares of Target Company plus the bank account that collects the ordinary share dividend proceeds (plus the interest thereon).

Result: The new preference shares issue is exempt for the same reasons as the initial share issue. The use of ordinary shares as security does not taint the SPV preference share issue because the ordinary shares do not qualify as a debt-bearing financial instrument or a financial instrument with a time-value of money yield. The use of a bank account as security does not taint the preference share issue because of the purpose test (the consideration for the preference shares was used to retire preference shares with the initial preference share issue dedicated to acquire equity shares in an active operating company).

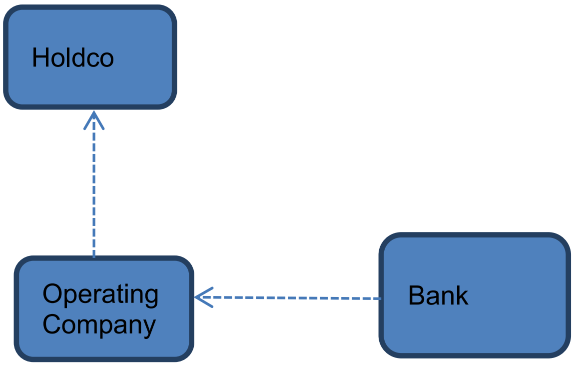
C. Shares backed by third-party guarantees

1. Basic anti-avoidance rule

The anti-avoidance rule for shares backed by third-party guarantees/obligations has a two-pronged trigger. Under the first prong, the share must be subject to an enforcement right or obligation in respect of a third party. Under the second prong, this enforcement right or obligation must be triggered upon the failure to pay a dividend or a return of capital distribution. The enforcement right or obligation at issue must essentially require another party (i.e. a person other than the issuer of the share) to directly or indirectly guarantee dividend or return of capital distributions to be paid to the holder in respect of the share.

If both prongs of the anti-avoidance rule described above are satisfied, the dividend yield is deemed to qualify as ordinary revenue. The rule equally applies to domestic and foreign dividends. The purpose of this anti-avoidance rule is to ensure that the credit worthiness of the issuer has a bearing on the holder versus complete reliance on the creditworthiness of a wholly unrelated entity.

EXAMPLE 1:



Facts: Holding Company own all the shares of Operating Company (as well as other various subsidiaries). Bank and Operating Company enter into a financing arrangement through the use of preference shares issued by Operating Company with a JIBAR yield. The consideration received for the preference shares is used by the Operating Company to reinvest in business operations and to distribute dividends. In order to enhance Bank's stake in the preference shares from a risk point of view, Holding Company guarantees to purchase the preference shares from Bank if the preference share yield falls below JIBAR.

Result: The arrangement triggers the anti-avoidance rule. The preference shares are backed by a third-party guarantee, and the guarantee relates to the preference share yield. The dividends in respect of the preference shares accordingly generate ordinary revenue.

2. Exceptions

As stated above, shares guaranteed by third parties may avoid the anti-avoidance rule if the consideration for the issue of the shares is applied directly or indirectly for the purpose of acquiring equity shares of an operating company. This exception recognises the need for (preference) share financing in the case of share acquisitions because South African tax law does not generally allow for deductible interest if the debt is employed to finance a share acquisition.

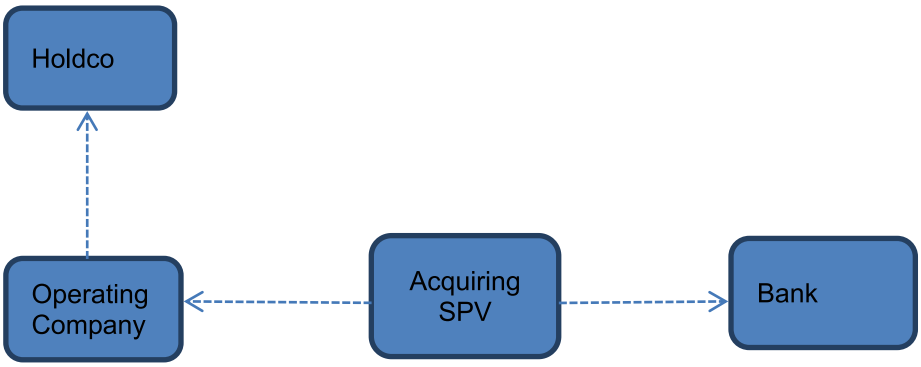
At its core, the exceptions to the anti-avoidance rule require that the consideration for the (guaranteed) share somehow relate to the acquisition of equity shares (e.g.

ordinary shares) in an active operating company. Under the first exception, the consideration for the (guaranteed) shares issued in exchange therefor must be directly or indirectly applied to acquire equity shares in an operating company. Under the second exception, the consideration must be dedicated to retiring bridging loans used for the same purpose of acquiring equity shares in an operating company. Under the third exception, the consideration must be dedicated to refinancing (guaranteed) shares initially used to finance the acquisition of equity shares in an operating company (or to retire bridging finance used for the same initial purpose). In the case of a refinancing arrangement, the consideration for newly issued hybrid shares cannot exceed the balance outstanding in respect of the initial (guaranteed) share interest (and the accrued interest thereon).

If the exceptions apply, the exceptions allow for a variety of third party guarantees/obligations. The guarantees/obligations can initially come from a qualifying holder of the issuer or a controlled subsidiary of the issuer. The guarantees/obligations can also come from the acquired operating company (that is the object of the financing), a qualifying holder of the operating company or a controlled subsidiary of the operating company. Lastly, the guarantees can come from an intermediary of a share issuer where the consideration is applied to acquire the same operating company shares as the initial issuer (and to qualifying holders of the intermediary issuer or a controlled subsidiary of the intermediary issuer). For purposes of these rules, a qualifying holder must own at least 20 per cent of the company at issue; a controlled subsidiary must be 70 per cent owned by the comlany at issue (and the parent controlling company of the controlled subsidiary must be subject to the same or a higher level of guarantees/obligations than the controlled subsidiary).

Note: No relief from the anti-avoidance rule exists if the preference share consideration is used to acquire ordinary shares in an operating company that is part of the same group of companies as the issuer. This limitation is meant to avoid possible artificial cash injections to a related member of the group.

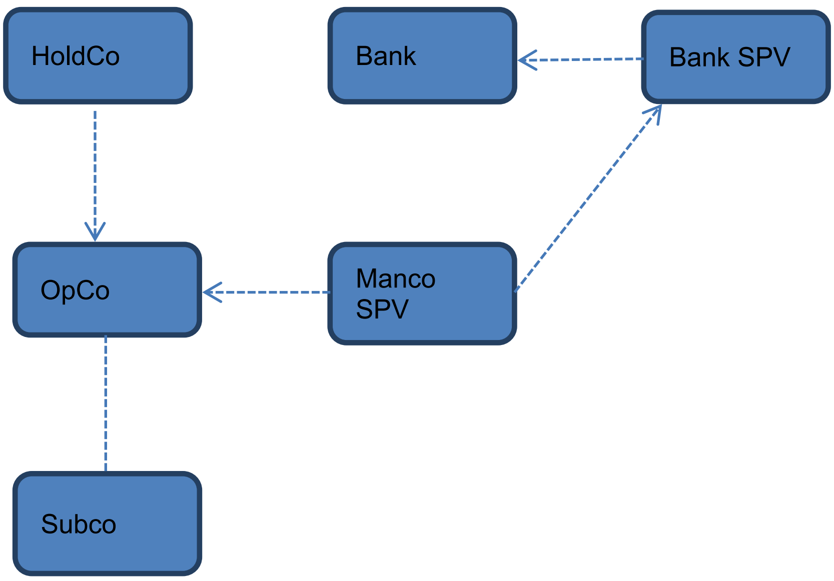
EXAMPLE 2:



Facts*:* Holdco owns all the shares of Operating Company. Holdco wants to shift some of its ownership in Operating Company to existing operating company managers. The managers accordingly form Acquiring SPV for financing purposes. Bank agrees to provide Acquiring SPV R20 million in cash to Acquiring SPV in exchange for preference shares issued by Acquiring SPV. The preference shares are redeemable after five years by Bank and generate a yield equal to JIBAR plus one per cent. Acquiring SPV then uses the funds to acquire 20 per cent of the ordinary shares of Operating Company. Bank requires a guarantee from Holdco and Operating Company that Bank can sell the Acquiring SPV preference shares to Holdco or Operating Company if insufficient funds exist to pay the required dividends.

Results: As an initial matter, the guarantees by Holdco and Operating Company could give rise to ordinary revenue in respect of the preference share yield. However, because the funds are used to acquire equity shares in an operating company, the exceptions apply, thereby allowing the parties to disregard both sets of guarantees.

EXAMPLE 3:



Facts: HoldCo owns all the shares of OpCo (an operating mining company),and Opco owns all the shares of Subco. A management committee SPV (formed as Manco SPV) comprises of senior management in OpCo. Manco SPV seeks to acquire 20 per cent of the ordinary shares in OpCo. In order to raise the necessary funds, Manco SPV enters into a back-to-back arrangement with Bank so as to obtain funding from outside investors.

- To facilitate this arrangement, Bank forms a wholly-owned SPV. Bank SPV issues preference shares and receives R15 million in exchange as consideration. The Bank SPV preference shares generate dividends of prime plus three per cent. Bank must repurchase the preference shares at the conclusion of Year 5; Manco SPV and Bank guarantee the preference share dividend yield if the preference shares fail to provide the prime plus three per cent dividend yield (with the investors first looking to the Manco guarantee).

- Bank SPV then transfers these funds to Manco SPV in exchange for Manco SPV shares. The preference shares generate dividends of prime plus five per cent; Manco SPV must repurchase the preference shares at the conclusion of Year 5. Holdco, Opco and Subco guarantee the preference share dividend yield if the preference shares fail to provide the prime plus five per cent dividend yield.

Results: At the outside, the preference shares issued by Bank SPV may be adversely impacted by the anti-avoidance rule because of the multiplicity of third party guarantees (by Bank, Manco SPV, Holdco, Opco and Subco). However, because the consideration was ultimately used for the share acquisition of a certain percentage of Opco's ordinary shares, the exceptions apply. This relief allows the parties to disregard Manco SPV's guarantee (the other issuer) and the Opco (the operating company). Holdco (holder of Opco) and Bank (holder of issuer) are qualifying holders so these entities can also be disregarded. Lastly, Subco can be disregarded because Subco is a controlled company for OPco and does not face greater restrictions than Holdco.

IV. Effective date

The proposed amendments apply to dividends received or accrued on or after 1 October 2012 in respect of years of assessment commencing on or after 1 October 2012.