Hybrid debt instruments what you need to know

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The hybrid debt rules were introduced into the Income Tax Act, 1962 (the Act) and came into effect in 2014 by way of specific anti-avoidance provisions contained in section 8F and 8FA of the Act.

The provisions relating to hybrid debt instruments as contained in section 8F of the Act seek to identify and provide for specific tax treatment of certain debt instruments that contain equity-like features. In instances where section 8F applies to a hybrid debt instrument, the legislation disallows the deduction of the amounts of interest incurred by the issuer and furthermore deems such amounts to be dividends in specie declared and paid by the issuer.

Section 8F of the Act was introduced in 2014 and has been subject to a number of changes since then. The latest set of changes to section 8F as promulgated in the Taxation Laws Amendment Act, 2017 are important from a substantive perspective as well as a timing perspective, and are summarised below.

Cross-border hybrid debt has been excluded from the rules retrospectively

The South African Revenue Service and National Treasury
identified that non-resident issuers were able to create tax arbitrage opportunities by issuing cross-border hybrid debt instruments.

Section 8F has now been amended with effect from 24 February 2016 (i.e., the date that the initial announcement regarding cross-border hybrid debt was made during the 2016 Budget Speech) and are applicable in respect of amounts incurred in respect of an instrument on or after that date.

- Even if an issuer has issued an instrument with equity-like features which falls within the scope of the definition of a hybrid debt instrument, section 8F will not apply to that instrument unless it has been issued a company that will take its interest deductions into account for South African tax purposes, i.e., the instrument must be issued by:
  - a South African resident company;
  - a non-resident company if the interest in respect of that instrument is attributable to a South African permanent establishment of that company; or
  - a company that is a controlled foreign company if the interest incurred in respect of that instrument must be taken into account in determining the net income of that controlled foreign company as contemplated in section 9D of the Act.

**Subordinated debts – timing aspects clarified**

The hybrid debt rules may be triggered by subordinated debts, i.e., where the terms of an instrument in issue are such that the obligation of the issuer to make payment of any amount owing in respect of that instrument is conditional on the solvency of such issuer.

However, the rules were not clear in respect of certain
aspects pertaining to such subordinated debts. In particular, it was not clear as to whether the rules would apply to a subordinated instrument from the date of issue thereof or from the date that payment of amounts owing were actually deferred (i.e. whether the rules apply for the entire term of the instrument, or for the term only that the subordination is active and the payment obligations of the payor are actually deferred).

In this regard, it has now been clarified (with effect from 1 January 2016 and applicable in respect of years of assessment commencing on or after that date) that a hybrid debt instrument will exist in a particular year of assessment where the obligation to pay an amount owing in respect of an instrument on a date or dates falling within that year of assessment has been deferred by reason of that obligation being conditional upon the market value of the assets of that company not being less than the amount of the liabilities of that company.

In other words, the hybrid debt rules will only apply to an instrument that is subject to subordination terms where, in a particular year of assessment, the obligation to make a payment in terms thereof has actually been deferred due to the solvency and liquidity circumstances of the payor. It is therefore necessary to analyse each subordinated debt on a continuous basis with reference to whether or not any payment obligations have actually been deferred.

Subordination relief for entities in financial distress

The hybrid debt rules pertaining to subordinated instruments were found to give rise to adverse tax implications (such as the non-deduction of interest and potential liability for dividends tax) for companies already in financial distress.

Relief has been provided in that, with effect from 1 January 2016 and applicable in respect of years of assessment
commencing on or after that date, a subordinated hybrid debt instrument will fall out of the hybrid debt rules if:

- that debt instrument constitutes a hybrid debt instrument solely by virtue of paragraph (b) of the definition of a hybrid equity instrument (ie the instrument falls within the scope of a hybrid debt instrument only by virtue of having payments deferred as discussed in more detail above); and
- a registered auditor has certified that the payment, by the issuing company, of an amount owed in respect of that instrument has been or is to be deferred by reason of the market value of the assets of that company being less than the amount of the liabilities of that company.

Consequently, a company in financial distress that has been required by its auditors to defer payments under a subordinated loan will not have its financial position compromised further due to the non-deduction of interest payments and suffering a potential dividends tax burden.

**Third-party backed instruments**

Section 8F of the Act, which applies to debt with equity-like characteristics, in certain circumstances effectively mirrors the provisions of section 8E, which applies to equity with debt-like characteristics.

In order to align section 8F with section 8E, the concept of a third-party backed instrument has been introduced with effect from 1 January 2017 and applicable in respect of years of assessment commencing on or after that date.

In this regard, the provisions of section 8F will not apply to an instrument that qualifies as a hybrid debt instrument, if that instrument falls within the definition of a third-party backed instrument.

A third-party backed instrument is defined as any instrument
in respect of which an enforcement right is exercisable as a result of any amount relating to that instrument not being received by or accruing to any person entitled thereto.

An enforcement right is in turn, defined as, in relation to an instrument, any right, whether fixed or contingent, to require any person other than the issuer of that instrument to:

(a) acquire that instrument from the holder thereof;

(b) make any payment in respect of that instrument in terms of a guarantee, indemnity or similar arrangement; or

(c) procure, facilitate or assist with any acquisition contemplated in (a) above or the making of any payment contemplated in (b) above.

Therefore, broadly speaking, the hybrid debt provisions contain in section 8F of the Act will not apply to a hybrid debt instrument in issue where the holder is able to require a person other than the issuer to either acquire that instrument, make a payment in respect thereof, or assist with such acquisition or payment in instances where the issuer has failed to make a payment in respect of such instrument.
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