Interest on debt instruments with equity features

On 4 July 2013, the draft Taxation Laws Amendment Bill (DTLAB) was issued by National Treasury in terms of which it was proposed that new anti-avoidance rules will be introduced into the Income Tax Act No. 58 of 1962 (the Act) in order to reduce the opportunity for the creation of equity instruments that are artificially disguised as debt instruments.

The first set of proposed anti-avoidance rules focus on the features relating to the instrument itself and are contained in section 8F of the Act. The second set of proposed anti-avoidance rules focus on the nature of the yield of the instrument and are contained in section 8FA of the Act.

In terms of section 8F of the Act, any amount of interest which is incurred by a company during a year of assessment in respect of a "*hybrid debt instrument*":

- is deemed for the purposes of the Act to be a dividend *in specie* declared and paid on the last day of the year of assessment by the company; and
- is not deductible in terms of the Act.

Any amount of interest in respect of a "*hybrid debt instrument*" which is incurred by a company which is deemed to be a dividend *in specie* declared is deemed to be declared and paid by that company on the last day of its year of assessment for purposes of the Act.

Similarly, any amount of interest which has accrued to the person to whom the amount is owed, in respect of "*hybrid interest*", is deemed to be a dividend *in specie*.

Further amendments were made to the proposed anti-avoidance

rules in section 8F and section 8FA by National Treasury and the final provisions of these sections are now contained in the Taxation Laws Amendment Act, 31 of 2013 (TLAA). A summary of the further amendments to section 8F and section 8FA of the Act are set out below.

- **Effective date**

The effective date of the proposed anti-avoidance rules in section 8F and section 8FA have been moved forward to **1 April 2014** from the initially proposed date of 1 January 2014 in order to allow taxpayers to restructure their transactions.

- **Definition of "hybrid debt instrument" in section 8F**

In terms of the DTLAB, a "*hybrid debt instrument*" was defined as any instrument in respect of which a company **that is a resident** owes an amount during a year of assessment if in terms of any arrangement:

- that company is not obliged to redeem the instrument within
  30 years from the date of issue of the instrument, but excluding any instruments payable on demand. Provided that, where the company has the right to convert that instrument to, or exchange that instrument for, a financial instrument other than a share, that conversion or exchange will be deemed to be an arrangement in respect of that instrument;
- the company is in that year of assessment entitled to **convert or exchange** that amount (or any part thereof) in any year of assessment for shares in that company or in any other company that forms part of the same group of companies as that company; or
- the obligation to pay an amount in respect of that instrument is conditional upon the market value of

the assets of the company not being less than the liabilities of the company.

Resident

In terms of the DTLAB the provisions of section 8F were only applicable in respect of debt owed by resident companies. National Treasury acknowledged that the proposal should apply to any company and not only to resident companies. National Treasury thus removed the words "**that is a resident**" in the definition of a "*hybrid debt instrument*" in the TLAA so that the definition will apply to any company and not only to resident companies.

30-year redemption period

In National Treasury's view, the 30-year redemption period referred to in the definition of a "*hybrid debt instrument*" is a reasonable indication of the time period of an equity instrument and not a debt instrument. However, in certain circumstances, National Treasury has acknowledged that it is not uncommon for arm's length third-party debt to be issued for periods in excess of 30 years and has indicated that the 30-year redemption period is more of a concern where there is an economic connection between the issuer and the holder. Therefore, the application of the 30-year redemption rule in the TLAA will be limited to instances where the issuer and the holder of the debt are **connected persons**.

Conversion or exchange

It was proposed that a distinction should be made between the conversion or exchange of an instrument for a fixed number of shares and between the conversion or exchange of an instrument for a variable number of shares in line with the accounting reclassification rules and the economic substance of the transaction. An instrument which is exchangeable for a fixed number of shares is generally regarded as an equity instrument because the holder is exposed to the underlying performance of the shares. However, an instrument convertible to a variable number of shares is, depending on the value of the instrument

still outstanding, regarded as being similar to a debt instrument.

National Treasury has indicated that a distinction will not be made between conversions or exchanges of instruments for a fixed or variable number of shares. However, an exception will be incorporated into the definition of a "*hybrid equity instrument*". In terms of the exception, where the **value of shares to which the instruments is converted or exchanged is equal to the amount outstanding in respect of the instrument**, such conversion or exchange will be excluded from the definition of a "***hybrid equity instrument***".

Linked units

A linked unit in a company held by a long-term insurer, a pension fund, a provident fund, a REIT, or a short-term insurer, will be excluded from the definition of a "*hybrid equity instrument*" if the long-term insurer, pension fund, provident fund, REIT or short-term insurer, *inter alia*, holds at least 20% of the linked units in that company. Accordingly, any interest paid in respect of linked units held by the above-mentioned entities will be excluded from the application of the anti-avoidance rules.

However, because the entity must hold at least 20% of the linked units in that company, property entities that are partially owned by pensions fund or insurers and do not meet the 20% shareholding requirement will be excluded from claiming the exemption. National Treasury have agreed that **the anti-avoidance rules should not apply to linked units** issued by property companies and owned by pension funds, long and short-term insurance companies and REITs and as a transitional measure (until legislation to regulate unlisted REITs is introduced), the application of sections 8F and 8FA will be delayed.

- **Definition of "*hybrid interest*" in section 8FA**

In terms of the DTLAB, "*hybrid interest*" was defined as any interest in respect of a debt owed by any company that is a resident if the amount of that interest is not determined with reference to a specified rate of interest or the time value of money. National Treasury has acknowledged that it is not uncommon for companies to obtain third-party funding that carries an 'equity kicker'. This entitles the funder to share in the profits of the business or assets being funded. Such funding is beneficial to the issuer of the instrument by obtaining better terms on the funding.

National Treasury has indicated that where the terms of an instrument allow the holder to share in a certain **percentage of the profits only, the anti-avoidance rules will apply** as the interest is not determined with reference to a specified rate of interest or the time value of money. Conversely, if the terms of an instrument are such that the holder is entitled to an additional percentage of interest, if the profits of the issuer exceed a certain level, only the portion of the additional interest will be affected by the anti-avoidance rules.

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IT Act: s8F, s8FA