The capitalisation of interest and section 8F

The provisions of section 8F of the Income Tax Act, 58 of 1962 (the **Act**) regulate hybrid debt instruments. Broadly speaking, from the time that an interest-bearing debt qualifies as a hybrid debt instrument, the interest incurred in respect thereof will be deemed to be a dividend *in specie* that is declared by the company which incurred such amount (i.e. the borrower) to the person to whom that amount accrued (i.e. the lender). Furthermore, the borrower is denied a tax deduction in respect of such interest.

As a result of current economic conditions parties may be placing particular focus on:

- the requirement that loan agreements be subordinated (for example, where new borrowings are advanced with the requirement that in the event of the financial distress of the borrower, existing creditors will permit the borrower to suspend payments of interest and/or capital in favour of making interest and/or capital payments in respect of the new borrowings); or
- particular terms regulating the payment (or non-payment) of interest in respect of loans.

The provisions of section 8F which require consideration in the circumstances mentioned above include those found in paragraph (*b*) of the definition of a hybrid debt instrument. In terms thereof, an interest-bearing debt issued by a company may constitute a hybrid debt instrument where the obligation to pay an amount owed is deferred by reason of that obligation

being conditional on the market value of the assets of the borrower not being less than the amount of the liabilities of that borrower.

The provision referred to above was inserted into the Act in order to address subordination agreements. It is clear that where a subordination agreement is entered into in respect of a loan, the impact thereof needs to be considered in light of the taxing provisions of section 8F and any exemptions which may apply.

However, the application of paragraph (b) of the definition of a hybrid debt instrument is not necessarily limited to subordination agreements. An unsubordinated loan agreement which contains provisions pertaining to the capitalisation of interest may result in the loan constituting a hybrid debt instrument.

For example, the terms of a loan agreement may contain provisions stipulating that interest will not be paid in cash in the event of the borrower being in an insolvent position, but rather that such interest will be capitalised. Where the capitalisation mechanism in the loan agreement is formulated in a way such that the borrowers obligation to pay interest is fulfilled by way of the capitalisation in the event of an insolvent position of the borrower, it could be that there is no deferral of such obligation and the requirements of paragraph (b) of the definition of a hybrid debt instrument may not be met.

However, where the capitalisation mechanism does not result in a fulfilment of the borrowers interest payment obligation, but rather a suspension or deferral thereof, then the loan agreement may give rise to hybrid debt instrument concerns. Failure by the parties to recognise this requirement being met once the capitalisation provisions of the loan agreement are triggered could result in adverse income tax and dividends tax implications arising in respect of the loan agreement.

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