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WHEN INTEREST BECOMES A DIVIDEND: HYBRID DEBT INSTRUMENTS

As of 1 April 2014 the Income Tax Act 58 of 1962 (the **Act**) was amended to regulate "hybrid debt instruments" more closely. A "hybrid debt instrument" now includes much more than it did before. This circular looks at the revised section 8F and the new section 8FA of the Act in order to identify where common shareholder loan arrangements may need to be revised.

WHAT IS A HYBRID DEBT INSTRUMENT?

A hybrid debt instrument is a loan agreement which is treated, for the purposes of the Act, as being an equity arrangement as opposed to a normal loan arrangement.

When a company owes debt and pays interest on it, the company can ordinarily deduct from its taxable income, the interest payable on the loan. The creditor receiving the interest receives income on which tax is payable.

By contrast, when a company declares cash dividends to its shareholders out of its profits, the company enjoys no tax deduction. The recipient of the dividend does not include the dividend in their taxable income but, if the recipient is not a company, pays 15% dividends tax on it.

WHAT DID SECTION 8F OF THE ACT USED TO SAY?

In general terms, the old section 8F provided that a debt instrument was a hybrid debt instrument if, within three years from the date when it was issued, it was convertible or exchangeable for shares at the instance of the issuing company or the holder of the debt instrument. The convertibility changed the character of the debt into equity. The instrument would be deemed to be a hybrid debt instrument and interest payments made would not be deductible in the hands of the company.

WHAT ARE THE IMPLICATIONS OF THE NEW SECTION 8F?

The new section 8F of the Income Tax Act is much wider. It sets out criteria which will result in a debt instrument being deemed to be a hybrid debt instrument. If any one criterion is satisfied, it is enough.

An “instrument” is widely defined as “any form of interest-bearing arrangement or debt”. Therefore shareholder claims against companies on loan account are “instruments” *unless* they are not interest-bearing.

If an instrument is deemed to be a hybrid debt instrument, then any interest incurred by the company on the instrument is deemed to be a dividend *in specie* meaning that the interest is not deductible and the company will be liable for dividends tax on the interest.

WHAT IS DEEMED TO BE A HYBRID DEBT INSTRUMENT?

An instrument in terms of which a company owes money is a hybrid debt instrument if:

- the company is entitled or obliged to convert the instrument into or exchange the instrument for shares, unless the market value of the shares is equal to the amount owed in terms of the instrument at the time of conversion or exchange; OR

- the obligation to pay an amount in respect of the instrument is conditional on the company being technically solvent (the market value of the assets not being less than the market value of the liabilities); OR

- the company owes the amount to a connected person in relation to the company (including a 20% shareholder) and is not obliged to redeem the instrument within 30 years from the date of issue or from the end of the current fiscal year of assessment, unless the instrument is payable on demand.

Deeming under the first category can be avoided by ensuring that any provisions in a shareholders agreement which demand a subscription for shares instead of advancing shareholder loans, provide that shareholders will take up a number of shares the collective value of which equals the required capital injection. Deeming under the second category can be avoided by leaving out or revising the wording of subordination clauses and deeming under the third category can be avoided by ensuring that shareholder loans are effectively repayable on shareholder demand.

There are certain exceptions to the deeming provisions, including linked units in a company held by long-term insurers, pension funds, provident funds and REITs. The National Treasury is being lobbied to provide relief to unlisted property owning companies with multiple small-scale shareholders whose investments are negatively affected by the introduction of the new sections 8F and 8FA.

WHAT ARE THE IMPLICATIONS OF THE NEW SECTION 8FA OF THE ACT?

Section 8FA of the Act is concerned with amounts paid in relation to an instrument, regardless of whether the instrument is a “hybrid debt instrument”. It looks at the type of interest paid on any instrument (“any form of interest-bearing arrangement or debt”) and classifies that interest as “hybrid interest” in certain instances.

If interest paid by a company is classified as hybrid interest, then it is deemed to be a dividend *in specie* and it is not deductible in the hands of the company. The recipient of the interest will be deemed to have received a dividend *in specie* and the company will be liable for dividends tax.

There are exceptions to the deeming provisions which run along the same lines as those for hybrid debt instruments themselves.

Interest in relation to any debt owed by a company in terms of any instrument is "hybrid interest" if:

- the amount of the interest is not determined with reference to a specified rate of interest; OR
- the amount of the interest is not determined with reference to the time value of money; OR
- the amount is payable over-and-above the normal amount of interest payable on the instrument by reason of an increase in the profits of the company – only the additional amount is hybrid interest.

Perhaps there are cases where anticipated company earnings can be estimated with enough accuracy to determine a rate of interest which the company can consistently pay, rather than linking repayment obligations to the earnings themselves.

CONCLUSION

It is important to bear in mind the hybrid debt instruments deeming provisions under the Act when establishing shareholder loan arrangements. Where existing arrangements are caught in the net of the deeming provisions, it is advisable to negotiate and agree on changes to them sooner rather than later.

FURTHER ADVICE

Should you require advice or assistance on commercial law matters, please contact Michael Jackson on 031 – 536 8512, email : **mjackson@coxyeats.co.za** or Keren Watson on 031 - 536 5818, email : **kwatson@coxyeats.co.za** or Simon Watson on 031 - 536 8530, email : **swatson@coxyeats.co.za** or Jason Goodison on 031 - 536 8517, email : **jgoodison@coxyeats.co.za** or Jenna Padoa on 031 - 536 8529, email : **jpadoa@coxyeats.co.za**.