

New proposals on recharacterisation of hybrid debt instruments



By [Heinrich Louw](#)

10 May 2013

The National Treasury (Treasury) and the South African Revenue Service (SARS) recently released certain proposed limitations on excessive interest deductions for public comment.

These proposals are to be incorporated in the Taxations Laws Amendment Bill 2013, the first version of which is expected to be released in June 2013.

The proposals focus on four particular areas where, according to Treasury and SARS, taxpayers are eroding the tax base through excessive interest deductions. These four areas are: hybrid debt, connected person debt, transfer pricing, and acquisition debt.

This article specifically focuses on the issue of hybrid debt.

More akin to equity instruments

Hybrid debt instruments are, essentially, instruments that are called debt instruments but have substantive features indicating that they are more akin to equity instruments (i.e. have share-like features) than debt instruments. For example, a loan that is convertible into shares at a future date could be seen as a hybrid debt instrument.

A main concern with these instruments is that they could locally be seen as debt instruments, entitling the issuer to interest deductions in respect of interest paid on the instruments, but in a foreign jurisdiction they might be seen as shares, allowing a holder in that jurisdiction to receive the interest as exempt or low-taxed dividends.

Currently s8F of the Income Tax Act, No 58 of 1962 (Act) limits interest deductions on certain such hybrid debt instruments. In simple terms, this section essentially provides that if a debt instrument is convertible, at the option of the issuer, within three years of its issue date to shares, no interest will be deductible by the issuer in respect of that instrument.

However, to get around this, parties could simply extend the conversion period beyond three years.

To extend the scope of current interest deduction limitations, new ss8F and 8FA had already been proposed in the draft Taxation Laws Amendment Bill 2012, but these proposals never made it into the final Bill as they were seen as being overly broad.

Revision proposed

The Treasury and SARS are now proposing that revised ss8F and 8FA be introduced.

The proposed s8F provides that interest paid in respect of hybrid debt instruments will be deemed to be a dividend declared by the issuing company. It will not be deductible in terms of the Act, but it will also not be included in the gross income of the recipient in terms of s24J of the Act. Dividends tax could in principle be levied in respect of such a deemed dividend.

Hybrid debt instruments will include any instruments in respect of which a company owes a debt and:

- The company does not have to repay the amount owed in cash within 30 years;
- The company may convert or exchange the amount owed into/for shares in itself or a group company; or
- The obligation to repay the amount owed is conditional upon the solvency of the company.

However, certain instruments are specifically excluded. These are instruments that are either:

- Issued by profit companies (but not public or state-owned companies) to resident natural persons;
- That are tier 1 or tier 2 capital instruments owed by a bank to any unconnected natural person; or
- Subject to approval by the registrar of the Short-term Insurance Act No 53 of 1998 or Long-term Insurance Act No 52 of 1998, and is owed by a short-term or long-term insurer.

Whereas the proposed s8F looks at the features of the instrument itself to disallow deductions, the proposed s8FA looks at the nature of the yield of the instrument to disallow deductions.

Section 8FA provides that "hybrid interest" will be deemed to be a dividend declared by the paying company. It will not be deductible in terms of the Act, but as with the proposed s8F, it will also not be included in the gross income of the recipient in terms of s24J of the Act. It is also expected that dividends tax could be levied in respect of the deemed dividend.

"Hybrid interest" will be defined as interest paid on a debt owed by a resident company and where:

- The amount of that interest is not determined with reference to a specified interest rate or the time value of money; or
- The obligation to pay the amount owed is conditional upon the solvency of the company.

The proposed s8FA will not apply to interest in respect of a debt:

- That is owed by profit companies (but not public or state-owned companies) to resident natural persons; or
- That constitutes a tier 1 or tier 2 capital instrument owed by a bank to any unconnected natural person.

Comments in respect of these proposals are due by 24 May 2013.

ABOUT HEINRICH LOUW

Heinrich Louw is a senior associate, tax at Cliffe Dekker Hofmeyr.

■ Impact of new Binding Private Ruling 185 - 4 Feb 2015

■ New proposals on recharacterisation of hybrid debt instruments - 10 May 2013

[View my profile and articles...](#)