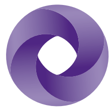

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A horse that looks like a cow is still a horse - *Hybrid debt instrument taxed as dividends*

By Donatella Callaway, Senior Tax Consultant, Grant Thornton Johannesburg

The new anti-avoidance rules in respect of hybrid debt instruments, which were introduced by the Taxation Laws Amendment Act 2013 (TLA), became effective on 1 April 2014. The provisions were introduced to reduce the opportunity to create equity instruments that are artificially disguised as debt instruments.

The effect of these provisions is that any amount of interest incurred by a company in respect of a "hybrid debt instrument" or any amount of "hybrid interest" incurred is not tax deductible and furthermore deemed to be a dividend in specie.

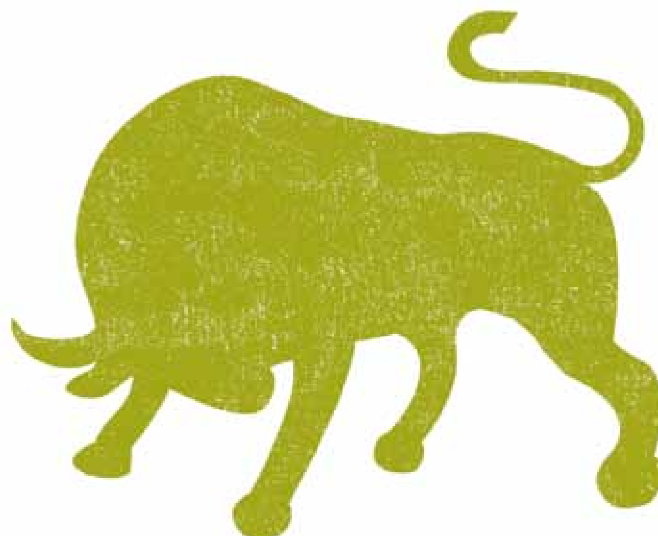
A "hybrid debt instrument" is defined as any agreement in terms of which a company owes an amount if:

- that company is entitled to, or obliged to convert or exchange that instrument to, or for shares in that company;
- the obligation to pay an amount in respect of that instrument is conditional upon the market value of the company's assets being more than its liabilities; or
- the company owes the amount to a connected person and is not obliged to redeem the instrument within 30 years. This excludes instruments payable on demand.

"Hybrid interest" is interest that is:

- not determined with reference to a specified interest rate; or
- not determined with reference to the time value of money; or
- determined in terms of an interest rate which increased due to an increase in the issuer's profits and if that amount is more than the interest amount that would have been calculated if the lowest interest rate during the current and past years of assessment was used.

The application of the 30-year redemption rule is limited to instances when the issuer and the holder of the debt are connected persons. Companies should therefore pay special attention to loans between connected persons to ensure that the loans are compliant with the "hybrid debt instrument" provisions and should consider amending the terms to avoid unnecessary taxes and penalties.



Loans disguised under share schemes are no more – it is time to restructure

By Hawa Bibi Hoosen, Senior Tax Consultant, Grant Thornton Durban

The revised section 8E and newly introduced section 8EA of the South African Income Tax Act ("the Act") deems certain dividends and foreign dividends received in cash by any person on or after 1 January 2013, to be income, taxed in the hands of the shareholder. This has resulted in significant changes in the tax planning of companies and individuals alike.

The purpose of section 8E is to address and close the gap on schemes in which the shares issued are in substance a financing arrangement. In other words, instead of a granting a loan, the lender acquires shares and stands to receive tax free dividends, and not interest, from the borrower. This section applies to "hybrid equity instruments" only and the definition considers three types of shares, namely preference shares, shares other than an equity share and any other share.

This definition has been expanded on to include any type of shares that meet these criteria:

- If there are any dividends or foreign dividends payable on such shares;
- If these dividends are calculated directly or indirectly by referencing a specified interest rate; or
- The amount of capital subscribed for that share is directly or indirectly secured by a financial instrument, and that financial instrument does not constitute an equity share as defined.

Section 8EA is a follow-on to section 8E, and is applicable to situations where the shares in question are "preference shares" and "third-party backed shares".

Simplistically described, these shares encompass the following attributes:

- An enforceable right exercisable by the shareholder or;
- An enforcement obligation is enforceable as result of any amount of any specified dividend, foreign dividend, return of capital or foreign return of capital not being received by, or accruing to any person entitled thereto.
- Third-party backed shares in essence grants the holder of the shares the right to require some person other than the company to buy the shares from it.

Section 8EA lists a number of exclusions, in which case this deeming provision will not apply, the overriding exclusion being that a share will not be construed to be a third-party backed share when that share was issued for a "qualifying purpose and the enforcement right or obligation is only exercisable against specifically mentioned persons". The list of persons is easily interpreted, however deciding or concluding on what is meant by a "qualifying purpose" has proven difficult.

There is no doubt that sections 8E and 8EA are laden with complexities and taxpayers are urged to seek professional advice to arrange their tax affairs most beneficially and to satisfy themselves of compliance with the Act's provisions.

Anti-avoidance share schemes income recognition

By Douglas Gaul, Tax Manager Grant Thornton Johannesburg

Prior to 1 March 2014, dividends received from equity shares that were acquired by an employee as part of a share incentive scheme, were exempt from income tax (with some exceptions), even if these shares were held by a share trust on behalf of the employees. This situation has changed, and share incentive schemes must be reviewed to determine whether they still achieve the outcomes they were originally setup to deliver.

Treasury has recognised that avoidance schemes were being implemented whereby share trusts held equity shares on behalf of employees with the sole intention of generating dividends for employees as compensation for past or future services rendered to the employer, without the employees ever taking ownership of the shares.

This means that, because ownership of the shares is never transferred to the employee, the employee enjoyed the benefit of receiving tax-free dividends. As set out in the Explanatory Memorandum to the Taxation Laws Amendment Act, 2013, "the dividend yield in these instances effectively operates as disguised salary for employees (that is not deductible by employers) even though these dividends arise from equity shares."

In order to shut down such anti-avoidance schemes, a new proviso has been inserted to section 10(1)(k), which is the section that provides for a general exemption of dividends received by, or accrued to, any person (subject to certain provisos).

In terms of the new amendment's proviso, any dividend received by, or accrued to a person in respect of services rendered, or to be rendered, or in respect of, or by virtue of employment or the holding of any office, will generally be taxable. However, an exemption remains in respect any dividend received or accrued in respect of a restricted equity instrument as defined in section 8C held by that person, or in respect of a share held by that person (our emphasis). This has the effect of taxing any payment made by an employer to an employee for services rendered even if such payment is facilitated indirectly in the form of dividends through an employee share trust.

In other words, in order for the employee to obtain an exemption from dividends received in respect of equity shares that form part of share incentive scheme, it will be necessary for the employee to directly hold the shares himself, as opposed to an employee trust holding the shares on his behalf.

Where the dividend is subject to normal tax, it will not be subjected to dividends withholding tax (DWT) as this would result in a double taxation.

Measures have been implemented whereby, in circumstances where the dividend is subject to normal tax in the employees' hands, the trust can make a declaration to the relevant Central Securities Depository Participant (CSDP) if the shares are listed, or to the distributing company in the case of non-listed shares, not to withhold dividends tax.

If dividends tax was withheld on dividends that will be distributed by the trust and included in the employee's income, the trust may make a declaration to the relevant CSDP or company in order to receive a refund and distribute the full dividend to the employee.

Are audit fees tax deductible?

By Hylton Cameron, Associate Tax Director, Grant Thornton Johannesburg

The Supreme Court of Appeal's findings in the matter relating to the tax deductibility of audit fees between CSARS v MTN Holdings (Pty) Ltd (MTN) has highlighted the care companies must take in analysing expenses.

MTN was a holding company and for its 2001 to 2004 years of assessment, it received revenue in form of dividends and interest. Out of its' total revenue, in terms of percentages, the dividends accounted for 89%, 94%, 98% and 99%. SARS disallowed the tax deduction of audit fees in terms of the above percentages.

The lower court (South Gauteng High Court), allowed MTN to claim 50% of the audit fees leading SARS to appeal the decision at the Supreme Court.

The Supreme Court stated that the audit fee was part of MTN's general overhead expenses. The Court continued and stated that the lower court's conclusion that the auditing of financial records is clearly a function that is necessarily attached to the production of MTN's income-earning operations, cannot be faulted.

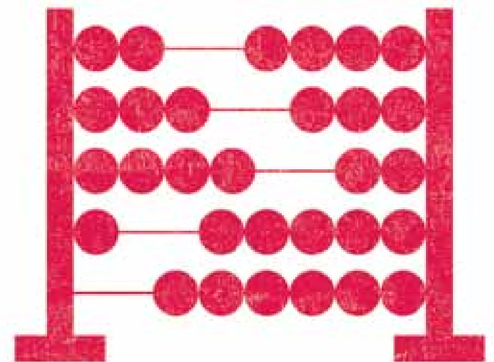
In terms of MTN's defence, part of MTN's argument was that very little work was undertaken in terms of the dividends and much more time was spent on the interest received. Further, the audit is required and that the auditor has to undertake a number of tasks which do not relate to specific income items. MTN contended that if there was to be an apportionment of the audit fees it should be based on the proportion of the time spent on dividends and interest.

The court added the time spent auditing interest and dividends may well have made up a relatively small component of the overall audit time. It further held that the process involved the auditing of MTN as a whole, the major part of which concerned the consolidation of the subsidiaries.
The court then concluded that any apportionment must be heavily weighted in favour of the disallowance of the deduction, given the predominant role played by MTN's equity (which seems to suggest the consolidation part of the audit) and dividend operations as opposed to its far more limited income (interest) earning operations.

The court also stated that analysing each of the years as SARS had done, may be artificial as the court assumed that for the years in question the audit function would have essentially been the same, despite the differences in the proportion of interest revenue for those years. The outcome was the Supreme Court of Appeal allowed MTN to claim 10% of the audit costs.

Where to from here?

Companies that earn non-taxable dividend income and other taxable income should be wary of a challenge from SARS relating to the deduction of its expenses, including as the example suggests audit fees. Companies should therefore be aware of this issue (which is not new) and ascertain if an expense relates to income or exempt income. If the expense relates to both, prior to submitting the tax return, an exercise should be undertaken to analyse what proportion of the expense is tax deductible.



VAT implications on waived or reduced debts and business rescue plans

By Anton Kriel, Tax Partner, Grant Thornton Cape

The VAT Input Claw Back

In the ordinary course of business, creditors often reduce or write-off bad and irrecoverable debts. For the creditors, the VAT treatment is simple. If output VAT on the written-off debts was accounted for, the creditor is entitled to claim the VAT portion of the written-off debt as input VAT. However, for the debtor the solution is not as simple, and it could give rise to additional liability. In fact, the debtor may just be trading one creditor for another – and the 'another' being SARS.

While vendors that account for VAT on an invoice basis can claim VAT incurred on expenses as input deduction (subject to specific restrictions), strict legislation determines the impact for the debtors when debts are reduced. A VAT vendor that claimed an input tax deduction in respect the reduced debt must account for output tax on the portion of the debt written-off.

Debtors do not only incur an output VAT liability in respect of the debt amounts that are reduced. If a debt, in respect of which an input deduction has claimed been is not paid in full within 12 months from the date it was incurred, the debtor may be required to make an output tax adjustment and pay the output VAT on the portion of the outstanding debt.

In respect of debt, that by a written agreement is payable in instalments after the tax period in which the input tax deduction is claimed, the 12-month period only starts running from the end of the month when each payment becomes payable in terms of the contract. The 12-month input claw-back provisions do not apply in respect of debts reduced or waived between companies that form part of a group of wholly owned companies.

Debts Reduced in terms of a Business Rescue Process

The Companies Act 71 of 2008 introduced the concept of Business Rescue. Business rescue centres on the concepts of creditors accepting a business plan that has to be adopted and implemented by the business. Inevitably, such plans also include a compromise by the creditors in respect of debts owed to them.

Any VAT input previously claimed by the business in respect of the debts that are compromised must be clawed back by the business in rescue. This gives rise to additional debts, which not only places more pressure on the rescue plan, but in some cases could even result in the failure of the rescue plan.

As the actual reduction (compromise) of the debt only occurs after the effective date of the business rescue, current tax legislation does not allow for the VAT liability arising from the claw back to be included in any tax debts owed to SARS, and subject to the compromise.

In the tax proposal documentation issued with the Budget Speech in February 2014, SARS indicated that it was contemplating amendments to legislation to provide relief from the hardship caused by the VAT claw back provisions and other potential taxation obligations that arise when a business rescue plan is implemented.

However, until legislation is changed, the status quo remains and businesses that apply for the protection of a business rescue process are faced with the additional tax debts. The best case scenario is not only that the legislation is amended very soon, but also that SARS will apply the amendments retrospectively, or at least provide for a mechanism to deal with the additional (and often unforeseen) tax liabilities that arose after the implementation of business rescue plans since the business rescue legislation was introduced.

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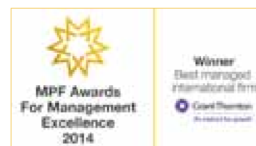

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