

CLASSIFICATION OF INSTRUMENTS AS DEBT OR EQUITY

Companies are typically funded through a combination of debt and equity.

The 'truest' form of debt would be a secured loan and returns in respect of that instrument would qualify as interest. While the 'truest' form of equity would be ordinary shares in a company and the returns in respect of such equity would qualify as dividends.

However, the Companies Act No 71 of 2008 allows companies to tailor make the debt and equity instruments that it issues, which may have a combination of debt and equity features. These instruments are referred to as hybrid instruments and it is often difficult to classify the instruments as either debt or equity.

Taxpayers worldwide have often sought to use these hybrid instruments to obtain tax benefits. In South Africa, specific legislation has been enacted to deal with hybrid instruments and perpetual debt instruments (see s8E, s8EA, s8F and s24J of the Income Tax Act, No 58 of 1962). Recently, National Treasury and the South African Revenue Service (SARS) released a document for public comment on certain proposed amendments and additions to the provisions relating to hybrid debt instruments, which reclassify the interest returns on these hybrid instruments as dividends.

Interestingly many of the debt and equity features that Treasury and SARS have indemnified in the specific hybrid instrument legislation are taken into consideration by foreign courts in determining the classification of an instrument. For instance, the proposed amended s8F provides that a hybrid debt instrument includes inter alia an instrument where:

- i. the company is not obliged to repay all amounts on the instrument in cash in full within 30 years; and
- ii. the obligations to pay is conditional upon the solvency of the company.

Last year, the United States Tax Court, in the cases of *PepsiCo Puerto Rico Inc (TC Memo 20012-269)*, *Hewlett-Packard Company & Consolidated Subsidiaries (TC Memo 2012-135)* and *NA General Partnership & Subsidiaries (TC Memo 2012-172)*, had to determine whether the instruments concerned constituted debt or equity. The number of factors that the court took into consideration varied between the cases. In the *PepsiCo* case, the court identified the following 13 factors to consider when resolving the debt-versus-equity enquiry:

- names or labels given to the instruments;

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- presence or absence of a fixed maturity date;
- source of payments;
- right to enforce payments;
- participation in management as a result of the advances;
- status of the advances in relation to regular corporate creditors;
- intent of the parties;
- identity of interest between creditor and stockholder;
- 'thinness' of capital structure in relation to debt;
- ability of the corporation to obtain credit from outside sources;
- use to which advances were put;
- failure of debtor to repay; and
- risk involved in making advances.

The courts will weigh up all of the factors mentioned above in considering the debt or equity nature of the instrument concerned. Importantly, in the *PepsiCo* case it was indicated that the absence

of any legitimate creditor safeguards afforded to the holders of the instrument was a significant factor evidencing the equity nature of the investment. It was indicated that "no enforcement provisions, no specific maturity date, and no sinking fund from which payments of interest and principles might be made' were more appropriately characterised as equity instruments."

Despite the specific hybrid instrument provisions contained in the Act, careful consideration should thus always be given to the particular terms and conditions of the instrument to establish its true nature. It is a well-established principle that 'the courts will not be deceived by the form of a transaction: it will rend aside the veil in which the transaction is wrapped and examine its true nature and substance'. Thus, if in substance, taking into consideration the factors mentioned above, an instrument is a debt instrument, the courts may treat the returns as interest (as opposed to dividends) triggering the attendant tax implications.

Andrew Lewis

E-SERVICES AND LOOMING VAT DRAGONS

It was proposed in the 2013 budget speech that foreign businesses that supply digital goods and services be required to register as vendors in South Africa.

This line of thinking follows the current trend adopted by the European Union (EU) requiring such suppliers to register for Value-added Tax (VAT) in the country where the consumer resides. E-commerce changes things of fundamental importance from a direct and indirect tax perspective. It allows a foreign vendor who essentially has no physical presence to sell into another territory and bypass the payment of any local taxes that may have been imposed on a source basis, for example, the purchase of e-books or music by a consumer, with no collection mechanism, as opposed to the delivery of physical goods that must go through customs. The tax issues associated with e-commerce, specifically cross-border activities on the internet, remain for the most part unresolved.

Tax compliance relies on geographical boundaries and in cyber space these boundaries are non-existent and cannot readily be defined. It has become much easier for a business operating as a manufacturer or financial service supplier to establish a direct relationship with a customer in another country, without the need for a physical presence in that country. The intermediaries in the supply chain between the manufacturer and the customer, such as a local agent, distributor, wholesaler or retailer, or even the manufacturer's own sales organisation or warehousing facilities may disappear.

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The issue that arises for governments is the inability to tax these activities as they no longer occur in their countries. While the effective date of the proposed amendment to the Value-added Tax Act, No 89 of 1991 (VAT Act) remains unclear, it is interesting to see that the EU has adopted Council Regulation 282/2011 (EU VAT Rules), which will be implemented on 1 January 2015, and which effectively changes the rules governing the place of supply of services relating to non-established taxable persons supplying telecommunications, broadcasting or electronic services to non taxable persons. The EU VAT Rules state that all telecommunications, broadcasting and electronic services are to be taxed in the member state in which the customer is established or has his permanent address or usual residence (member state) regardless of where the taxable person supplying these services is established.

To facilitate the compliance with fiscal obligations where such services are supplied to non taxable persons, a special scheme called the union scheme has been put in place for taxable persons established in the community, but not in the member state where the services are supplied. The objective is that this should enable non-established taxable persons to designate a member state of identification as a single point of electronic contact for VAT identification and declaration. In terms of the EU VAT Rules, the EU located supplier will be required to register for the union scheme in the country in which it is located or resides. The effect of this registration means that the EU located supplier will have to determine the rate of VAT it is required to levy on the supplies made to its EU customers on the basis of where their EU consumers are located or reside in the 28 member states, as each member state has a different rate for the levying of VAT.

It is appreciated that the VAT regime in the EU applies different rules and more notably that South Africa does not have various member states imposing different rates of VAT in each member state. However, van Eeden in Tax Planning International makes the fundamental point that notwithstanding the effective date of the proposed amendment to the VAT Act, essentially the question remains how the South African Revenue Service intends implementing a stricter regime on VAT registration requirements and the proposed mechanisms for VAT collection. We await the draft tax legislation with heightened anticipation.

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