Tax Alert

9 May 2014

Hybrid debt instruments and reportable arrangements

In terms of notice no. GN 1108 (published in the Gazette on 28 December 2012) read with section 8F of the Income Tax Act 58 of 1962 (ITA), certain loans between connected persons that have a term of more than 10 years constitute reportable arrangements with effect from 1 April 2014.

In terms of section 35 of the Tax Administration Act (TAA), if the Commissioner is satisfied that an "arrangement" may lead to an undue "tax benefit", he may list that arrangement by way of notice in the Government Gazette. An arrangement so listed will, in terms of section 35(1), be a reportable arrangement to which sections 34 to 39 of the TAA will apply. Generally, this means that certain details of the arrangement must be disclosed to SARS by the "promoter" (or, in certain circumstances, the "participants") in relation to the arrangement within 45 business days of any amount being paid, incurred or received by or accrued to any participant in relation to the arrangement.

Only one notice under section 35(2) has been issued to date. Paragraph 2 of the Schedule to that notice (notice no. GN 1108) lists the following as reportable arrangements:

"(*a*) Any arrangement which would have qualified as a 'hybrid equity instrument' as defined in section 8E of the Income Tax

Act, 1962 … if the prescribed period had been 10 years; or

(*b*) Any arrangement which would have qualified as a 'hybrid debt instrument' as defined in section 8F of the Income Tax Act, 1962 … if the prescribed period in that section had been 10 years, but does not include any instrument listed on an exchange regulated in terms of the Securities Services Act, 2004 …".

The sections to which these paragraphs refer – sections 8E and 8F of the Income Tax Act respectively – have both been the subject of substantial amendments (section 8E in 2011 and section 8F in 2013).

Subparagraph (*a*) was published in notice no. GN 1108 with the full knowledge of the substantial amendments to section 8E that preceded the publication of the notice. However, it is not clear that the implications on subparagraph (*b*) of the amendments to section 8F have been considered.

Under section 8F, prior to its amendment with effect from 1 April 2014, an instrument constituted a hybrid debt instrument if, generally, it was convertible into to or exchangeable for shares in the issuer within a period of three years from the date of its issue. The three-year period was critical in the determination of whether an instrument constituted a hybrid debt instrument or not – no such determination could be made without reference to this three-year period.

However, under section 8F as it now applies, the three-year period criterion that previously existed has been completely removed and the period within which an instrument is convertible into or exchangeable for shares is no longer relevant in the determination of whether or not an instrument is a hybrid debt instrument. The only instance in which any time period is relevant in such a determination is in the context of instruments (other than instruments that are payable on demand) that are held by parties that are connected persons in relation to the issuing company. In this context, an instrument will generally constitute a hybrid debt instrument if the issuer is not obliged to redeem the instrument within 30 years.

Consequently, under section 8F prior to its amendment, the effect of paragraph 2(*b*) of the Schedule to notice no. GN 1108 was that if an instrument would have been a hybrid debt instrument under section 8F if the three-year period prescribed in section 8F had been 10 years, that instrument would constitute a reportable arrangement.

However, under section 8F in its current form (i.e. subsequent to its amendment with effect from 1 April 2014), the effect of paragraph 2(*b*) of the Schedule to notice no. GN 1108 is that if an instrument (other than an instrument that is payable on demand) is held by a party that is a connected person in relation to the issuing company and the issuer is not obliged to redeem the instrument within 10 years, that instrument constitutes a reportable arrangement.

It is possible that paragraph 2(*b*) of the Schedule to notice no. GN 1108 might require some attention due to the recent fundamental overhaul of its subject, section 8F. Whether or

not this attention is required and whether or not notice no. GN 1108 currently applies are, however, two separate enquiries, and until such time as the situation is clarified (if at all), any loan between connected persons that is not fully repayable within 10 years will constitute a reportable arrangement.

It should also be noted that the other types of hybrid debt instruments, namely certain convertible instruments and instruments where the obligation to pay amounts in respect thereof is conditional upon the assets of the company exceeding its liabilities, will also be reportable arrangements with effect from 1 April 2014.

Companies with such instruments in issue or to be issued should therefore carefully consider the potential reportability of such arrangements.

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