

## STC CREDITS AND NEW BINDING CLASS RULING

The Dividends Tax regime was implemented just over a year ago on 1 April 2012.

As part of the transitional arrangements from Secondary Tax on Companies (STC) to Dividends Tax, companies had to calculate their STC credits as at 31 March 2012.

In terms of s64J(2) of the Income Tax Act, No 58 of 1962 (Act), a company's STC credit had to be calculated as the amount by which the dividends accruing to that company in its final dividend cycle exceeds the dividends declared by that company on the final day of that cycle. That is, the STC credit is the net amount of dividends accruing to a company in its final dividend cycle, and which would have been carried forward to the next dividend cycle for STC purposes, had there been such a next cycle.

In terms of s64J(1) of the Act, no Dividends Tax will be payable by shareholders in respect of any cash dividends (or by the company in the case of dividends *in specie*) until such time as the company's STC credit has been completely used up. Any dividend declared and paid on or after 1 April 2012 will reduce the company's STC credit by the amount of the dividend. This does not happen automatically and the company paying the dividend must submit a written notice to the person to whom the dividend is paid stating by how much the company's STC credit is reduced (s64J(1)(b)).

Where a company has a large STC credit, it is good news for shareholders as they will not be paying Dividends Tax until the STC credit is used up. Companies will however have to use up their STC credits by 1 April 2015 because it will be deemed to be zero at that date.

It is important to appreciate that, where a company pays a dividend to an exempt entity such as another local company, the dividend will in any event reduce the company's STC credit

### IN THIS ISSUE

- **STC credits and new binding class ruling**
- **New proposals on recharacterisation of hybrid debt instruments**

despite the fact that it is an exempt dividend. However, the company paying the dividend can 'pass on' that portion of its STC credit to the shareholder receiving the exempt dividend where the shareholder is a company.

This means that, in a group context, subsidiary companies can 'move up' their STC credits to the holding company level. This does not happen automatically either and the company paying the dividend must submit a written notice to the company to whom the dividend is paid stating by how much the company's STC credit is reduced (and therefore by how much the recipient's STC credit is increased).

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The South African Revenue Service (SARS) recently released Binding Class Ruling 99 (ruling). The ruling deals with the obligation of a company to submit a notice to shareholders in terms of s64J(1)(b) of the Act stating the amount by which a dividend reduces the company's STC credit. The ruling specifically addresses the issue of what constitutes sufficient notification in the context of a listed holding company.

In this particular case the applicant was a listed holding company who would receive dividends from time to time from its subsidiaries, the subsidiaries all having STC credits. The applicant would also from time to time declare interim and final dividends to its shareholders.

The ruling did not address the declaration of dividends by subsidiary companies to the applicant, but focused on the declaration of dividends by the applicant to its shareholders. The ruling specifically indicated that:

- the applicant (or the regulated intermediary through which dividends are paid) need not obtain any declaration claiming exemption from shareholders for them to benefit from the applicant's STC credit;

- the applicant (or the regulated intermediary through which dividends are paid) has to give notice to its shareholders of the amount by which the applicant's STC credit is reduced, even where such shareholders are companies; and
- the applicant will be seen as having given sufficient notice if the information is communicated via:
  - SENS;
  - the applicant's website; and
  - the central securities depository system of Strate Ltd.

The applicant would be required to publish full details of all dividends paid in respect of a relevant year when it publishes its interim and annual results in the press.

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## NEW PROPOSALS ON RECHARACTERISATION OF HYBRID DEBT INSTRUMENTS

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.

Hybrid debt instruments are essentially instruments that are called debt instruments but have substantive features indicating that they are more akin to equity instruments (ie 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.

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.

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