**ADDRESSING BASE EROSION AND PROFIT SHIFTING IN SOUTH AFRICA**
**DAVIS TAX COMMITTEE INTERIM REPORT**

# ACTION 2: NEUTRALISE THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS

## 1 INTRODUCTION

The OECD 2013 BEPS report [1] notes that international mismatches in the characterisation of hybrid entities and hybrid instrument arrangements can result in tax arbitrage. The OECD defines a hybrid mismatch arrangement as "an arrangement that exploits a difference in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to produce a mismatch in tax outcomes where that mismatch has the effect of lowering the aggregate tax burden of the parties to the arrangement.[2] Hybrid mismatch arrangements can be used to achieve unintended double non-taxation or long-term tax deferral. The OECD notes that it may be difficult to determine which country has in fact lost tax revenue, because multinational enterprises (MNE) will ensure that the laws of each country involved have been followed, but the result would be a reduction of the overall tax paid by all parties involved as a whole. [3] Hybrid arrangements generally use one or more of the following elements:

- hybrid entities, that are treated as transparent for tax purposes in one country and as non-transparent in another country;
- dual residence entities, that are resident in two different countries for tax purposes;
- hybrid instruments, that are treated differently for tax purposes in the countries involved, for example as debt in one country and as equity in another.
- hybrid transfers are arrangements that are treated as transfer of ownership of an asset in one country, but as a collateralised loan in another.[4]

Hybrid mismatch arrangements generally aim to achieve the following results:

- double deduction schemes, where a deduction related to the same contractual obligation is claimed in two different countries;
- deduction or no inclusion schemes, that create a deduction in one country, but avoid the corresponding income inclusion in another country;
- foreign tax credit "generator", arrangements that generate foreign tax credits that would otherwise not be available, or available to the same extent.[5]

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1 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 15.
2 OECD/G20 Base Erosion and Profit Shifting Project Neutralise the Effects of Hybrid Mismatch Arrangements: Action 2: 2014 Deliverable (2014) at 29 (OECD/G20 BEPS Project: Action 2: 2014 Deliverable)
3 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 15.
4 OECD "Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues" (March 2012) at 7.
5 OECD "Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues" (March 2012) at 7.

- prolonged tax deferral, which over time equates economically to double non-taxation.

Key tax issues that arise from hybrid mismatches:

- Tax revenue: It is often difficult to determine which of the countries has lost tax revenue, but it is clear that the countries concerned collectively lose tax revenue. [6]
- Tax policy concerns: The particular difficulty encountered with these arrangements is that they are ostensibly compliant with the letter of the law in both affected tax jurisdictions yet they achieve a result unintended in either jurisdiction. The concern around this type of tax arbitrage hinges upon relief granted in respect of the same tax loss in multiple jurisdictions in consequence of differences in tax treatment between jurisdictions. The tax policy concern is that either due to the lacuna between different tax systems, or the application of certain bilateral tax treaties, income from cross-border transactions may escape tax altogether, alternatively be taxed at unduly low rates. [7]
- Competition: Businesses that use mismatch opportunities have competitive advantages over businesses that cannot use mismatch opportunities. [8]
- Economic efficiency: Where a hybrid mismatch is available, a cross-border investment will often be more attractive than an equivalent domestic investment. Hybrid mismatch arrangements may also contribute to increases in leverage from tax-favoured borrowing. [9]
- Transparency: The adoption of tax-driven structures leads to a lack of transparency. The public will be generally unaware that the effective tax regime is quite different for those taxpayers that use mismatch opportunities.
- Fairness: Fairness relates to the fact that mismatch opportunities are more readily available for taxpayers with income from capital, rather than labour.[10]

## 2 EARLIER WORK BY THE OECD ON HYBRID MISMATCHES

The role played by hybrid mismatch arrangements in aggressive tax planning has been discussed in a number of earlier OECD reports:

(i) The 1999 report entitled: "The Application of the OECD Model Tax Convention to Partnerships"[11]

This report contains an extensive analysis of the application of treaty provisions to partnerships, including in situations where there is a mismatch in the tax treatment of the partnership. The Partnership Report, however, did not consider the application of the tax transparency rules to entities other than partnerships (i.e. hybrid entities that

[6] OECD "Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues" (March 2012) at 11-12.
[7] Ibid.
[8] Ibid.
[9] Ibid.
[10] Ibid.
[11] OECD "The Application of the OECD Model Tax Convention to Partnerships" (1999).

do not constitute partnerships under the law of the contracting jurisdictions but are nevertheless treated as fiscally transparent for tax purposes) and did not consider payments made under hybrid instruments.

(ii) The 2010 OECD Report entitled: "Addressing Tax Risks Involving Bank Losses"[12]

This report highlighted the use of hybrid mismatches in the context of international banking and recommended that revenue bodies "bring to the attention of their government tax policy officials those situations which may potentially raise policy issues, and, in particular, those where the same tax loss is relieved in more than one country as a result of differences in tax treatment between jurisdictions, in order to determine whether steps should be taken to eliminate that arbitrage/mismatch opportunity".

(iii) The 2011 OECD Report entitled: "Corporate Loss Utilisation through Aggressive Tax Planning"[13]

This report recommended that countries "consider introducing restrictions on the multiple use of the same loss to the extent they are concerned with these results".

(iv) The 2012 OECD Report entitled: "Hybrid Mismatch Arrangements"

In 2012, the OECD undertook a review with a number of interested member countries to identify examples of tax planning schemes involving hybrid mismatch arrangements and to assess the effectiveness of response strategies adopted by those countries. The review culminated in the 2012 OECD report on "*Hybrid Mismatch Arrangements*".[14] The 2012 Hybrids Report concludes that the collective tax base of countries is put at risk through the operation of hybrid mismatch arrangements even though it is often difficult to determine unequivocally which individual country has lost tax revenue under the arrangement. Apart from impacting on tax revenues, the report also concluded that hybrid mismatch arrangements have a negative impact on competition, efficiency, transparency and fairness. The 2012 Hybrids Report sets out a number of policy options to address hybrid mismatch arrangements:

a) On General anti-avoidance rules: The 2012 report noted that general anti-avoidance rules (including judicial doctrines such as "abuse of law", "economic substance", "fiscal nullity", "business purpose" or "step transactions") could be an effective tool in addressing some hybrid mismatch arrangements, particularly those with circular flows, contrivance or other artificial features, however the terms of general anti-avoidance rules and the frequent need to show a direct link between the transactions and the avoidance of that particular jurisdiction's tax tended to make the application of general anti-avoidance rules difficult in many cases involving hybrid mismatch arrangements. As a consequence, although general anti-avoidance rules are an effective tool, they do not always provide a

12 OECD *"Addressing Tax Risks Involving Bank Losses" (*2010).

13 OECD "Corporate Loss Utilisation through Aggressive Tax Planning" (2011).

14 OECD "Hybrid Mismatch Arrangements: Policy and Compliance Issues" (2012).

comprehensive response to cases of unintended double non-taxation through the use of hybrid mismatch arrangements. [15]

c) On Specific anti-avoidance rules: The report noted that a number of countries have introduced specific anti-avoidance rules that had an indirect impact on hybrid mismatch arrangements. For example, certain countries have introduced rules that in certain cases deny the deduction of payments where they are not subject to a minimum level of taxation in the country of the recipient. Similarly, other countries deny companies a deduction for a finance expense where the main purpose of the arrangement is gaining a tax advantage under local law. While these provisions are not specifically aimed at deductions with no corresponding inclusion for tax purposes, they may impact on those structures by denying the deduction at the level of the payer.[16]

d) On rules specifically addressing hybrid mismatch arrangements: The report considered rules which specifically targeted hybrid mismatch arrangements. Under these rules, the domestic tax treatment of an entity, instrument or transfer involving a foreign country is linked to the tax treatment in the foreign country, thus eliminating the possibility for mismatches. The report concluded that domestic law rules which link the tax treatment of an entity, instrument or transfer to the tax treatment in another country had significant potential as a tool to address hybrid mismatch arrangements. Although such "linking rules" make the application of domestic law more complicated, the report noted that such rules are not a novelty as, in principle, foreign tax credit rules, subject to tax clauses, and CFC rules often do exactly that.[17]

## 3 OECD 2013 BEPS ACTION PLAN ON HYBRID MISMATCHES

Action Plan 2 of the 2013 OECD Report on "Base Erosion and Profits Shifting (BEPS)[18] recommends that countries should develop tax treaty rules regarding the design of domestic rules to neutralise the effects of (e.g. double non-taxation, double deduction, and long-term deferral) of hybrid instruments and entities.

- On the domestic front, the OECD recommends that countries come up with domestic laws that:
  - prevent exemption or non-recognition for payments that are deductible by the payor;
  - deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (CFC) or similar rules);
  - deny a deduction for a payment that is also deductible in another jurisdiction;

15 OECD "Neutralise The Effects of Hybrid Mismatch Arrangements" (2014) para 4.
16 OCD "Neutralise The Effects of Hybrid Mismatch Arrangements" (2014) para 5.
17 OECD "Neutralise The Effects of Hybrid Mismatch Arrangements" (2014) para 6.
18 OECD Action Plan on Base Erosion and Profit Shifting (2013) at 15.

- provide guidance on co-ordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure.
- On the international front, the OECD undertakes to come up with changes to the OECD Model Tax Convention that will ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly.
  - OECD's work will be co-ordinated with the work on CFC rules, and the work on treaty shopping. [19]

Following the OECD 2013 BEPS Report, in 2014, the OECD issued a Discussion Draft document entitled "Neutralise the effects of Hybrid mismatches" which sets out draft recommendations for domestic rules designed to neutralise the effect of hybrid financial instruments and for payments made by and to hybrid entities. [20] After comment from various stakeholders, the OECD came up its September 2014 Report on hybrid mismatches which is discussed below.

## 4 OECD SEPTEMBER 2014 REPORT ON HYBRID MISMATCHES: ARRANGEMENTS TARGETED BY ACTION PLAN 2

The focus of Action 2 is on arrangements that exploit differences in the way cross-border payments are treated for tax purposes in the jurisdiction of the payer and payee and only to the extent such difference in treatment results in a mismatch.[21] Hybrid mismatch arrangements can be divided into two distinct categories based on their underlying mechanics:

- Arrangements that involve the use of hybrid entities (explained in detailed paragraph 6 below), where the same entity is treated differently under the laws of two or more jurisdictions. Conflicts in the treatment of the hybrid entity generally involve a conflict between the transparency or opacity of the entity for tax purposes in relation to a particular payment. [22]
- Use of hybrid instruments (explained in detail in paragraph 7 below), where there is a conflict in the treatment of the same instrument under the laws of two or more jurisdictions. Most commonly the financial instrument is treated by the issuer as *debt* and by the holder as *equity*. This difference in characterisation often results in a payment of deductible interest by the issuer being treated as a dividend which is exempted from the charge to tax in the holder's jurisdiction or subject to some other form of equivalent tax relief.[23]
  - Under the category of hybrid instruments there is included arrangements involving hybrid transfers. These are arrangements in relation to an asset

[19] Ibid.

[20] OECD "Neutralise The Effects of Hybrid Mismatch Arrangements" (2014) at 4.

[21] OECD/G20 Base Erosion and Profit Shifting Project Neutralise the Effects of Hybrid Mismatch Arrangements: Action 2: 2014 Deliverable (2014) at 29 (OECD/G20 BEPS Project: Action 2: 2014 Deliverable)

[22] OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 30.

[23] OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 30.

where taxpayers in two jurisdictions take mutually incompatible positions in relation to the character of the ownership rights in that asset, and hybrid financial instruments, which are financial instruments that result in taxpayers taking mutually incompatible positions in relation to the treatment of the same payment made under the instrument. Hybrid transfers are typically a particular type of collateralised loan arrangement or derivative transaction where the counterparties to the same arrangement in different jurisdictions both treat themselves as the owner of the loan collateral or subject matter of the derivative. This difference in the way the arrangement is characterised can lead to payments made under the instrument producing a mismatch in tax outcomes.[24]

## 5 RECOMMENDATIONS ON HYBRID MISMATCHES IN THE OECD SEPTEMBER 2014 REPORT ON ACTION PLAN 2

The September 2014 reiterates that hybrid mismatch arrangements can be used to achieve double non-taxation including long-term tax deferral. Further that hybrid mismatches reduce the collective tax base of countries around the world even if it may sometimes be difficult to determine which individual country has lost tax revenue.[25] Action 2 of the BEPS Action Plan therefore calls for the development of model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect of hybrid instruments and entities.[26]

The September OECD 2014 Report sets out recommendations for domestic rules to neutralise the effect of hybrid mismatch arrangements which were of the most concern to jurisdictions. These recommendations cover rules to counter mismatches in respect of payments made under a hybrid financial instrument, payments made to or by a hybrid entity and indirect mismatches that arise when the effects of a hybrid mismatch arrangement are imported into a third jurisdiction. [27]

- These hybrid mismatch rules are “linking rules” that seek to align the tax treatment of an instrument or entity with the tax outcomes in the counterparty jurisdiction but otherwise do not disturb the tax or commercial outcomes. [28]
- The recommendations are intended to drive taxpayers towards less complicated and more transparent cross-border investment structures that are easier for jurisdictions to address with more orthodox tax policy tools.
- There is an interaction with the other Action Plans, particularly Action 3 (dealing with the design of CFC rules) and Action 4 (looking at interest deductions), on which further guidance will be required. [29]

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[24] OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 30
[25] OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 11.
[26] OECD Action Plan on Base Erosion and Profit Shifting (2013) at 15.
[27] OECD/G20 BEPS Project: Action 2: 2014 Deliverable para 42.
[28] OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 12.
[29] OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 12.

- The Report recognises the importance of co-ordination in the implementation and application of the hybrid mismatch rules. Such co-ordination includes the sharing of information to help jurisdictions and taxpayers to identify the potential for mismatches and the response required under the hybrid mismatch rule. [30]

In both cases involving hybrid entity and hybrid instrument mismatches, the hybrid element leads to a different characterisation of a payment under the laws of different jurisdictions. Both hybrid instrument and hybrid entity mismatch arrangements involve payments. While differences in the way two jurisdictions value a payment can give rise to mismatches, differences in the valuation of money itself are not within the scope of the hybrid mismatch rule. [31]

Action 2 therefore calls for domestic rules targeting the following payments:

1) Payments under a hybrid mismatch arrangements that give rise to duplicate deductions for the same payment (double deduction or DD outcomes).[32] A DD mismatch arises to the extent that all or part of the payment is deductible under the laws of another jurisdiction. Payments made by hybrid entities can, in certain circumstances, also give rise to DD outcomes.
2) Payments under a hybrid mismatch arrangement that are deductible under the rules of the payer jurisdiction and not included in the ordinary income of the payee or a related investor (deduction/no inclusion or D/NI outcomes).[33] Thus, generally a D/NI mismatch occurs when the proportion of a payment that is deductible under the laws of one jurisdiction does not correspond to the proportion that is included in ordinary income by any other jurisdiction
3) Action Plan 2 also deals with Indirect D/NI outcomes. Once a hybrid mismatch arrangement has been entered into between two jurisdictions without effective hybrid mismatch rules, it is a relatively simple matter to shift the effect of that mismatch into a third jurisdiction (through the use of an ordinary loan, for example). [34]

To prevent hybrid mismatches, the OECD recommends specific changes to domestic law to achieve a better alignment between domestic and cross-border tax outcomes. The OECD recommends that every jurisdiction should introduce all the recommended rules so that the effect of hybrid mismatch arrangement is neutralised even if the counterparty jurisdiction does not have effective hybrid mismatch rules. [35] The OECD notes that overly broad hybrid mismatch rules may be difficult to apply and administer. Accordingly, each hybrid mismatch rule (as discussed below after

[30] OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 12.
[31] OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 31.
[32] OECD/G20 BEPS Project: Action 2: 2014 Deliverable para 14.
[33] OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 14.
[34] OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 15.
[35] OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 15.

the explanation of each of hybrid arrangement) has its own defined scope, which is designed to achieve an overall balance between a rule that is comprehensive, targeted and administrable.[36]

The rest of the discussion that follows explains how hybrid entities, hybrid instruments and hybrid transfers can result in hybrid mismatches. In the sections that discuss each of these hybrid mismatch arrangements the OECD recommendations to prevent the mismatches are discussed. Thereafter international trends in addressing the same are discussed. After that the rules that South Africa has in place in prevent these mismatches are discussed, and then recommendations are provided.

## 6 HYBRID ENTITY MISMATCH ARRANGEMENTS

A "hybrid entity" refers to a legal relationship that is treated as a corporation in one jurisdiction and as a transparent (non-taxable) entity in another.[37] The entity is transparent in that in the other country the profits or losses of the entity are taxed/deducted at the level of the members. The divergent treatment of the hybrid entity as between jurisdictions precipitates different characterisation of payments made in relation to such hybrid entity under the laws of different jurisdictions. The hybridity of an entity is generally a function of its transparency or opacity for tax purposes; and consequently how its tax treatment in a particular jurisdiction, impacts a particular payment. Since hybrid entities are treated as tax transparent in one jurisdiction and non-transparent or opaque in another, hybrid mismatch arrangements exploit the transparency or opacity of the entity for tax purposes to the extent that the discrepant tax treatment of the hybrid entity as between jurisdictions impacts a particular payment.

When a particular entity is afforded varying tax treatment in different jurisdictions, either double taxation or double non-taxation may arise. The varying tax status of entities arises because most countries adopt their own domestic entity classification approach when determining the tax status of foreign entities.[38] The hybrid mismatch arrangements in the case of hybrid entities involve the exploitation of cross-jurisdictional differences in the treatment of hybrid entities to produce duplicate deductions or deduction/no inclusion outcomes in respect of payments made by such entities. The most common hybrids involve partnerships and trusts. A multinational company subject to corporate income tax in one jurisdiction that qualifies for tax transparent treatment in another may be able to achieve significant tax savings. Typically this is accomplished when a company is organized as a

[36] OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 16.

[37] B Arnold & M McIntyre *International Tax Primer* (2002) at 144; L Olivier & M Honiball *International Tax: A South African Perspective* (2011) at 554.

[38] C Elliffe and A Yin "Hybrid Entity Double Taxation: A Case Study on the Taxation of Trans-Tasman Limited Partnerships" (2011) 21 No1 *Revenue Law Journal*

partnership in one jurisdiction and as a corporation in another.

In the country where the entity is classified as a partnership for tax purposes the members or partners are taxable on their share of the entity's income. In the country where the entity is classified as a legal person, the entity itself is subject to tax on its income. Thus the different treatment of the entity in the two countries creates many tax planning opportunities.[39] For example, when an entity is classified as a corporation, the taxation of income may be deferred if the company does not distribute dividends to its shareholders. The deferral of taxes can however be prevented when a country has controlled foreign company (CFC) legislation. Where the foreign entity is classified as a partnership, CFC legislation may not be applied to the entity. Instead, the partners are taxed on their share of the profits of the partnership.[40]

The result of these arrangements is "stateless income" as tax authorities cannot determine which country has in fact lost tax revenue, even though the laws of each country involved have been followed, and there is a subsequent reduction of the overall tax paid by all parties involved. The double non taxation, double deduction, and long-term deferral problems created by such arrangements can be boiled down to actions that neutralize the effect of an arrangement that consists of a deduction on one side and no income, or insufficient income, on the other side.

### 6.1 HYBRID ENTITY ARRANGEMENTS THAT PRODUCE DOUBLE DEDUCTION OUTCOMES

A double deduction technique frequently employed involves the use of a hybrid entity as a subsidiary of an investor where the hybrid subsidiary is treated as transparent under the tax regime governing the investor's jurisdiction but non-transparent in terms of the laws of its jurisdiction of establishment or operation. The differing tax treatment of the hybrid subsidiary across jurisdictions may result the same payment being tax deductible in both the investor's and the subsidiary's jurisdiction.

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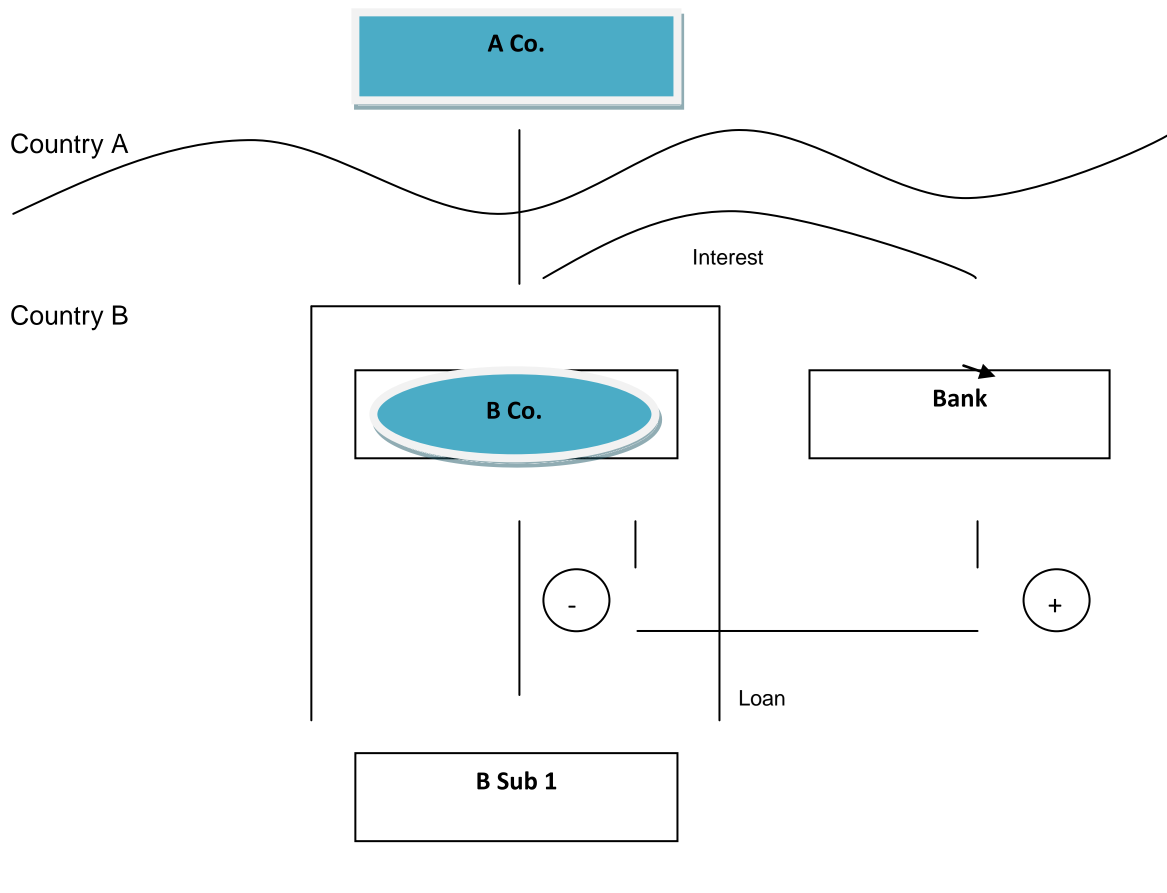
39 Arnold & Mclyntre at 144.

40 AW Oguttu "The Challenges of Taxing Investments in Offshore Hybrid Entities: A South African Perspective" (2009) 21 No 1 *SA Mercantile Law Journal* 58.

The Example 1 below[41] illustrates the use of a hybrid entity to achieve a double deduction outcome:

**Basic Double Deduction Structure Using Hybrid Entity**




In this example, A Co holds all the shares of a foreign subsidiary (B Co). B Co is disregarded for Country A tax purposes. B Co borrows from a bank and pays interest on the loan. B Co derives no other income. Because B Co is disregarded, A Co is treated as the borrower under the loan for the purposes of Country A's tax laws. The arrangement therefore gives rise to an interest deduction under the laws of both Country B and Country A.

B Co is consolidated, for tax purposes, with its operating subsidiary B Sub 1 which allows it to surrender the tax benefit of the interest deduction to B Sub 1. The ability to "surrender" the tax benefit through the consolidation regime allows the two deductions for the interest expense to be set-off against separate income arising in Country A and Country B. The creation of a permanent establishment in the payer

[41] Adopted from OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 52.

jurisdiction, that is eligible to consolidate with other taxpayers in the same jurisdiction, can be used to achieve similar DD outcomes. [42]

**OECD Recommended rule for Hybrid Entity Arrangements that Produce DD Outcomes**

The OECD recommends that countries should neutralise the effects of hybrid mismatches that arise under such DD structures through the adoption of a linking rule that aligns the tax outcomes in the payer and parent jurisdictions. The hybrid mismatch rule isolates the hybrid element in the structure by identifying a deductible payment made by a hybrid payer in the payer jurisdiction and the corresponding "duplicate deduction" generated in the parent jurisdiction. The primary response is that the duplicate deduction cannot be claimed in the parent jurisdiction to the extent it exceeds the claimant's dual inclusion income (income brought into account for tax purposes under the laws of both jurisdictions). A defensive rule applies in the payer jurisdiction to prevent the hybrid payer claiming the benefit of a deductible payment against non-dual inclusion income if the primary rule does not apply. [43]

## 6.2 HYBRID ENTITY MISMATCHES AND DUAL RESIDENT COMPANIES

The OECD BEPS report points out that hybrid mismatch arrangements can also result when dual resident companies create double deductions, namely, in both the jurisdiction of incorporation and the jurisdiction of effective management. [44] An example of a scheme that was used to avoid taxes in this regard is the Double Irish and Dutch Sandwich scheme, discussed in the Report on Action Plan 8.

When a company is regarded as tax resident in two jurisdictions, the tiebreaker rules in article 4 of the OECD Model Tax Convention can determine that for treaty purposes, that the company is resident in only one of the two jurisdictions. In many tax treaties, that is the jurisdiction in which the company is effectively managed. The tiebreaker test applies only for purposes of the tax treaty, but most jurisdictions adopt the treaty residence status in their national tax laws so that it applies for all domestic tax legislation. In these circumstances, a double deduction cannot arise since the company is singly resident from the viewpoint of both jurisdictions. This process therefore predates what is envisaged by the BEPS Action Plan 2. Following publicity about the Double Irish and Dutch Sandwich and publication of the OECD Action Plan, Ireland's Finance (No. 2) Bill 2013 now provides that a company incorporated in Ireland is to be treated as resident in Ireland for tax purposes. In treaties in which dual residence is settled instead by the mutual agreement procedure (all U.S. treaties and an increasing number of newer treaties, such as that of the Netherlands

[42] OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 52.
[43] OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 52.
[44] A Cinnamon "How the BEPS Action Plan Could Affect Existing Group Structures" Tax Analyst (12 Nov 2013)

and the UK.) action 14 aims to address current obstacles that tend to make these procedures time-consuming.

The determination of whether a hybrid entity constitutes a resident person is critical not only from a domestic tax perspective, but also within the international domain for purposes of establishing whether a hybrid entity qualifies for DTA protection as a person resident in one of the Contracting States to the DTA. The following may occur within a DTA context by virtue of the inconsistent classification of hybrid entities cross-jurisdictionally: The hybrid entity may be deemed liable to tax in both Contracting States. This would be the case if the hybrid entity constituted a person resident in both Contracting States. Once the hybrid entity qualifies as a person[45] for purposes of Article 3(1)(a) and (b) of the OECD Model Tax Convention, liability to tax in both Contracting States may arise in consequence of the hybrid entity constituting a person resident in one Contracting State where residence is established with reference to incorporation and registration; while the other State bases residence on the place of effective management of a person.[46] Article 4(3) of the OECD MTC provides that "where by reason of the provisions of paragraph 1[47] a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated." Place of effective management has been adopted as the preference criterion for persons other than individuals for MTC purposes;[48] a concept which in itself is interpretationally problematic both domestically and internationally.

Where the hybrid entity is treated as opaque and subject to tax in one Contracting State, and as transparent in the other State, it will qualify for DTA protection as a person[49] resident[50] in the first-mentioned Contracting State. Where the hybrid entity is classified as transparent in both Contracting States and accordingly not liable to tax in either, the hybrid entity would not qualify as a person resident in either one of the Contracting States, and it would not be entitled to any DTA protection or relief.

From a hybrid entity classification perspective, it is important to consider the breadth of meaning accorded the term "person" for treaty purposes. In addition to individuals, the definition explicitly references companies and other bodies of persons.[51] The

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45 Article 1 of the OECD Model Tax Convention, defines the term "person" as including an individual, a company and any other body of persons; b) the term “company” means anybody corporate or any entity that is treated as a body corporate for tax purposes."

46 K Vogel Vogel on Double Taxation Conventions (1997) at 93

47 Paragraph 1 of Article 4 of the MC reads as follows: "For the purposes of this Convention, the term “resident of a Contracting State” means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein."

48 Vogel at 259.

49 Article 3(1)(a) and (b) of the OECD MTC

50 Article 4(1) of the OECD MTC

51 Article 3(1)(a) of the OECD MTC

meaning ascribed to "company"[52] encompasses any entity which, although not a body of persons itself, is treated as a body corporate for tax purposes. This potentially brings a range of internationally employed transparent entities within scope. Examples include:

- The *fonds commun de placement* (FCP) (established in terms of the Luxembourg Law on Specialized Investment Funds, in terms of which an FCP must be managed by a management company established under Luxembourg law.
- The US Limited Liability Company (LLC) and generally the US 'check the box' rules;
- The UK Limited Liability Partnership (LLP);
- The S*ociété d'investissement à capital variable* (SICAV) which is an open-ended collective investment scheme common in Western Europe (especially Luxembourg, Switzerland, Italy, Spain, Belgium, Malta, France and Czech Republic) to mention a few.
- The UK, the open-ended investment company (OEIC) or investment company with variable capital (ICVC) which is a type of open-ended collective investment formed as a corporation under the Open-Ended Investment Company Regulations 2001. In the UK the incorporated OEIC is the preferred legal form of new open-ended investment over the older unit trust.

Another popular hybrid entity encountered in the international arena is the Dutch cooperative association (COOP) popular due to the favourable Dutch tax treatment it receives and its structural flexibility from a Dutch legal perspective. The COOP[53] has a legal personality but it does not have shares and instead of shareholders, it has members. This fact notwithstanding; its distributions are deemed to be dividends. The COOP is subject to Dutch corporate income tax and is regarded as a tax resident under Dutch DTAs. As such, the COOP has access to reduced withholding tax rates and DTA relief. Structurally a COOP is usually interposed between a pooled investment fund (e.g. a limited partnership) and a target company. From a tax perspective an investor in a COOP is not subject to Dutch corporate income tax and profit distributions by a COOP are not subject to Dutch dividend withholding tax, except in abusive situations.[54] Generally, the target company distributes dividends free of withholding tax to the COOP. These dividends are received tax free as they fall under the participation exemption. The COOP can distribute its profits to its ultimate investors free of dividend withholding tax. Advance tax rulings[55] can be

[52] Article 3(1)(b) of the OECD MTC

[53] The COOP is an association incorporated by at least two members by way of a notarial deed. The liability of the members of the COOP can be excluded in the deed of incorporation.

[54] Abusive situations only arise if a COOP has no "real function" within the chain of ownership. Whether a COOP can be regarded as having a real function can be determined in advance with the Dutch tax authorities.

[55] Minimal substance is required to obtain an advance tax ruling. However, the source jurisdiction may demand more substance before DTA access, and consequently reduced withholding tax

obtained from the Dutch tax authorities for active target companies provided there is active involvement from the fund owning the COOP. If the interests in a COOP form part of the business assets of an active company;[56] the investor will not be subject to Dutch corporate income tax and distributions will be exempt from Dutch dividend withholding tax.

From the South African perspective, SARS issued Binding Private Ruling 149,[57] which provides that if the profit to be distributed by the COOP that was party to the transaction would be treated as a dividend or like payment for Dutch tax law purposes; the interest in the COOP would qualify as a "share" and an "equity share"[58] as defined in the Act. The COOP therefore constitutes a "company" and a "foreign company" within the meaning of the Income Tax Act; and a "foreign dividend" would be received pursuant to declaration made by the COOP.

Since partnerships have always created transparency issues because of the cross-jurisdictional differences in their treatment, in some jurisdictions, South Africa amongst them, partnerships are treated as transparent i.e. they have no separate legal identity. The individual partners are taxed on their respective shares of partnership income. Other jurisdictions treat partnerships as opaque, taxable as separate entities (on occasion as companies). The divergent treatment of partnerships impacts the application of DTA terms, particularly if one or more of the partners are not residents of the State where the partnership was established or created.

As a departure point, one must ask whether a partnership would be entitled to DTA protection or relief. In terms of the OECD MTC, the partnership would have to constitute a person resident in one of the Contracting States to invoke the relevant DTA provisions. In the absence of specific DTA provisions dealing with partnerships, it would seem that if a partnership is not considered opaque in one of the jurisdictions party to the DTA, it would be denied DTA relief.[59]

This conundrum is exacerbated by the spectrum of OECD MTC provisions available to deal with income derived by a partner from a partnership. If a partnership is treated as a company in a Contracting State, the distribution of partnership profits

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rates will be granted. This regime is causing investment funds to increasingly relocate skilled personnel to the Netherlands to set up office. If certain conditions are met, personnel are entitled to apply for the 30% ruling, which allows them to receive 30% of their remuneration tax-free. Combined with the entitlement to deduct mortgage interest in respect of their primary residence and a full tax exemption for investment income, the Netherlands is a decidedly attractive option for skilled personnel.

[56] Advance tax rulings are not required in such circumstances.

[57] Dated 24 July 2013 dealing with the disposal of an asset that constitutes an equity share in a foreign company

[58] For purposes of the Income Tax Act an “equity share” “means any share in a company, excluding any share that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specific amount in a distribution.”

[59] Vogel at 86

will in all likelihood be treated as dividends in terms of article 10(3) of the OECD MTC.[60] However, in certain jurisdictions, partnership profits, whether distributed or not, may be considered to be business profits of the partners in terms of article 7 of the OECD MTC. Depending on the jurisdiction, business profits in turn may incorporate other specific types of income and article 7(4) provides that "where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article." Alternatively the taxing jurisdiction may not treat partnership profits as business profits at all, and they may fall to be taxed as income from immovable property,[61] interest,[62] royalties,[63] independent[64] or dependent[65] personal services.

Similarly divergent treatment may result from the investment of capital in a partnership or the disposal by a partner of its partnership interest. Depending on the approach adopted by a taxing jurisdiction applying DTA provisions akin to those of the OECD MTC; capital may either be taxed in terms of Articles 22(2)[66] and 13(2)[67] as the capital attributable to a PE; or in terms of Articles 22(4)[68] or 13(4)[69] with regard to all other movable property.

The complexity arising by virtue of the domestic disconformity in tax treatment of partnerships within the realm of DTAs and the spectrum of provisions available to deal with income derived by a partner from a partnership is clearly evident in the Australian case of *Commissioner of Taxation v Resource Capital Fund III LP.*[70] In brief the case dealt with the interplay of certain Australian domestic legislation,[71] in particular, the Australian Income Tax Assessment Act 1997 and the DTA between

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60 Article 10(3) of the MC states that "the term "dividends"…means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident"

61 Article 6 of the OECD MTC.

62 Article 11 of the OECD MTC.

63 Article 12 of the OECD MTC.

64 Article 14 of the OECD MTC.

65 Article 15 of the OECD MTC.

66 This article deals with "*capital represented by movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State may be taxed in that other State.*"

67 This article deals with "*gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other State.*"

68 This article deals with "*all other elements of capital of a resident of a Contracting State shall be taxable only in that State.*"

69 This article deals with "*gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.*"

70 [2014] FCAFC 37 on appeal from Resource Capital Fund III *LP v Commissioner of Taxation* [2013] FCA 363

71 including the International Tax Agreements Act 1953 and the Taxation Administration Act 1953

Australia (the source jurisdiction), and the USA (the jurisdiction of residence of the partners of Resource Capital Fund III LP (RCF) which was a limited partnership, resident and formed in the Cayman Islands). RCF made a taxable capital gain on the sale of shares[72] it had held in an Australian mining company, St Barbara Mines Ltd (SBM). Australia treats corporate limited partnerships such as RCF as opaque and taxes them as companies. The US however, the jurisdiction of residence of the partners of RCF, treats limited partnerships as fiscally transparent and disregards them for US tax purposes while taxing the partners on their respective shares in the Australian sourced gain derived by RCF from the sale of the SBM shares.

Since in Australia RCF is a foreign limited partnership, Australia is only entitled to tax the capital gain it derived from the sale of the SBM shares if they constituted "taxable Australian real property." The Commissioner sought to tax RCF on the capital gain it derived from the sale of its SBM shares. RCF challenged such taxation. The issue raised was how the DTA should be applied if the gain was derived by RCF for Australian tax law purposes yet simultaneously treated as having been derived by the partners of RCF in terms of the US tax regime. The court *a quo* found in favour of RCF on the basis that, since the gain had been derived by the US partners of RCF and not RCF,[73] the provisions of the Australian Income Tax Assessment Act, which imposed the liability to tax the gain on RCF as the relevant taxable entity, were inconsistent with the provisions of the Australia/US DTA which treated the gain as having been derived not by RCF but by the partners of RCF. As such the court *a quo* found that the Commissioner was precluded from assessing RCF to tax on the gain.[74]

The Commissioner appealed the decision of the court *a quo* and argued that he was not precluded from taxing RCF on the gain in terms of Article 13 (Capital Gains) because the provisions of the Australia/ US DTA only applied to RCF if RCF were a resident of the US. In that case, Article 13(1) of the Australia/US DTA, which states that "*income or gains derived by a resident of one of the Contracting States from the alienation or disposition of real property*[75] *situated in the other Contracting State may be taxed in that other State*;" granted Australia the right to tax RCF on the gain. As

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[72] In Australia "real property" includes shares in a company, the assets of which consist wholly or principally of real property situated in Australia.

[73] The primary judge substantiated his treatment of the gain as having been derived by the US partners of RCF rather than RCF on the strength of OECD Commentary on Article 1, paragraph 6.4, which comments that "(t)*his interpretation avoids denying the benefits of tax Conventions to a partnership's income on the basis that neither the partnership, because it is not resident, nor the partners, because the income is not directly...derived by them, can claim the benefits of the Convention with respect to that income...*(T)*he conditions that the income be...derived by a resident should be considered to be satisfied even where, as a matter of the domestic law of the State of source* (Australia*), the partnership would not be regarded as transparent for tax purposes, provided that the partnership is not actually considered as a resident of the State of source.*"

[74] In terms of section 4(2) of the International Tax Agreements Act 1953

[75] This discussion assumes that the SBM shares sold constituted "real property" for Australian tax purposes.

fiscally transparent, RCF did not constitute a US resident. The Commissioner argued that the "essential error" made by the primary judge in the court *a quo* was by construing Article 13 as containing the negative inference that if a partnership was treated as fiscally transparent in the Resident State (US), the Source State (Australia) is prohibited from taxing such partnership and may only tax the partners. The Commissioner averred that it was irrelevant whether or not RCF was a US resident, as irrespective thereof, there existed no inconsistency between Article 13 of the Australia/US DTA and the application of the Australian Income Tax Assessment Act *vis-á-vis* the tax treatment of RCF as the entity taxable in Australia on the gain.

RCF argued that the gain on the sale of the SBM shares had been derived by the US partners of RCF and not by RCF. Accordingly RCF refuted the imposition of tax on it in terms of the Australian Income Tax Assessment Act on the basis that such taxation was inconsistent with the application of the Australia/US DTA by reason of Article 7 (Business Profits) thereof, which applied to the "business profits" of the US partners in terms of US tax law. As such RCF contended that Australia was precluded from taxing the gain in terms of Article 7(6) which provides that "where business profits include items of income which are dealt with separately in other Articles of (the Australia/US DTA), then the provisions of those Articles shall not be affected by this Article." RCF argued that while Article 13 operated as an exception to Article 7, it only entitled Australia to tax "*gains derived by a* (US) *resident*" and since RCF was not a US resident by virtue of its fiscal transparency for US tax purposes, alternatively because it was a resident of the Cayman Islands; Article 13(1) did not entitle Australia to tax RCF on the gain.

The Commissioner contended further on appeal that Article 7 was not applicable to the gain in the hands of RCF although he acknowledged that the partners of RCF were entitled to the benefits bestowed by Article 7 subject to Article 7(6).

On appeal, the court disagreed with the conclusions of the court *a quo*, and found as follows: The inconsistencies arose not by virtue of the Australia/US DTA, but in consequence of the differing domestic tax treatment of partnerships as between Australia and the US. Because Australia regards certain limited partnerships as taxable entities, while the US treats partnerships as transparent non-taxable entities; the application of the DTA in Australia (the source jurisdiction) differs from its application in the US (the residence jurisdiction).

The departure point was to determine RCF's tax status for Australian tax purposes. As a foreign corporate limited partnership, Australia may assess it to tax as a company on its capital gains from the disposal of "taxable Australian real property." Since RCF is not a US resident nor an Australian resident, it follows that the Australia/US DTA can have no application[76] to the gain derived by FCP.

[76] See article 1 of the Australia/US DTA

RCF is an independent taxable entity liable to tax in Australia on Australian sourced income. The provisions of Australia/US DTA cannot refute RCF's liability to Australian tax in these circumstances. There is no inconsistency between the Australia/US DTA and the provisions of the Australian Income Tax Assessment Act as regards the taxation of the gain in RCF's hands. The inconsistency pertains to the imposition of the liability for tax on the gain, resulting in the Australia/US DTA provisions applying differently between Australia as the source jurisdiction and the US as the jurisdiction of residence of the RCF partners.

There may be an argument for the US resident RCF partners to seek Australia/US DTA benefits based upon the Australian sourced "business profits" received by them in consequence of the gain derived from the sale of "taxable Australian real property" but the court did not consider this possibility further. As such the court found that the Commissioner was not precluded from assessing RCF to tax on the gain.

### 6.2.1 OECD Recommendation on Hybrid Entity Mismatches and Dual Resident Companies

To prevent a deductible payment made by a dual resident entity triggering a duplicate deduction under the laws of another jurisdiction, the OECD recommends hybrid mismatch rule which isolates the hybrid element in the structure by identifying a deductible payment made by a dual resident in the payer jurisdiction and the corresponding "duplicate deduction" generated in the other jurisdiction where the payer is resident. The primary response is that the deduction cannot be claimed in the payer jurisdiction to the extent it exceeds the payer's dual inclusion income (income brought into account for tax purposes under the laws of both jurisdictions). As both jurisdictions will apply the primary response there is no need for a defensive rule. [77]

### 6.2.2 Tax Treaty Recommendations

Action 2 refers expressly to possible changes to the OECD Model Tax Convention to ensure that dual resident entities are not used to obtain the benefits of treaties unduly. The proposals resulting from the work on Action 6 (Preventing Treaty Abuse may play an important role in ensuring "that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly". The change to Article 4(3) of the OECD Model Tax Convention[13] that is recommended as part of the work on Action 6 will address some of the BEPS concerns related to the issue of dual-resident entities by providing that cases of dual treaty residence would be solved on a case-by-case basis rather than on the basis of the current rule based on place of effective management of entities which creates a potential for tax avoidance in some countries. The new version of Article 4(3) that is recommended reads as follows:

[77] OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 55.

> *Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.*

This change, however, will not address all BEPS concerns related to dual-resident entities. It will not, for instance, address avoidance strategies resulting from an entity being a resident of a given State under that State's domestic law whilst, at the same time, being a resident of another State under a tax treaty concluded by the first State. The solution to these avoidance strategies must be found in domestic law. Also the change to Article. 4(3) will not address BEPS concerns that arise from dual-residence where no treaty is involved.

### 6.2.3 Proposed Treaty Provision on Transparent Entities

The 1999 OECD report on *The Application of the OECD Model Tax Convention to Partnership* [78] (the Partnership Report) contains an extensive analysis of the application of treaty provisions to partnerships, including in situations where there is a mismatch in the tax treatment of the partnership. The Partnership Report, however, did not expressly address the application of tax treaties to entities other than partnerships.

- In order to address that issue, as well as the fact that some countries have found it difficult to apply the conclusions of the Partnership Report, the OECD September 2014 Report on Action 2 proposes to include in the OECD Model Tax Convention a new provision and detailed Commentary that will ensure that income of transparent entities is treated, for the purposes of the Convention, in accordance with the principles of the Partnership Report.
- This will not only ensure that the benefits of tax treaties are granted in appropriate cases but also that these benefits are not granted where neither Contracting State treats, under its domestic law, the income of an entity as the income of one of its residents.

## 6.3 INTERNATIONAL TRENDS ON THE TAXATION OF HYBRID ENTITIES

Before the BEPS Action plan, the advantages of hybrid entity structures have already been attacked as follows by some countries.[79] Set out below are existing international legislative provisions that combat duplicate deductions in respect of the

[78] OECD *The Application of the OECD Model Tax Convention to Partnerships*, Issues in International Taxation, No. 6, ((1999, OECD Publishing).

[79] A Cinnamon "How the BEPS Action Plan Could Affect Existing Group Structures" Tax Analyst (12 Nov 2013)

same payment or expense within the context of hybrid entities or dual resident entities. Countries that have rules denying the deduction of a payment or expense on the basis of its deductibility in another jurisdiction include Denmark, Germany, the UK and the US.

UK: There are specific provisions aimed at eliminating double tax deductions for the same expense. The rule against double deductions in section 244 of the Taxation (International and Other Provisions) Act 2010 stipulates that no amount is allowable as a deduction for purposes of the UK Corporation Tax Acts "*so far as an amount is otherwise deductible or allowable in relation to the expense in question…An amount is otherwise deductible or allowable if it may be otherwise deducted or allowed in calculating the income, profits or losses of any person for the purposes of any tax.*" The deduction rules apply only where a scheme involving a hybrid entity or hybrid instrument increases a UK tax deduction or deductions to more than they would otherwise have been in the absence of the scheme.[80] The legislation effectively limits tax deductions to the extent necessary to cancel the increase in UK tax deductions attributable to the scheme. The deductions rules are designed to disallow UK tax deductions in circumstances where there is another deduction allowed for the same item of expenditure where the UK tax deduction is not matched by a taxable receipt.

- Further, UK companies and UK PEs of foreign entities are prohibited from surrendering losses to other group companies where such losses relate to amounts that are for foreign tax purposes, deductible or otherwise allowable against the foreign profits of any person.[81]
- Section 106 of the UK Corporation Tax Act 2010 applies to UK resident companies and eliminates from group relief certain amounts that are attributable to foreign PEs. In most cases the profits of a foreign PE are taxed in the country where the PE is located and operates. The profits remain subject to UK tax but credit is granted for foreign tax on the profits. If the PE is not profitable, relief may be available for the loss in the foreign jurisdiction. This section prevents relief being granted for the same loss both in the foreign jurisdiction and in the UK.[82]
- Section 107 of the UK Corporation Tax Act 2010 applies to foreign companies conducting trade in the UK through a PE. It eliminates from group relief amounts that arise from activities that are not within the UK tax net, or are relieved elsewhere. If a DTA exempts the income of the PE from UK tax, it will be prohibited from surrendering its losses in terms of the UK group relief provisions.
- Section 109 of the UK Corporation Tax Act 2010 extends the prohibition on double deductions to dual resident investment companies. A company that is

[80] HMRC Manual INTM594500

[81] This UK provision is concerned with foreign group relief, thus any potential circularity (e.g. simultaneous denial of foreign group relief) is resolved by giving relief where the company is resident (i.e. in the UK). However there is an exception to this rule if the company is also resident in the country where the PE is. In that case, UK relief is denied.

[82] UK National Archives: Corporation Tax Act 2010 – Explanatory Notes

resident both in the UK and in a foreign jurisdiction is prohibited from surrendering losses in terms of the UK group relief provisions. The provision is limited in application to investment companies that do not carry on a trade.

USA: Internationally, concerns have been raised about how the USA Check the box rules which are too flexible in the international context that they play a major role in the tax mismatch of hybrid arrangements. The problem arises when a USA-based multinational company with subsidiary companies in other countries elects to use the check-the-box rules (Reg. section 301.7701-3) so that it is not exposed to USA CFC rules (subpart F rules). Essentially the multinational company's income can be moved through its subsidiary companies without any subpart F exposure (since all of those transactions are disregarded). For example, if one subsidiary company is located in Germany and the other in Bermuda (as a finance company), the German company can borrow from the Bermuda finance company and the taxation of interest income can be deferred, but the income is also no longer subject to the higher German tax rate because all of the profits have been stripped out of Germany and put into a zero-tax jurisdiction. The concern therefore is that the USA subpart F rules encourage the stripping of income in other countries through the use of check-the-box rules. [83] As a result of the check the box rules, the multinational company's income disappears for tax purposes in the USA and the company is also able to avoid the application of the CFC rules in other countries. [84]

The USA tax entity terminology and classification differ significantly from South African terminology. Accordingly, what follows is an attempt to use neutral, commonly understood tax and entity terminology and classification in summarising the USA rules prohibiting the multiple deduction of a single expense.

- In the USA, a dual resident company, which is defined as a US resident company subject to tax in a foreign jurisdiction on its worldwide income (i.e. on a residence basis of taxation); is prohibited from deducting an expense or loss, in the first instance, against income subject to USA tax but not subject to foreign tax; and secondly, from deducting such expense or loss against income subject to foreign tax but not US tax. These provisions apply to a foreign branch or PE of a US resident company in the event that the relevant foreign group relief provisions extend to such branch or PE of the US resident company. The type of expense or loss under consideration here is a "dual consolidated loss,"[85] which refers to either the net operating loss of a dual resident company, or the net loss attributable to a foreign branch or PE of a USA resident company.

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[83] DL Glene "U.S. Check-the-Box Rules Largely to Blame for Hybrid Tax Mismatches, Practitioner Says" *Tax Analyst* 4 February 2014.

[84] DL Glene "U.S. Check-the-Box Rules Largely to Blame for Hybrid Tax Mismatches, Practitioner Says" *Tax Analyst* 4 February 2014.

[85] The US Internal Revenue Service and Treasury Department's final regulations issued under the Dual Consolidated Loss Regulations, I.R.C. §1503(d), 2007

- The deduction for USA group relief purposes (i.e. "domestic use") of a "dual consolidated loss" is generally prohibited. The primary exception to the blanket prohibition occurs when the taxpayer makes an election to apply the loss for US group relief purposes, subject to an undertaking that the taxpayer will refrain from using any portion of the "dual consolidated loss" for foreign group relief purposes for a five year period.

Denmark: A Danish resident taxpayer is denied the deduction of an expense that is tax deductible under foreign tax provisions against income that is not included for Danish tax purposes. A deduction is also denied in circumstances where the expense incurred by the Danish resident taxpayer is deductible under foreign tax rules against the income of affiliated companies which is not subject to Danish tax. These dual consolidated loss rules disallow a deduction for expenses in Denmark if the expenses are also deductible in a foreign country, colloquially termed a “double dip”. The rules apply, *inter alia*, when an expense may be deducted by a foreign affiliated company and their scope of application encompasses situations where the affiliation is caused by unrelated taxpayers acting in concert or through a transparent entity.[86] Similar rules operate to ring-fence the losses of PEs, denying set-off of the PE’s loss against the income of other group members if such loss is included in the calculation of the taxable income of the company in its jurisdiction of residence. The loss is carried forward and may only be claimed against future income of the PE.

Denmark [87] also has rules addressing the deduction of payments without commensurate inclusion in the taxable income of the recipient (deduction/no inclusion) within the domain of hybrid entities. A Danish resident company or a foreign company with a PE in Denmark is treated as transparent for Danish tax purposes: if such company is treated as transparent for tax purposes in a foreign jurisdiction; the income of the transparent entity is included in the foreign taxable income of one or more foreign affiliated companies located in the foreign jurisdiction that disregards the transparent entity; the foreign affiliated companies control the transparent entity; and the foreign jurisdiction forms part of the EU or the EEA. In such cases, the transparent entity will be denied a deduction for payments made to the foreign affiliated controlling company on the basis that the transparent entity and the foreign controlling recipient of the payments from a single legal entity.[88]

- The ambit of the above prohibition is extended, in the case of attempted circumvention, to treat affiliated companies in other jurisdictions as transparent for Danish tax purposes if such affiliated companies are considered transparent in the jurisdiction of residence of the company that controls both the Danish company and the other affiliated companies. Consequently, the Danish company would be denied the deduction of payments made to such affiliated companies as such payments would similarly be treated as being made within a

[86] Section 5G of the Danish Tax Assessment Act

[87] OECD “Neutralise the effects of Hybrid Mismatch Arrangements” (2014) paras 0, 0.0o and 0.

[88] Section 2A of the Danish Corporate Tax Act

single legal entity. The rule is not applicable if the affiliated company is resident in an EU, EEA or treaty country other than the country of residence of the controlling company; although it does apply if such affiliated company is not the beneficial owner of the payment.

- Further specific Danish law provisions[89] have been introduced to address deduction/no inclusion cases involving hybrid entities which are treated as tax transparent in Denmark but as taxable non-transparent entities in foreign jurisdictions.[90] The provisions apply to partnerships organised in Denmark,[91] Danish registered branches of foreign entities, and transparent entities registered, organised or effectively managed in Denmark, in respect of which one or more foreign persons directly hold more than 50% of the capital or voting rights in such entity, which is treated as a non-transparent, separate entity for tax purposes in the foreign jurisdiction; or the foreign jurisdiction does not exchange information with the Danish tax authorities under a tax treaty or other international convention or agreement. In these circumstances, the otherwise transparent entity will be treated as a Danish resident company for tax purposes. The participants would be deemed to have disposed of all assets and liabilities at fair market value at the time the entity is classified as a non-transparent entity. In the normal course the entity would be deemed to have acquired all assets and liabilities at fair market value at the time of its reclassification and a distribution to the participants would be deemed to constitute a dividend distribution, possibly triggering withholding tax.

Germany: A parent company's loss is denied for purposes of the group taxation regime if it has been permitted in a foreign jurisdiction in a manner similar to the application of tax to the parent company under the German tax regime.[92] This provision prohibits dual-resident companies from deducting the same loss in both Germany and another jurisdiction.

- In some jurisdictions, preferred shares take on a hybrid character in that dividend payments are treated as a tax-deductible financing expense. In the recipient jurisdiction, a participation exemption can often apply to the preferred dividend. However, an increasing number of countries disqualify the participation exemption when the dividend has been deducted in the payer's jurisdiction. Several European countries already have laws that deny the participation exemption when the payee has deducted the payment. For

[89] Section 2C of the Danish Corporate Tax Act

[90] Deloitte Touche Tohmatsu *Danish Tax Alert* (2008)

[91] The provisions were enacted to target US investors establishing Danish partnerships. Typically the US investors would transfer intangibles (intellectual property) to the transparent Danish partnership, which would facilitate contract product manufacture (using the intellectual property) by a Danish or foreign subsidiary, with yet another Danish or foreign subsidiary distributing the finished products. As such the profits generated through the use of the intellectual property escaped both Danish and US taxation provided the partnership did not constitute a PE in Denmark.

[92] Section 14.1.5 of the German Corporation Tax Act

example German domestic law disallows a dividend exemption when the payer was allowed to deduct the payment in its country of residence.[93] Other countries that disqualifying participation exemption include Austria, Italy, New Zealand, South Africa, and the UK

- Profit participating interest, or interest on hybrid convertible debt, may be denied by treating the interest payment as a dividend. This applies, for example, in Australia and the UK.
- Interest incurred by a hybrid entity, such as a U.S. check-the-box foreign holding company used for inbound investment, can be denied tax consolidation in the home or host country. Denmark and the UK are examples of jurisdictions already applying these anti-hybrid rules.
- A treaty may disqualify interest paid on hybrid instruments from reduced withholding rates, typically through a subject-to-tax condition. Subject-to-tax conditions are included in most of Germany's treaties. Another anti-hybrid treaty mechanism is article 1.6 of the US model treaty restricting treaty benefits for fiscally transparent entities to income that is taxed to a resident in the treaty partner's state. Also, a few countries deny treaty reductions through specific domestic override legislation, which could thereby impose full withholding taxes on outbound hybrid interest. Germany, Switzerland, and the US are examples.

## 6.4 HYBRID ENTITY MISMATCHES IN SOUTH AFRICA

In South Africa, the typical transactions involving hybrid entities result:

- In the claiming of <u>foreign tax credits</u> by South African entities in circumstances where the foreign tax suffered is effectively neutralised in the foreign jurisdiction.
- Alternatively such arrangements result in the South African entities claiming <u>exemption</u> from South African tax in respect of foreign sourced income by virtue of an appropriate DTA.

The most common transaction entered into by South African residents in respect of hybrid entity arrangements has been the United States (US) repurchase transactions. There are several variations of these transactions, but the key mechanics are essentially the same. In essence:

- A US partnership is set up by various companies within a US (banking) group;
- A South African investor acquires an “interest” in the US partnership in terms of a repurchase agreement. The South African investor may borrow money to acquire this “interest”;
- The US partnership uses its capital to invest in a loan and earns interest;

[93] L A Sheppard “News Analysis: OECD BEPS Hybrid Developments” *Tax Analysts* 29 January 2014.

- The South African investor is, in terms of South African law, entitled to its share of the partnership income derived in accordance with the partnership agreement.

From the US tax perspective the US partnership is viewed as a separate entity and is liable to US tax. The US partnership therefore pays tax in the USA and the South African investor claims a credit for the US tax suffered in respect of its partnership distributions.

- In terms of the OECD Commentary on conflict of qualification issues, the South African investor is entitled to a credit for the US tax paid by the partnership.
- The South African investor also claims a deduction for any funding costs.
- The US partnership distributes a post-tax return to the South African Investor. Using simplified numbers and mechanics, the South African investor borrows R100 from the market on which it pays interest of R10. It uses the R100 to acquire the "partnership interest" (essentially an undivided share in the underlying assets of the US partnership) in terms of a repurchase agreement from the repurchase counterparty.
- The US partnership invests in loans of R100 and earns interest of R10.
- The US partnership pays tax in the USA of, say, 3.5 and distributes 6.5 to the SA investor.
- The South African investor enters into a swap arrangement with its repurchase counterparty in terms of which it pays "manufactured interest" of 10 and receives "manufactured interest" of, say, 12.
- The South African investor then pays interest of 10 on its loan funding from the market.
- The South African investor then claims a tax credit in South Africa of 3.5 against other income. The reason it receives a high swap payment is because its repurchase counterparty claims a credit in respect of the amount of tax paid by the US partnership on the basis that it forms part of the same group as the US partnership. The US tax paid is therefore "neutralised" since, on a group basis, no US tax is suffered.
- In addition in terms of US tax law the repurchase agreement is not viewed as a transfer of ownership, but rather as a collateralised loan. Therefore, from a US tax perspective, the "partnership interest" remains in the tax group of the US repurchase counterparty. However, from a South African tax perspective the South African investor is viewed as having acquired an undivided share in the assets of the partnership.

### 6.4.1 Addressing Hybrid Entity Mismatches in South Africa

Until the 2010 Taxation Laws Amendment Act 7 of 2010, South Africa did not have legislation to deal with the taxation of hybrid entities. Uncertainty about the tax treatment of foreign hybrid entities existed for a long time even though there had been growing use of these entities by South Africans investing offshore and

foreigners investing in South Africa.[94] Examples are the UK LLP which is a body corporate (with legal personality separate from that if its members). It combines the organisational flexibility and taxation treatment of a partnership but with limited liability for its members.[95] For purposes of taxation, the UK LLP is not treated as a corporation but as a partnership.[96] The other example is the United States' (LLC) which is recognised as a corporate entity in the United States but it is treated as partnerships for tax purposes.[97] This tax treatment implies that the taxable income of the LLC passes through to its owners, thereby avoiding corporate tax.[98]

The main concern had been the company status of these entities which perpetuated uncertainty in the tax treatment of these entities.[99] In South Africa, partnerships have their origin in common law and are as such mainly regulated by common law principles. Sundry pieces of legislation do however regulate certain aspects of partnerships. South African case law[100] has also developed and clarified the legal principles relating to partnerships. As a result, a partnership is not regarded as a "person" as defined in section 1 of the Act for tax purposes and is therefore not separately taxable.[101] Rather, the individual partners are taxed on their share of the partnership income in their personal capacity, making partnerships tax transparent. This is so irrespective of whether a partner's liability to creditors of the partnership is limited. Section 24H(5) of the Income Tax Act provides that the income of the partnership is taxed in the hands of the individual partners at the time it accrues to or is received by the partnership. Section 24H of was introduced into the Act with the aim of :

- deeming each partner (including limited partners) to be carrying on the trade or business of the partnership;
- regulating the timing of accruals of income [102] and the incurral of expenditure[103] in respect of persons conducting business in a partnership; and
- regulating deductions and allowances claimable by partners whose liability to creditors of the partnership are limited.

Generally in South Africa where by some rule of law, a legal entity is established that is legally separate from the members comprising that entity, it is taxed in its own right

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94 See AW Oguttu "The Challenges of Taxing Investments in Offshore Hybrid Entities: A South African Perspective" (2009) 21 No 1 *SA Mercantile Law Journal* 51-73.

95 D Armour Tolley's Limited Liability Partnerships: The New Legislation (Reed Elsevier, UK 2001) at 295.

96 Section 10 of the LLPA 2000 which inserts section 118ZA to 118ZD in the Income and Corporations Act 1988 (ICTA) and sections 59A and 156A in the Taxation of Capital Gains Act 1992 (TCGA), provides that an LLP is treated as if it were a partnership for purposes of these two Acts.

97 Whittenburg G, & Altus-Buller M, *Income Tax Fundamentals* (Thomson West Eagan, Minnesota USA 2007) in par 10.8.

98 Ibid.

99 Explanatory Memorandum Para 5.7 in part II.

100 In the case of *Sachs v CIR* 13 SATC 343 it was specifically held that a partnership is not a separate legal person and does not have an existence separate from its members.

101 *R v Levy* 1929 AD 312; *Muller en Andere v Pienaar* 1968 (3) SA 195 (A).

102 Section 24H(5)(*a*) of the Income Tax Act.

103 Section 24H(5)(*b*) of the Act

as a “person.” Where no separate legal personality is conferred, the members are taxed individually (as is the case with partnerships). Problems arise where hybrid entities are involved in cross-border transactions, such as where they are employed as either inbound or outbound investment vehicles.

The Income Tax Act has always recognised entities incorporated in foreign jurisdictions. Specifically, the definition of “company” in section 1 of the Act includes "any association, corporation or company incorporated under the law of any country other than the Republic or anybody corporate formed or established under such law."[104] In addition the Act provides specific definitions for "foreign company";[105] "foreign dividend"; and the "foreign return of capital”. The latter means:

> "any amount that is paid or payable by a foreign company in respect of any share in that foreign company where that amount is treated as a distribution or similar payment (other than an amount that constitutes a foreign dividend) by that foreign company for the purposes of the laws relating to -(a) tax on income on companies of the country in which that foreign company has its place of effective management; or (b) companies of the country in which that foreign company is incorporated, formed or established, where that country in which that foreign company has its place of effective management does not have any applicable laws relating to tax on income, but does not include any amount so paid or payable to the extent that the amount so paid or payable — (i) is deductible by that foreign company in the determination of any tax on income of companies of the country in which that foreign company has its place of effective management; or (ii) constitutes shares in that foreign company."

Thus if a South African resident and a United Kingdom resident decided to incorporate an LLP in the United Kingdom, one of the issues that arose was whether the South African CFC rules could be applied to tax the South African shareholder. Since the previous section 1(b) of the definition of “company” in section 1 of the Income Tax Act included foreign companies, CFC rules could potentially not apply to the LLP. The other issue is that since a UK LLP or a USA LLC was considered a company in South Africa law, it was also not clear whether LLP or LLC could be considered a South African resident if it is effectively managed in South Africa.[106]

In a similar vein, if a transparent entity (such as the Luxembourg *fonds commun de placement* (FCP), the S*ociété d'investissement à capital variable* (SICAV) that is utilised in Western Europe or the UK open-ended investment company (OEIC)) constitutes a paragraph (*e*)(ii) company as defined in section 1 of the Income Tax Act, it may fall within the definition of a CFC in section 9D of the Act. Paragraph e(ii) defines a company to include:

> "any portfolio comprised in any investment scheme carried on outside the Republic that is comparable to a portfolio of a collective investment scheme in participation bonds or a portfolio of a collective investment scheme in securities in pursuance of any arrangement in terms of which members of the public (as defined in section 1 of the Collective Investment

[104] Paragraph (*b*) of the definition of "company"
[105] That is any company that is not a resident
[106] Olivier & Honiball at 434

Schemes Control Act)[107] are invited or permitted to contribute to and hold participatory interests in that portfolio through shares, units or any other form of participatory interest;"

In brief, a paragraph (*e*)(ii) company or a foreign company[108] would constitute a CFC if; after having discounted all South African resident investors who hold less than 5% of the participation rights in such company, and may not exercise at least 5% of its voting rights; the remaining South African investors were found to hold, either directly or indirectly, more than 50% of the participation rights in the company, or more than 50% of the voting rights in such company were directly or indirectly exercisable by such remaining South African investors. If this were the case, all South African resident investors holding more than 10% of the participation rights in the company constituting a CFC would be required to attribute and include deemed income proportionate to their participation in the CFC in their income for the relevant year of assessment; notwithstanding that the CFC may not have distributed any income or declared a dividend. Further, the participation exemption embodied in section 10B(2) of the Act for shareholders who hold more than 10% of the total equity shares and voting rights in a foreign company is denied to investors earning foreign dividends by virtue of holding such percentage in a paragraph (*e*)(ii) company.

In order to alleviate the concerns regarding hybrid entities, and to ensure that their tax treatment in South Africa corresponds with their tax treatment in foreign jurisdictions, the Act was amended to ensure the consistent treatment of all hybrid entities. The Taxation Laws Amendment Act 7 of 2010, inserted the definition of a "foreign partnership" in section 1 of the Income Tax Act which inter alia means a partnership, association, [or] body of persons or entity formed or established under the laws of any country other than the Republic if it is not liable for or subject to any tax on income in that country. The definition of a "foreign partnership" in section 1 of the Act means:

"any partnership, association, body of persons or entity formed or established under the laws of any country other than the Republic if:

(a) for the purposes of the laws relating to tax on income of the country in which that partnership, association, body of persons or entity is formed or established –

(i) each member of the partnership, association, body of persons or entity is required to take into account the member's interest in any amount received by or accrued to that partnership, association, body of persons or entity when that amount is received by or accrued to the partnership, association, body of persons or entity; and

(ii) the partnership, association, body of persons or entity is not liable for or subject to any tax on income in that country; or

(b) where the country in which that partnership, association, body of persons or entity is formed or established does not have any applicable laws relating to tax on income –

(i) any amount –

(aa) that is received by or accrues to; or

[107] The paragraph will come into operation as cited on 1 January 2015, but the amendment from the current wording pertains only to the removal of the Collective Investment Schemes Control Act's number and year.

[108] That is, a company that is not a South African resident

(bb) of expenditure that is incurred by, the partnership, association, body of persons or entity is allocated concurrently with the receipt, accrual or incurral to the members of that partnership, association, body of persons or entity in terms of an agreement between those members; and

(ii) no amount distributed to a member of a partnership, association, body of persons or entity may exceed the allocation contemplated in subparagraph (i) after taking into account any prior distributions made by the partnership, association, body of persons or entity."

- Provisos were added to the definitions of "person" and "company" in section 1 of the Act. The term "person" is defined in section 1 of the Act as including "(a) an insolvent estate; (b) the estate of a deceased person; (c) any trust; and (d) any portfolio of a collective investment scheme, but does not include a foreign partnership."
- The provisions of section 24H of the Act have also been amended to ensure that "foreign partnerships" (i.e. hybrid entities) are treated in the same manner as ordinary partnerships are treated for South African tax law purposes.
- The definitions of "permanent establishment" and "qualifying investor" were also amended to specifically provide for a "foreign partnership." In consequence of these amendments:–
  - the Income Tax Act mirrors the tax treatment in foreign legislation whereby hybrid entities are taxed on a conduit basis, i.e. a foreign partnership will not be subject to tax in South Africa, but the members or partners may be subject to tax;
  - foreign partnerships will not be regarded as companies;[109]
  - foreign partnerships will not be regarded as persons;[110]and
  - foreign partnerships may be used as investment vehicles without many of the previous uncertainties and complications.
- Sec 24H of the Income Tax Act was also amended to provide that a "limited partner" means:

> "Any member of a partnership *en commandite*, an anonymous partnership [or], any similar partnership or a foreign partnership, if such member's liability towards a creditor of the partnership is limited to the amount which the member has contributed or undertaken to contribute to the partnership or is in any other way limited.''

From the above changes, since LLP/LLCs and similar hybrid entities have been included in the definition of a "foreign partnership" this synchronises the South African tax treatment with foreign tax practice. Since foreign partnerships are no longer defined as companies for purposes of the Income Tax Act, they are not CFCs for purposes of section 9D of the Income Tax Act.

It should however be appreciated that to the extent that a "partnership, association,

[109] Thus the provisions relating to CFCs in section 9D of the Act will not apply to foreign partnerships

[110] This implies that foreign partnerships will probably not constitute employers for employees' tax purposes

body of persons or entity" is subject to tax in its own right in a foreign jurisdiction, it will fall outside of the definition of "foreign partnership" and will in all likelihood be subject to tax as a "person" or "company" in South Africa.

The following is how the South African provisions could be applicable to Example 1 involving a bank loan. Assume South Africa is Country A, the investor jurisdiction. A Co holds all the shares in a foreign subsidiary, B Co. B Co is a hybrid entity that initially appears to be tax transparent for South African tax purposes. B Co borrows funds from a bank and pays interest on the loan. B Co derives no other income. If B Co were to constitute a "foreign partnership" as defined in section 1 of the Act, A Co would qualify as the borrower under the loan. However since B Co is opaque in terms of the laws of Country B and liable to tax in its own right in terms of Country B's tax regime, it will fall outside the definition of "foreign partnership" and its tax deductible interest payment will not be available for deduction by A Co, thus eliminating the base erosion risk in South Africa.

Let's consider how a deduction/no inclusion outcome would be alleviated in Example 1 where B Co borrows funds from A Co instead of the bank. The treatment of B Co under the tax laws of Country B will result in B Co falling outside the definition of "foreign partnership": While B Co may be entitled to deduct the interest payment it makes to A Co in terms of the loan, the payment will not be disregarded for South African tax purposes. To the extent that Country B imposes withholding tax at full or reduced rate, should a DTA apply, A Co will be entitled to claim a section 6*quat* rebate against such foreign tax withheld. The deduction/no inclusion outcome is effectively resolved by applying the definition of "foreign partnership" in determining the transparency or opacity of B Co with reference to its treatment in Country B.

### 6.4.2 Recommendations on Hybrid Entity Mismatches in South Africa

With the above changes in the legislation, that brought the tax treatment of hybrid entities in line with international practice, one could say that hybrid mismatches are not of a major concern in the South Africa for now. Nevertheless, South Africa's legislation on hybrid entities is still behind the G20 and there is need for further reform of the provisions to ensure that any tax planning schemes that entail hybrid entities as a mechanism for double non-taxation (as well as potentially giving rise to double taxation) are curtailed. Thus will require:

- Further refinement of domestic rules related to treatment of hybrid entities;
- There is need for specific double tax treaty anti-avoidance clauses.

In light of the OECD September 2014 Report on hybrid mismatches, South Africa should make appropriate domestic law amendments. Similarly South Africa should adopt the OECD tax treaty recommendations with regard to hybrid entity mismatches and adopt appropriate anti-avoidance treaty provisions.

## 7 HYBRID INSTRUMENT MISMATCHES

Investors involved in international transactions often consider an appropriate funding method for their offshore investments as there are tax consequences that flow from both the structure and the funding method selected for investment.[111] Traditionally there are two main financial instruments that have been used to finance offshore investments: debt and equity.[112] In most jurisdictions interest on a loan is normally regarded as an expense incurred in earning profits, so it is deductible by the payer of the interest in computing its taxable income (unless there are special rules to the contrary).[113] In equity investment, dividends paid to shareholders are generally not deductible when calculating a taxpayer's taxable income.[114] The past few decades have however seen the development of "hybrid financial instruments"; are neither debt nor equity, but possess characteristics of both debt and equity.[115] The economic and legal form of hybrid instruments allows them to be treated or classified differently for tax purposes (and even for non-tax purposes such as in corporate law or for accounting purposes).[116]

A hybrid financial instrument may be described as a financial instrument possessed of economic characteristics which are partially or wholly inconsistent with the classification of its legal form.[117] Indeed hybrid financial instruments may have characteristics which are consistent with more than one tax classification in more than one jurisdiction; or are not obviously consistent with any tax classification. As such, the term hybrid instrument is used to encompass a vast range of financial instruments which have both debt and equity features.[118] Thus a hybrid instrument may be treated as debt in one country and yet be regarded as equity in another country.[119]

In the 2014 OECD Discussion Draft on Hybrid Mismatches,[120] a hybrid financial instrument is described as "any financing arrangement that is subject to a different tax characterisation under the law of two or more jurisdictions such that a payment

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111 L Oliver & M Honiball International Tax: A South African Perspective at 216.

112 Equity investment involves the contribution of capital in return for shares. As a result, the investor has no assurance of any return. Debt involves the relending of money to the company, which is often evidenced by the issuing of debentures to the creditor in exchange for interest or some other form of fixed return. Boltar 253-255; HS Cillers, ML Benade, JJ Henning, JJ Du Plessis, PA Delprt, L De Koker L & JT Pretorius JT *Corporate Law* 3rd ed (2001) chapter 14.

113 K Huxham & P Haupt *Notes on South African Income Tax* (2014) at 80.

114 Ibid.

115 Oliver & Honiball at 240; K Keller & C McKenna "International Taxation of Derivatives" in Swan at 73; Arnold & Mclyntre at 144.

116 R Rohatgi *Basic International Taxation* (2002) at 562.

117 Duncan, General Reporter on Subject I: Tax treatment of hybrid financial instruments in cross-border transactions, *Cahiers de droit fiscal international*, Vol.85a (2000) at 21 (54th Congress of the International Fiscal Association, Munich, 2000)

118 Committee of European Banking Supervisors ("**CEBS**"), Report on quantitative analysis of the characteristics of hybrids in the European Economic Area ("**EEA**") (2007) at 6

119 Rohatgi at 562.

120 OECD "Discussion Draft: Neutralise The Effects of Hybrid Mismatch Arrangements" (2014) at 19

under that instrument gives rise to a mismatch in tax outcomes".

Assume that a company in Country A buys financial instruments issued by a company in Country B. Under Country A's tax laws, the instrument is treated as equity, whereas for Country B's tax purposes the instrument is regarded as a debt instrument. Payments under the instrument are considered to be deductible interest expenses for the company under Country B tax law while the corresponding receipts are treated as dividends for Country A tax purposes and therefore exempt therein. Hybrid mismatch arrangements can be used to achieve unintended double non-taxation or long-term tax deferral, for instance, by creating two deductions for one borrowing, generating deductions without corresponding income inclusions, or misusing foreign tax credit and participation exemption regimes.[121]

Other financial transactions including those involving captive insurance or derivatives can give rise to similar outcomes of payments being deductible in one country, but not being taxed in another country.[122] Derivatives are financial instruments in which the rights and obligations under the instrument are derived from the value of another underlying instrument but they are not themselves the primary instruments.[123] The underlying instrument could be in the form of financial variables such as share indexes, interest rates, foreign exchange rates, stock market indexes, commodity prices, corporate stock or bonds; which could be linked to precious metals, agricultural products, property or contract rights.[124] Internationally, no accepted norm exists for classifying instruments as hybrid instruments. Generally the classification rules do not take cognisance of the classification of the instrument in other jurisdictions.[125]

Hybrid instruments may be subdivided into:

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121 A Cinnamon "How the BEPS Action Plan Could Affect Existing Group Structures" *Tax Analyst* (12 November 2013).

122 OECD "Base Erosion and Profit Shifting" (2013) at 40-41.

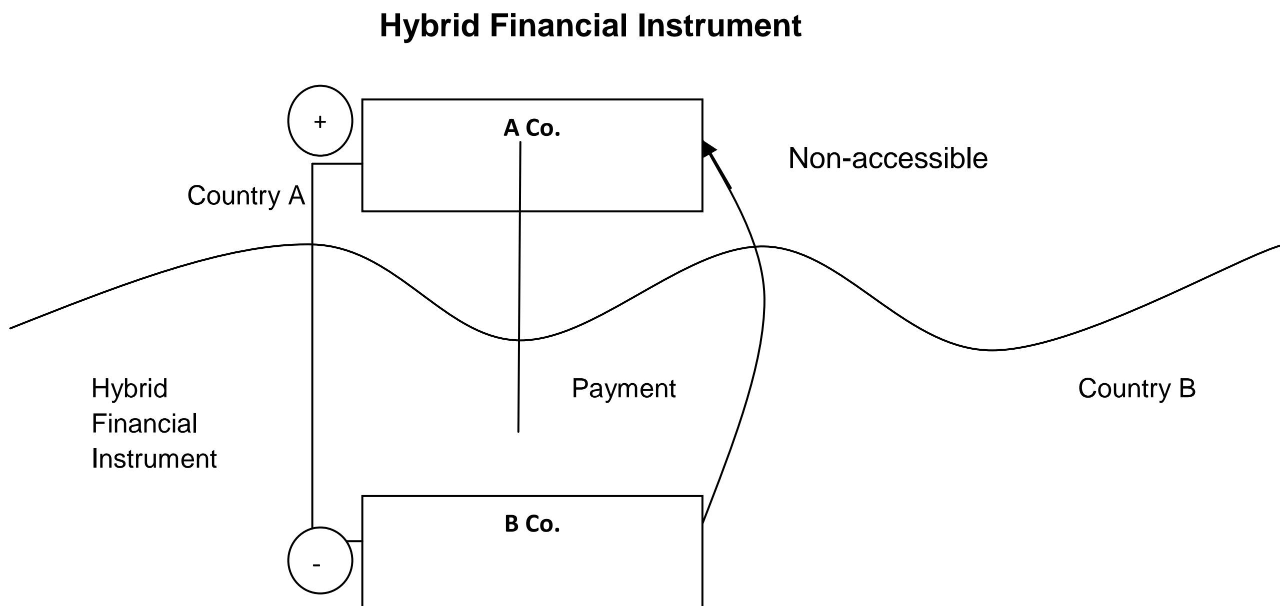
123 AW Oguttu "Challenges In Taxing Derivative Financial Instruments: International Views And South Africa's Approach" *(2012) 24 South African Mercantile law Journal at* 387*;* Oliver & Honiball at 252.

124 Oguttu at 387-388; JB Darby "International Tax Aspects of Derivative Instruments" in D Campbell *Globalisation of Capital Markets* (1996) at 379.

125 Duncan at 29.

- <u>Hybrid financial instruments:</u> Financial instruments in terms of which taxpayers assume mutually incompatible positions in relation to the same payment made under the instrument
- <u>Hybrid transfers:</u> Arrangements pertaining to an asset where taxpayers in two jurisdictions assume mutually incompatible stances relative to the ownership of such asset, e.g. the transfer qualifies as a transfer of ownership of the asset in one jurisdiction for tax purposes but as a collateralised loan in the other jurisdiction.

Example 2 below illustrates a basic mismatch arrangement using a hybrid financial instrument to achieve a tax mismatch: [126]




In this example B Co (an entity resident in Country B) issues a hybrid financial instrument to A Co (an entity resident in Country A). The instrument is treated as debt for the purposes of Country B law and Country B grants a deduction for interest payments made under the instrument while Country A law does not tax the payment or grants some form of tax relief (an exemption, exclusion, indirect tax credit, etc.) in relation to the interest payments received under that instrument. [127]

This mismatch can be due to a number of reasons. Most commonly the financial instrument is treated by the issuer as *debt* and by the holder as *equity*. This difference in characterisation often results in a payment of deductible interest by the issuer being treated as a dividend which is exempted from the charge to tax in the holder's jurisdiction or subject to some other form of equivalent tax relief. In other cases the mismatch in tax outcomes may not be attributable to a general difference in the characterisation of an instrument for tax purposes but rather to a specific

[126] Adopted from OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 33.
[127] Adopted from OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 34.

difference in the tax treatment of a particular payment made under the instrument. For example the hybrid financial instrument might be an optional convertible note where B Co is entitled to a deduction for the value of the embedded option while A Co ignores the value of the option component or gives it a lower value than the B Co. This difference in tax treatment may result in a portion of the payment under the instrument being deductible under the laws of Country B but not included in ordinary income under the laws of Country A. [128]

### 7.1 OECD Recommendation on Curtailing Hybrid Instrument Mismatches

The OECD September 2014 Report on Action 2, recommendation is to neutralise the effect of hybrid mismatches that arise under financial instruments (including hybrid transfers) through the adoption of a linking rule that aligns the tax outcomes for the payer and payee under a financial instrument. This Report recommends that the primary response should be to deny the payer a deduction for payments made under a hybrid financial instrument, with the payee jurisdiction applying a defensive rule that would require a deductible payment to be included in ordinary income in the event the payer was located in a jurisdiction that did not apply a hybrid mismatch rule to eliminate the mismatch. [129]

Because of the wide variety of financial instruments and the different ways jurisdictions tax them, the OECD noted that it was impossible, to comprehensively identify and accurately define all those situations where cross-border conflicts in the characterisation of a payment under a financial instrument may lead to a mismatch in tax treatment. Rather than targeting these technical differences the focus of this Report is on aligning the treatment of cross-border payments under a financial instrument so that amounts that are treated as a financing expense by the issuer's jurisdiction are treated as ordinary income in the holder's jurisdiction. Accordingly the recommended rule recommended provides that a financial instrument should be treated as a hybrid financial instrument where the terms of the instrument would have been sufficient to bring about a mismatch in tax outcomes. [130]

#### 7.1.1 Other OECD recommendations for the tax treatment of financial instruments

- Denial of dividend exemption for deductible payments

In order to prevent D/NI outcomes from arising under a financial instrument, a dividend exemption that is provided for relief against economic double taxation should not be granted under domestic law to the extent the dividend payment is deductible by the payer. Equally, jurisdictions should consider adopting similar

[128] Adopted from OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 34.
[129] OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 36.
[130] OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 36.

restrictions for other types of dividend relief granted to relieve economic double taxation on underlying profits. [131]

- Limitation of credits for taxes withheld at source

In order to prevent duplication of tax credits under a hybrid transfer, any jurisdiction that grants relief for tax withheld at source on a payment made under a hybrid transfer should restrict the benefit of such relief in proportion to the net taxable income of the taxpayer under the arrangement. [132]

### 7.1.2 Hybrid Mismatch Rule for Disregarded Payments Made by a Hybrid Payer

Hybrid mismatches can also arise were a hybrid payer making a deductible payment under the laws of the payer jurisdiction that is disregarded under the laws of the payee jurisdiction. [133]

- To neutralise the effect of hybrid mismatches that arise under disregarded hybrid payments the OECD recommends the adoption of a linking rule that aligns the tax outcomes for the payer and payee. This OECD recommends that the primary response should be to deny the payer a deduction for payments made under a disregarded payment with the payee jurisdiction applying a defensive rule that would require a disregarded payment to be included in ordinary income in the event the payer was located in a jurisdiction that did not apply a hybrid mismatch rule. [134]

### 7.1.3 Recommended Hybrid Mismatch Rule for Reverse Hybrids

D/NI tax outcomes can also arise out of payments made to a hybrid payee. The hybrid in this case is usually described as a reverse hybrid because, in a reversal of the examples considered above the hybrid is treated as opaque by its foreign investor and transparent under the jurisdiction where it is established.

- To neutralise the effect of hybrid mismatches that arise under payments made to reverse hybrids the OECD recommends the adoption of a linking rule that denies a deduction for such payments to the extent they give rise to a D/NI outcome. This Report only recommends the adoption of the primary response of denying the payer a deduction for payments made to a reverse hybrid. [135]
- Reverse hybrids mismatches can also be eliminated by the investor jurisdiction applying an offshore investment regime (such as a CFC regime) that taxes income accrued through offshore investment structures on a current basis. [136]

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[131] OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 41.
[132] OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 41.
[133] OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 43.
[134] OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 44.
[135] OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 46.
[136] OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 47.

### 7.2 Recommended Rule for Indirect D/NI Outcomes

Once a hybrid mismatch arrangement has been entered into between two jurisdictions without effective hybrid mismatch rules, the effect of a hybrid mismatch that arises between two jurisdictions can be shifted (or imported) into another jurisdiction through the use of a plain-vanilla financial instrument such as an ordinary loan.[137] Imported mismatches rely on the absence of effective hybrid mismatch rules in the investor and intermediary jurisdictions in order to generate the mismatch in tax outcomes which can then be imported into the payer jurisdiction.[138]

The OECD recommends the adoption of a linking rule that denies a deduction for such payments to the extent they give rise to an indirect D/NI outcome.[139]

## 8 INTERNATIONAL DEVELOPMENTS ON CURBING HYBRID INSTRUMENT MISMATCHES

Set out below are existing international legislative provisions that deny the deduction of payments that are not matched by the commensurate taxation of payments in the payee's jurisdiction.

United Kingdom: Specific provisions are in place to disallow UK tax deductions which are not matched by a taxable receipt. These provisions are grouped with provisions that eliminate double tax deductions for the same expense. The rule against double deductions in section 244 of the Taxation (International and Other Provisions) Act 2010 stipulates that no amount is allowable as a deduction for purposes of the UK Corporation Tax Acts "so far as an amount is otherwise deductible or allowable in relation to the expense in question...An amount is otherwise deductible or allowable if it may be otherwise deducted or allowed in calculating the income, profits or losses of any person for the purposes of any tax." The deductions rules apply only where a scheme involving a hybrid entity or hybrid instrument increases a UK tax deduction or deductions to more than they would otherwise have been in the absence of the scheme.[140] The legislation does not apply in a case where, although there is such a scheme, it has no effect on UK taxation. Where the legislation does apply, it effectively limits tax deductions to the extent necessary to cancel the increase in UK tax deductions attributable to the scheme. The deductions rules are designed to disallow UK tax deductions which are not matched by a taxable receipt; or in circumstances where there is another deduction allowed for the same item of expenditure.

- The rules only apply if HM Revenue and Customs ("HMRC") issue a notice

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137 OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 15.
138 OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 59.
139 OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 60.
140 HMRC Manual INTM594500.

directing a company to make or amend its self-assessment taking into account the deductions rules (i.e. disallowing the tax deduction for UK corporation tax purposes).[141]

- As stated above the UK has specific legislation that targets situations where a payment may be deducted for UK tax purposes in the absence of a corresponding inclusion of such payment as taxable income. There is a carve-out for payments received that are not taxable because the recipient is not liable to tax under the tax legislation of the foreign jurisdiction, or the payment is not subject to tax because it is exempt in terms of the tax law of the foreign jurisdiction. Should the provision apply, HMRC will issue a notice advising the company that the tax deduction will be disallowed for UK corporation tax purposes.

Denmark: A tax policy was adopted to align the domestic tax treatment of certain transactions with their tax treatment in foreign jurisdictions.[142] Section 2B of the Danish Corporate Tax Act is a specific anti-arbitrage provision targeting tax arbitrage structures using hybrid financial instruments. The provision applies if:

- A fully taxable Danish company, or a foreign company with a Danish permanent establishment or immovable property situate in Denmark, is "indebted or similarly obligated" to a foreign individual or foreign company;
- Tthe foreign individual or foreign company has "decisive influence"[143] over the Danish debtor company; or the foreign individual or foreign company and the Danish debtor company form a "group of companies,"[144] which is broadly defined as a group of legal persons in which the same circle of participants is in control; or where there is common management among the shareholding entities;[145]
- The hybrid financial instrument in question constitutes debt as defined in Danish Tax law; and the hybrid financial instrument is treated as equity/paid-up capital under the tax legislation of the creditor's/investor's jurisdiction of residence.

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141 HMRC operate a voluntary clearance process in terms of which they may issue clearance in circumstances when they are of the opinion that the rule does not apply. Such clearances are binding upon HMRC.

142 Bundgaard at 33

143 Section 2(2) of the Danish Tax Assessment Act defines "decisive influence" as ownership of, or the right to dispose of, voting rights by foreign individuals or corporations that directly or indirectly own or dispose of more than 50% of the share capital or voting rights of a Danish company. The reference to foreign individuals and foreign companies as controlling shareholders has been interpreted by the Danish Minister of Finance as including transparent entities, which has led to certain interpretational issues regarding the interchangeability of the terms "company" and "legal person," and further whether the term "company" can be defined expansively to include both taxable and non-taxable (i.e. transparent) entities.

144 In 2006 Danish tax law introduced a concept of "group of companies" specifically for purposes of transfer pricing and thin capitalisation legislation, withholding tax on interest payments and capital gains on claims and the like.

145 Bundgaard at 37

- If all the above requirements are satisfied, the hybrid financial instrument will be construed as equity for Danish tax calculation purposes. The reclassification will result in any interest payments and capital losses being treated as dividend payments made by the Danish debtor company. As such they will not be deductible for Danish tax computation purposes. In addition, the withholding tax rate applicable to such reclassified dividend payments would differ from the rate applicable to interest and capital gains.[146]

Several jurisdictions, including Austria, Denmark, Germany and the UK have introduced legislation that prohibits the exemption of income which is tax deductible in another jurisdiction; an approach which has been endorsed by the European Union ("EU") Code of Conduct Group (Business Taxation) as appropriate to counter the arbitrage achieved through the use of hybrid instruments. The Group acknowledged that problems arose when the jurisdiction of a debtor company permitted a deduction for an interest payment (thereby reducing its tax base) to a corporate recipient resident in a jurisdiction that treated such receipt as a tax exempt dividend. Accordingly the Group proposed that in so far as payments made in terms of hybrid loan arrangements were tax deductible for the debtor/payer, EU Member States ought to deny the exemption of such payments as profit distributions/dividends under the participation exemption.[147]

- Austria: Income derived from hybrid instruments that constitute equity investments in terms of Austrian tax legislation, will only qualify for tax exemption under the Austrian participation exemption regime if it does not entitle the payer to a tax deductible expense.
- Denmark: Dividends received by a Danish parent company will not be granted exemption from tax if the subsidiary payer is entitled to claim a tax deductible expense in respect of such dividends.[148] This prohibition also applies if a deduction has been permitted in a lower tier subsidiary and the dividend has been granted exemption in an intermediary subsidiary sandwiched between the lower tier subsidiary claiming the deduction and the Danish parent company. The rule does not apply if the dividends fall within the ambit of the European Commission (EC) Parent-Subsidiary Directive.[149]
- Germany: Dividend distributions are generally exempt from tax for the recipient shareholder. In terms of the EC Parent-Subsidiary Directive, domestic dividend withholding tax will be reduced to zero if dividends are

[146] Bundgaard at 39
[147] Report of the Code of Conduct Group (Business Taxation) to the ECOFIN Council of 8 June 2010, No. 1033/10
[148] Section 13 of the Danish Corporate Tax Act
[149] The EC Parent-Subsidiary Directive was designed to eliminate tax obstacles in the domain of profit distributions between groups of companies in the EU by abolishing withholding tax on dividends between associated companies (minimum participation threshold of 10%) within different Member States; preventing double taxation of parent companies on the profits of their subsidiaries; and eliminating double taxation of subsidiaries of subsidiary companies.

distributed to a qualifying EU shareholder that holds a minimum of 10% of the subsidiary. Such exemption does not apply to constructive dividends[150] in circumstances where such dividends were tax deductible for the payer thereof.

- The UK: There is legislation capable of taxing certain receipts, which in normal circumstances would not be subject to UK corporation tax. HMRC may issue a "receipt notice"[151] disallowing the exemption of the offending receipt for UK corporation tax purposes in circumstances where:[152]
  - There is a scheme that makes or imposes a provision as between the company and another person (the paying party/payer)[153] by means of a transaction or series of transactions;
  - The provision entails the paying party making, by means of a transaction or series of transactions, a "qualifying payment" (i.e. a contribution to the capital of the company) in relation to the company;
  - When embarking upon the scheme the company and the paying party expected that a benefit would arise because at least part of the qualifying payment would be exempt from UK corporation tax; and
  - There is an amount in relation to the qualifying payment that is a deductible amount, and it is not set against any scheme income arising to the paying party for income tax purposes or corporation tax purposes.

  As is clear from the foregoing, the receipts rules apply in relatively narrow circumstances where an amount that represents a contribution to capital is received by a UK resident company in a non-taxable form while it creates a tax deduction for the payer.

It should also be noted that in 2013, Mexico came up with Tax Reforms that would reduce deductions on payments to related companies if the income received by the related party would be subject to little or no taxation. To be deductible, the income would have to be subject to an effective tax rate of at least 75 percent of the rate that would be applied to the income in Mexico. Mexico's tax reform plan is a "first effort at legislating what may come out of the BEPS report."[154]

## 8.1 Hybrid Instrument Mismatches in South Africa

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150 A constructive dividend is a taxable benefit derived by a shareholder from the company even though the benefit is not designated a dividend. For German tax law purposes, any transaction concluded between a company and its shareholders other than on an arm's length basis could potentially give rise to a constructive dividend (*verdeckte Gewinnausschüttungen*).

151 Issued in terms of section 249 of the UK Taxation (International and Other Provisions) Act 2010

152 Section 250 of the UK Taxation (International and Other Provisions) Act 2010

153 There are exceptions for certain paying parties e.g. dealers

154 DD Stewart "Mexico's Tax Reform Reflects BEPS Action Plan, Practitioner Says" Tax Analyst 10 October 2013. Available at http://services.taxanalysts.com/taxbase/tni3.nsf/(Number/2013+WTD+197-1?OpenDocument&Login accessed 28 October 2013.

Hybrid instruments allow for tax neutrality in a foreign jurisdiction and non-taxation in South Africa. However the risk for South Africa regarding tax avoidance involving hybrid instrument mismatches is limited as these are really only used in "niche" transactions.

- Typical examples in this regard often involve transactions entered into by a South African resident company, incorporated in South Africa for exchange control reasons. However the company is also tax resident in a jurisdiction that has a DTA with South Africa, for example, The Netherlands;
- The company does not qualify as a "resident" as defined in section 1 of the Act since it is treated as a resident of The Netherlands in terms of the tie-breaker test in that DTA;
- The company issues redeemable preference shares and invests in debt instruments in South Africa;
- From a South African tax perspective the company earns South African sourced income which is not taxed in South Africa due to the provisions of the DTA;
- The company pays out "foreign dividends" which are not subject to dividend withholding tax and are exempt from normal tax in the hands of non-resident investors. South African resident investors will, however, be taxed on these foreign dividends since they do not qualify for exemption in terms of the provisions of section 10B of the Act.
    - From a Dutch tax perspective, the interest received by the company is taxable. However the redeemable preference shares are re-characterised as debt for tax purposes and therefore a deduction is granted for the dividends paid on these shares. The company is therefore only taxed on its spread in The Netherlands.
    - This is an example of both a dual resident company and a hybrid instrument mismatch.

Many such transactions were entered into, in particular, by financial institutions between 2002 and 2009.

## 8.2 SARS Investigations into hybrid instrument mismatches

SARS investigations show that most cross border hybrid instruments arrangements involve major financial institutions dealing in the artificial generation of local foreign tax credits (FTC) and exemptions give effect to permanent tax benefits to both local and offshore taxpayers and contribute to the erosion of the hosting country's tax base.[155] Although there are variations of these transactions, the tax benefits generally flow from the fact that the tax relief claimed is in excess of any economic double taxation that has occurred on interest income or post-tax dividends. The tax

[155] Adapted from SARS Media Release dated 05 October 2010.

benefits are normally shared between the financial institution and its foreign counterparty through the pricing of the transactions. The transactions would typically lead to a financial loss for the institution in the absence of the tax benefits. It is understood that these transactions have had a substantial effect on tax bases of a number of countries and have been challenged internationally. In a notable success, the New Zealand Inland Revenue Department ("NZIR") succeeded in its litigation against two major financial institutions in the High Court and finally settled those disputes, together with similar disputes with two other financial institutions, for a combined amount exceeding NZ$2.2 billion. The total value that SARS derived from those settlements was in excess of R3 billion. In addition to the recovery of a substantial sum of tax and the respective financial institutions' co-operation in ensuring that the tax effects of these transactions were to be immediately terminated, SARS also obtained their undertaking not to enter into similar or substantially the same transactions in future. The financial institutions concerned advised SARS that they acted in good faith when they entered into the transactions in light of independent legal advice furnished to them at the time. SARS, however, regarded and still regards these transactions as constituting unacceptable tax avoidance that, *inter alia*, erodes the South African tax base.

The transactions identified in South Africa by and large operate on the basis of exploiting the double taxation relief mechanisms contained in either domestic tax law or double taxation treaties between South Africa and other countries. Artificial tax credits and exemptions were generated in South Africa, without which the transaction would not have been economically viable for the local financial institution. In fact the transactions actually generated an economic loss had it not been for the tax credit or exemption. It is only when the tax credit or exemption is brought into the equation that the transaction produces a "profit".

It should be noted that in respect of foreign tax credit transactions there are essentially two aspects.

- Firstly, the South African investor claims foreign tax credits. This essentially results in the income on which the foreign tax credits is claimed being protected from South African tax.
- Secondly such foreign tax credit transactions may be debt funded. In these circumstances the South African investor only makes a spread representing the difference between the income earned from the foreign tax credit transaction and its funding costs. The ability to claim a foreign tax credit in respect of the <u>gross</u> amount of income received from the foreign tax credit transaction, essentially shelters other income earned by the South African taxpayer from South African tax.

An example of a version of a FTC generator investigated by SARS involved a limited liability partnership ("LLP") established in Delaware in the United States of America ("U.S."). It is noted that the use of a LLP is just one method in achieving the same

benefit that could have been obtained through the use of a company, in different circumstances. The structure in issue involved a foreign multinational bank in the U.S. (“Bank 1”) that sought to take advantage of the tax arbitrage opportunities available in the U.S. / South Africa double taxation treaty. It approached a South African banking group (“Bank 2”) to participate in the transaction and share in the tax benefit. The LLP was set up by Bank 1 as a special purpose vehicle to facilitate the transaction. The general partner rights (“GP rights”) associated with the LLP were then sold to Bank 2 in terms of a repurchase agreement in terms of which Bank 2 would contribute the economic amount necessary for the LLP to acquire fixed interest bearing instruments. In return, Bank 2 would be entitled to receive distributions from the LLP and the capital back after a predetermined term. As Bank 2 required a floating return, it swapped the fixed return received from the LLP for a floating return (Libor plus a margin) with Bank 1 in terms of an interest rate swap agreement. In order to create the tax benefit in the form of a FTC in South Africa, the LLP elected to “check the box” and be regarded for Federal Income Tax purposes as a stand-alone entity and subject to Federal Income tax. The consequence of this election was two-fold: firstly, it enabled Bank 2, which was in a neutral tax position, to claim a credit from SARS to the extent of the taxes paid by the LLP, secondly, it enabled Bank 1 to treat the entire transaction as a “secured lending arrangement” and claim the distribution to Bank 2 as a deemed interest deduction against the swap receipt from Bank 2. Economically, prior to any sharing of the tax benefit generated in Bank 2, Bank 1 and Bank 2 were both pre and post-tax neutral. However as a result of the tax benefit being priced into the fixed leg of the interest rate swap (based on a profit sharing formula) Bank 1 became profitable both pre and post-tax and Bank 2 made a pre-tax loss but a post-tax profit.

The effect of these transactions is that both the international and local financial institutions that were party to these transactions were enriched at a cost to the South African fiscus. Furthermore, to the extent that international financial institutions were being enriched, the South African tax base was being eroded. The portion of the tax benefit kept by the South African financial institutions served as compensation (lucrative) for participating in the transaction. Table 1 below gives examples of a few countries where these arrangements have been effected. The approximate amounts involved show that the taxes lost with regard to these transactions are significant.

**Table 1: Extent of FTC generator nationally and internationally**

| Country | No. of t/a’s | Tax benefit |
|---|---|---|
| South Africa | 7 | ZAR2.8bn |
| United States of America | 11 | US$3.5bn |
| Canada | 17 | CDN$850m |
| New Zealand | 6 | NZD$2.2bn |

The transactions identified in South Africa relate only to two major South African financial institutions.

At the time of SARS' investigation into these transactions, the New Zealand Revenue authority (NZIR) was the only tax authority that had any degree of success internationally. SARS followed the NZIR approach in challenging these transactions together with the assistance from the Canadian Revenue Agency which proved to be of significant value. On 23 December 2009 NZIR announced that it had satisfactorily reached a settlement with four Australian-owned banks. The settlement followed an audit and litigation process of approximately eight years where each of the banks concerned challenged assessments brought by NZIR for tax avoidance using FTC generator type structured finance transactions. Prior to the settlement it was expected that the appeals would work their way to the New Zealand Supreme Court. Earlier in 2009 the New Zealand High Court had decided against BNZ and Westpac, both of whom were appealing the decisions. In the end the approach NZIR took was to tackle all the transactions together under the same assessment for each of the banks concerned. They were able to do this due to the nature of the grounds used to support the assessments issued. NZIR applied their general anti-avoidance legislation and focused more on the purpose of the arrangements rather than the purpose of the parties concerned. The Commissioner's argument was essentially that the purpose of all the arrangements was the same, namely to solely to avoid tax. It was held that while taxpayers are free to structure their affairs in the most tax effective way and to take post-tax consequences into account when deciding whether to proceed with a transaction, it is still premised on the assumption that the transaction has an independently justifiable commercial rationale. The arrangements in issue were however not cases of a taxpayer choosing between "two means of carrying out an economically rational transaction, one of which would result in less tax being payable than the other".

SARS noted from the Australian and New Zealand cases that the judgements were lengthy and reflected the amount of evidence adduced. It is perhaps also indicative of the intensity of resource and time required to execute such an approach. As many as twelve experts in different fields were used (and five Counsels employed).

### 8.3 Curtailing Hybrid Mismatches Involving Dual Resident Entities And Hybrid Instruments

There are currently far less of the above transactions being entered into. Some of the reasons for this are as follows:

- SARS' Interpretation Note on section *6quat* of the Act as well as DTA's had an impact these transactions. This Note, although only draft and not binding in law, argued that foreign tax credits would not be granted on a "gross" basis, but instead after the deduction by the South African entities of their funding costs. This significantly reduces the benefit arising from such transactions.
- Pressure was excreted on the group tax department/financial directors of various banks/institutions/corporates by SARS and National Treasury. These "extra-judicial" meetings are very effective particularly in a small market like

South Africa. The pressure helped to ensure that such transactions are not overdone and commoditised. In particular they were being offered by numerous foreign banks in various jurisdictions including South Africa.

- Various New Zealand cases dealt with foreign tax credits and disallowed such credits in the hands of the New Zealand entities. Although only of persuasive influence in South Africa, the New Zealand courts held that the foreign tax credits could not be claimed and, in particular, set out detailed reasoning in this regard. They "laid bare" the mechanics of such transactions and, in particular, the fact that the foreign taxes suffered in the other jurisdiction were effectively neutralised.

**Recommendations:**

From the above, it is clear that the reason why foreign tax credit/exemption transactions are not currently being entered into is not as a result of legislative amendments, but rather for the reasons set out above.

- The problem is therefore that, as long as the law is not being amended, such transactions may still be concluded. Tax credit may be claimed on a gross basis in respect of various DTAs entered into by South Africa with other jurisdictions.
- There should be a focus on re-negotiating relevant DTA's to the language contained in the modern DTA's where the foreign tax credit granted cannot exceed that claimable under domestic law (i.e. on a net basis).
- With respect to the granting of credit, there is no policy/principle issue with the fact that a credit is granted in circumstances where the foreign tax is effectively neutralised from an economic perspective by a foreign group entity claiming a credit or through the application of group relief provisions. It is submitted that to place an onus on a South African taxpayer to prove that the foreign tax was not economically neutralised in some manner is too high a burden.
- In terms of current law, both section 6*quat* of the Act as well as the provisions relating to the elimination of double taxation in DTA's, require that <u>tax is paid</u> in the foreign jurisdiction and that this represents a <u>final tax</u> by the relevant entity. This should be sufficient for a South African taxpayer to claim a credit in respect of foreign taxes.
- It is also submitted that no further amendments to domestic law are required to deal with the position where taxes paid by, for example, a foreign partnership in circumstances where South Africa does not recognise the partnership as a separate taxpayer. This is adequately dealt with by the OECD Commentary.

### 8.4 Legislation on Hybrid Financial Instruments in South Africa

Section 24J

Using Example 2 as the point of departure, assume Country B is South Africa. Assume South African tax resident B Co, issues a hybrid financial instrument to A Co, an entity tax resident in Country A. No entity hybridity exists in respect of B Co or A Co – both entities are non-transparent corporate entities liable to tax in their respective jurisdictions. Assume further that the instrument has sufficient debt characteristics from a South African tax law perspective for the payment made by B Co to constitute interest as defined in section 24J of the Income Tax Act, No 58 of 1962.

In order for the interest payment to be deductible in the determination of B Co's taxable income, the interest expense must have been incurred in the production of income in the course of B Co's trade as required in terms of section 24J(2) of the Act.

Interest withholding tax:

As part of South Africa's uniform withholding tax regime,[156] which is hopped to be instrumental in eliminating base erosion, an interest withholding tax at the rate of 15% will apply to South African sourced interest paid to a non-resident with effect from 1 January 2015.[157] With regard to the expel above, in terms of the interest withholding tax, A Co will be exempt from normal tax[158] on the interest unless the debt claim in respect of which the interest is paid is effectively connected to a PE of A Co in South Africa. This exemption aligns with the treatment of interest in terms of South Africa's DTA network which generally exempts non-residents from tax on South African sourced interest unless the interest is attributable to a South African PE of the non-resident. This exemption is designed to attract foreign debt capital to the domestic market.

Section 23M

National Treasury has placed considerable emphasis on limiting cross-border interest[159] deductibility in circumstances where a controlling relationship[160] exists between the payer/debtor and payee/creditor and the latter is not subject to tax. This

[156] The regime includes interest withholding tax; dividend withholding tax, withholding tax on royalties; withholding tax on foreign entertainers and sportspersons; withholding tax on the disposal of immovable property by non-residents; and withholding tax on service fees. For a detailed discussion of South Africa's withholding tax regime please refer to: AW Oguttu "*An Overview of South Africa's Withholding Tax Regime*" TaxTalk (March/April 2014).

[157] Section 50A - H of the Act

[158] Section 10(1)(*h*) of the Act

[159] Interest as defined in section 24J of the Act

[160] A controlling relationship exists if the payer/debtor and payee/creditor are "connected persons" as defined in section 1 of the Act. The interest deduction limitation will also apply in the absence of a controlling relationship between debtor and creditor if the creditor facilitated the funding for the debt through a connected person in relation to the debtor; or the debt is guaranteed by a connected person in relation to the debtor.

is dealt with under section 23M in Chapter II, *Part I* of the Income Tax Act.[161] The reason for Treasury's preoccupation with placing a limitation on interest deductibility is that, notwithstanding the importance of debt capital as an investment mechanism, it has the potential to erode the South African tax base. The particular issue that section 23M of the Act has been designed to address is the perceived risk to the *fiscus* of a deduction/no inclusion outcome due to deductible interest being paid to non-resident and other exempt persons.[162] That noted, Treasury has acknowledged that a balance must be struck between attracting foreign direct investment and protecting the South African tax base from erosion. The limitation on interest deductibility is formula driven[163] and the section is scheduled to come into operation with effect from 1 January 2015.

Section 23M may operate to redress a deduction/no inclusion outcome such as that envisaged in Example 2, if B Co - a South African resident, and A Co are in a controlling relationship; and A Co, as the person to whom the interest accrues, is not subject to tax thereon. As such, with effect from 1 January 2015, section 23M will operate in a manner akin to the primary rule of the OECD hybrid financial instrument rule, provided there is a controlling relationship between the payer and the payee. In such circumstances, section 23M will impose a formula-driven limitation on the tax deductibility of the interest payment by the payer if the payee is not subject to tax under Chapter II, *Part I* of the Act.

Treasury is of the view that when the payer/debtor and payee/creditor are connected persons, the terms of the hybrid financial instrument are often flexible and subject to change by the parties in service of the objectives of the group as a whole. As such instruments are sometimes categorised as debt for tax purposes, when in fact they

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161 Section 23M will not apply to limit interest deductibility if such interest is included in the net income of a CFC in terms of section 9D of the Act in the foreign tax year commencing or ending in the year of assessment in which the interest deduction is claimed by the debtor. Further, section 23M does not apply to interest incurred by a debtor where the creditor funded the debt advanced to the debtor with funding granted by a lending institution (i.e. a foreign bank comparable to a bank contemplated in the Banks Act) that is not in a controlling relationship with the debtor and the interest rate does not exceed the South African repurchase (repo) rate plus 200 basis points. In addition, the section will not limit the deduction of interest incurred on linked units (comprising a share and debenture) in a company where the linked unit is held by a long-term insurer, a pension fund, a provident fund, a Real Estate Investment Trust ("**REIT**"), or a short-term insurer; if such holder holds at least 20% of the linked units in the company; the units were acquired before 1 January 2013; and at the end of the previous year of assessment at least 80% of the asset value of the company was directly or indirectly attributable to immovable property.

162 Treasury is also concerned with over-gearing to achieve tax benefits but further discussion of that issue falls beyond the scope of this report.

163 The annual deduction is limited to the amount of interest received by or accrued to the debtor plus 40% of the debtor's adjusted taxable income as defined, less any amount of interest incurred by the debtor in respect of debt other than that contemplated in section 23M (i.e. between a debtor and creditor in a controlling relationship where the creditor is not subject to tax under Chapter II, *Part I* of the Act). Should the average repo rate exceed 10% in any year of assessment, the percentage of adjusted taxable income of the debtor (40%) will be increased proportionately.

more closely resemble capital to be repaid only once the debtor is profitable.[164]

Section 23N

While not entirely apposite to Example 2, it is relevant to mention the limitation imposed on interest deductibility in terms of section 23N of the Act. Section 23N was specifically enacted to limit the use of excessive debt financing to achieve tax savings in reorganisation and "acquisition transactions."[165]

Sections 8F and 8FA

The domestic concern with hybrid debt instruments and interest deductibility is apparent in sections 8F and 8FA of the Act. Treasury is of the view that since tax law generally follows the form of a particular instrument, this affords taxpayers an opportunity to select a label for an instrument with the consequent tax benefits without due regard to its economic substance. Of particular concern to the *fiscus* is the use of hybrid financial instruments to achieve deduction/no inclusion outcomes. The stated provisions operate to deny a deduction in respect of any amount paid or payable in terms of a hybrid debt instrument, while leaving the debt characterisation of the instrument intact for all other purposes of the Act. This aligns with the treatment of hybrid financial instruments in the OECD September 2014 Report on hybrid mismatches.

In a manner similar to that in the above mentioned OECD Report section 23M of the Act recognises the hybrid regulatory capital held by the financial sector. Thus certain forms of regulatory capital issued by regulated intermediaries are excluded[166] from the ambit of the anti-avoidance provisions. These exceptions should simplify administration to some extent and ensure that South Africa is not rendered uncompetitive as an emerging jurisdiction for investment purposes.

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164 National Treasury Republic of South Africa, Explanatory Memorandum on the Taxation Laws Amendment Bill, 2013, 24 October 2013 [W.P. – '13]

165 An "acquisition transaction" is defined as "any transaction - (a) in terms of which an acquiring company acquires an equity share in an acquired company that is an operating company as defined in section 24O; and (b) as a result of which that acquiring company, as at the close of the day of that transaction, becomes a controlling group company in relation to that operating company." Section 24O applies to "acquisition transactions" concluded on or after 1 January 2013 and in certain circumstances allows for the deduction of interest on funding for equity share acquisitions. Previously, under section 23K of the Act, the Commissioner's approval had to be obtained to deduct such interest. Section 23K has been repealed with effect from 1 April 2014, and section 23N operates in its stead effective from the same date.

166 Section 8F does not apply to any instrument that constitutes a tier 1 or tier 2 capital instrument (section 90 of the Banks Act) issued by a bank or controlling company in relation to a bank; any instrument subject to approval by the Registrar as defined in the Short-term Insurance Act or the Long-term Insurance Act where an amount is owed in terms of such instrument by a long-term or short-term insurer as defined in the relevant Act; or any instrument that constitutes a linked unit in a company where the linked unit is held by a long-term insurer, a pension fund, a provident fund, a REIT; or a short-term insurer, if such holder holds at least 20% of the linked units in the company; the units were acquired before 1 January 2013; and at the end of the previous year of assessment at least 80% of the asset value of the company was directly or indirectly attributable to immovable property.

Section 8F has been amended, and section 8FA was introduced with effect from 1 April 2014, to deny the deduction of interest incurred or accrued under a hybrid debt instrument; or the deduction of hybrid interest incurred or accrued on or after the above date. The two-pronged approach applicable to domestic corporate debt issuers is designed to reduce the potential for artificially disguising equity as debt so as to generate interest deductions when equity features are clearly evident in the debt instrument. Section 8F deals with the *corpus* of the hybrid debt instrument while section 8FA focuses on the nature of the yield.

Section 8F defines a "hybrid debt instrument" as:

> "any instrument in respect of which a company owes an amount during a year of assessment if in terms of any arrangement as defined in section 80L[167] — (a) that company is in that year of assessment entitled or obliged to — (i) convert that instrument (or any part thereof) in any year of assessment to; or (ii) exchange that instrument (or any part thereof) in any year of assessment for, shares unless the market value of those shares is equal to the amount owed in terms of the instrument at the time of conversion or exchange; (b) the obligation to pay an amount in respect of that instrument is conditional upon the market value of the assets of that company not being less than the market value of the liabilities of that company; or (c) that company owes the amount to a connected person in relation to that company and is not obliged to redeem the instrument, excluding any instrument payable on demand, within 30 years — (i) from the date of issue of the instrument; or (ii) from the end of that year of assessment:
>
> > Provided that, for the purposes of this paragraph, where the company has the right to — (aa) convert that instrument to; or (bb) exchange that instrument for, a financial instrument other than a share — (A) that conversion or exchange must be deemed to be an arrangement in respect of that instrument; and (B) that instrument and that financial instrument must be deemed to be one and the same instrument for the purposes of determining the period within which the company is obliged to redeem that instrument."

As is apparent from the above definition, the provision targets hybrid debt instruments that have features that facilitate a conversion to shares; where the market value of which is less than the amount of the outstanding debt; if it has a yield determined with reference to the solvency of the debtor/issuer; or in respect of which redemption seems unlikely within a reasonable period.[168]

As regards the yield from a debt instrument, section 8FA defines "hybrid interest" in relation to any debt owed by a company in terms of an instrument, to mean

> "(a) any interest where the amount of that interest is — (i) not determined with reference to a specified rate of interest; or (ii) not determined with reference to the time value of money; or (b) if the rate of interest has in terms of that instrument been raised by reason of an increase in the profits of the company, so much of the amount of interest as has been determined with reference to the raised rate of interest as exceeds the amount of interest that would have been determined with reference to the lowest rate of interest in terms of that instrument during the current year of assessment and the previous five years of assessment."

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167 For purposes of the General Anti-Avoidance Rule in section 80A-80L of the Income Tax Act an arrangement is defined as "any transaction, operation, scheme, agreement or understanding (whether enforceable or not), including all steps therein or parts thereof, and includes any of the foregoing involving the alienation of property."

168 The existence of such features must be investigated on an ongoing basis.

To avoid the application of section 8FA, the yield must be based on the time value of money and it must not fluctuate in accordance with the profits of the debtor/issuer.

As stated above, should a debt instrument constitutes a "hybrid debt instrument" as defined, the instrument will remain within the debt paradigm, but the interest thereon will be deemed to be a dividend *in specie* for both the payer and payee for the duration of the instrument's classification as a hybrid debt instrument. The payer will be denied an interest deduction and the dividend *in specie* may be subject to dividends tax. In addition, the section 24J interest incurral provisions will no longer be of application to the instrument.

Should the yield rather than the *corpus* of the debt instrument be under scrutiny, on the assumption that the particular yield[169] under consideration constitutes "hybrid interest" as defined in section 8FA, it will be deemed to be a dividend *in specie* for both payer and payee and the same consequences as those detailed above will ensue.

<u>Applying section 8F to Example 2:</u> Assuming Country B is South Africa and B Co issues a hybrid financial instrument to A Co, which instrument falls within the definition of "hybrid debt instrument" in section 8F; B Co will be denied a deduction in respect of the payment to A Co, which will be deemed to be a dividend *in specie* for both B Co and A Co. B Co will be required to withhold dividends tax at the rate of 15% in terms of section 64FA of the Act unless A Co, as beneficial owner of the deemed dividend *in specie*, qualifies for and submits a declaration to B Co confirming its entitlement to exemption from dividends tax[170] in terms of the Act; or reduction in the rate thereof in terms of DTA relief, as appropriate. Since A Co is a non-resident, it will not qualify for exemption in terms of section 64F(*a*) of the Act.

<u>Applying section 8FA to Example 2</u>: While the hybrid financial instrument issued by B Co may not constitute a hybrid debt instrument for purposes of section 8F, if the yield has equity characteristics that result in it being caught within the definition of "hybrid interest". B Co will be denied a deduction in respect of the payment to A Co which will be deemed a dividend *in specie* for both parties subject to dividends tax at 15% unless A Co qualifies for exemption under the Act or relief by way of a reduction in the rate of dividends tax in terms of a DTA.

It warrants mention that the hybrid debt provisions (sections 8F and 8FA) and the hybrid equity provisions (sections 8E and 8EA) are to some extent operationally contradictory and there is the risk of potential abuse with reference to sections 8F

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[169] As opposed to any other yields from the instrument which may not bear equity characteristics and accordingly will not be deemed to be dividends *in specie*

[170] A Co would have to establish that if the dividend *in specie* had not constituted a distribution of an asset *in specie*, it would have qualified for exemption as a dividend other than a dividend *in specie* under section 64F of the Act

and 8FA. A taxpayer may intentionally structure an arrangement to fall within the ambit of section 8F, thereby circumventing the need to comply with the complicated provisions of section 8E or section 8EA.

Continuing with Example 2 as the point of departure, now assume conversely that Country A is South Africa. South African tax resident A Co is the holder/payee of a hybrid financial instrument issued by B Co, an entity tax resident in Country B. No entity hybridity exists in respect of A Co or B Co – both entities are non-transparent corporate entities liable to tax in their respective jurisdictions. Assume further that the instrument has adequate equity characteristics from a South African tax law perspective for the payment made to A Co to constitute a dividend. The term "dividend"[171] is defined in section 1 of the Act as "any amount transferred or applied by a company that is a resident for the benefit or on behalf of any person in respect of any share in that company…". Since B Co is not a South African resident, we must consider whether the payment received by A Co constitutes a "foreign dividend" which is defined in section 1 of the Act as follows:

> "any amount that is paid or payable by a foreign company[172] in respect of a share in that foreign company where that amount is treated as a dividend or similar payment by that foreign company for the purposes of the laws relating to — (a) tax on income on companies of the country in which that foreign company has its place of effective management; or (b) companies of the country in which that foreign company is incorporated, formed or established, where the country in which that foreign company has its place of effective management does not have any applicable laws relating to tax on income, but does not include any amount so paid or payable that — (i) constitutes a redemption of a participatory interest in an arrangement or scheme contemplated in paragraph (e)(ii)[173] of the definition of "company"; or…(iii) constitutes a share in that foreign company."

It would appear that the payment received by A Co from B Co would not qualify as a "foreign dividend" in terms of the Act since B Co considers the hybrid instrument it issued to A Co to be debt in character and the payment, interest. If Country B does not treat the payment as a dividend or similar payment in terms of its income tax regime, it will not qualify as a foreign dividend for South African tax purposes. This

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[171] Dividends are included in gross income in terms of paragraph (*k*) of the "gross income" definition in section 1 of the Act and then exempted from normal tax under section 10(*k*)(*i*) subject to certain exceptions to which the exemption does not apply, namely: dividends received by a South African resident from a REIT or an International Financial Reporting Standards ("**IFRS**")-defined subsidiary of a REIT (a "controlled company" in terms of section 25BB of the Act); dividends received by a company in consequence of a cession of the right to such dividends or the exercise of discretion by a trustee of a trust; dividends received in respect of shares borrowed by the recipient; the aggregate amount of manufactured dividends incurred by a person reduced by the aggregate of manufactured dividends received by such person; dividends received by a person (excluding manufactured dividends) to the extent that such dividends will be applied in meeting deductible expenditure which is wholly or partly determined with reference to such dividends; and dividends received by a person in respect of services rendered or to be rendered or by virtue of employment or holding office, other than a dividend in respect of a section 8C restricted equity instrument.

[172] Any company which is not a South African resident

[173] That is: a portfolio comprised of any investment scheme conducted outside South Africa that is comparable to a collective investment scheme (CIS) in bonds or securities available to the public at large

provision which links the domestic treatment of the payment with its tax or corporate law treatment in the foreign jurisdiction aligns with the OECD hybrid financial instrument secondary rule by compelling inclusion of the payment in A Co's ordinary income and denying any exemption or equivalent relief to which A Co would be entitled if the payment had constituted a foreign dividend. Accordingly, since South African residents are taxed on their worldwide income, the payment would fall into A Co's gross income and be subject to corporate income tax at the rate of 28%. Had the payment to A Co constituted a "foreign dividend" as defined, it would have fallen into A Co's gross income in terms of paragraph (*k*) of the definition of "gross income" in section 1 of the Act being "any amount received by or accrued by way of a dividend or foreign dividend".

<u>Section 10B</u>

Section 10B of the Income Tax Act operates to wholly[174] exempt foreign dividends from normal tax or subject them to tax at a reduced rate. The section 10B(3)[175] formula-driven exemption for foreign dividends results in the effective rate of tax applicable to so much of the foreign dividends as does not qualify for exemption, being 15% - the dividends tax rate.[176]

Neither the participation exemption nor the exemption available to foreign corporate dividend recipients resident in the same jurisdiction as the foreign company that declared or paid the foreign dividend, may be availed of if the foreign dividend payer is permitted a tax deduction in determining its liability to any tax on companies in the jurisdiction in which it has its place of effective management.

Applying the above to A Co, any exemption for which the “foreign dividend” from B Co may have qualified in terms of the participation exemption, would have been denied on the assumption that B Co was entitled to a tax deduction in Country B in respect of the payment to A Co. As such only the formula-driven exemption would

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174 In terms of section 10B(2), the foreign dividend will be exempt from normal tax if the recipient of the foreign dividend holds (alone or together with any other company forming part of the same group of companies as the recipient) at least 10% of the total equity shares and voting rights (the participation exemption) in the company declaring the dividend and the foreign dividend is received in respect of an equity share (as opposed to a non-equity share); if the recipient is a foreign company resident in the same jurisdiction as the foreign company that declared or paid the foreign dividend; if the dividend is paid out of profits that have been taxed in terms of section 9D (CFC provisions) of the Act; to the extent the foreign dividend, other than a foreign dividend *in specie*, arises from a listed share; or if the foreign dividend is an *in specie* dividend in respect of a listed share and the recipient is a South African resident company.

175 For any corporate foreign dividend recipient, the amount of the foreign dividend to be exempted from normal tax for the relevant year of assessment is calculated by multiplying the aggregate of foreign dividends received during such year that do not qualify from exemption in terms of section 10B(2) by the ratio of 13 to 28. The balance of the foreign dividend not exempted in terms of the formula is subject to tax at the 28% normal corporate rate of income tax.

176 While the recipient of the foreign dividend may be liable to tax to the extent that the foreign dividend does not qualify for exemption, section 23(*q*) of the Act denies “*any expenditure incurred in the production of income in the form of foreign dividends*” as a deduction in the determination of taxable income.

apply to the foreign dividend A Co received from B Co resulting in the foreign dividend being subject to tax at the effective rate of 15%.

Sections 10(1)(k)(i)(ee), (ff), (gg) and (hh)

There are also anti-dividends scheme rules contained in sections 10(1)(k)(i)(ee), (ff), (gg) and (hh). These counter mismatches achieved through the creation of a deduction (e.g. a deductible manufactured dividend) in respect of exempt dividends income. Under these provisions, a dividend exemption is denied.

Section 64EB

While dealing with dividends, the anti-avoidance provisions of section 64EB[177] of the Income Tax Act require mention. The section was introduced to prohibit the transfer of dividend income from entities that are subject to dividends tax, to entities that are exempt from dividends tax. The cession of the right to a dividend ceded after the announcement or declaration of such dividend is disregarded for purposes of section 64EB(1) and the cedent of such dividend is deemed to be the beneficial owner thereof. This is not the case if a share is ceded *cum dividend* to a cessionary that holds the full bundle of rights attaching to such share post cession. The anti-avoidance provision operates to prohibit for example, a non-resident shareholder, either ceding its right to dividends or selling its shares *cum dividend* and repurchasing them *ex dividend* from an entity exempt from dividends tax (e.g. a South African company). By ignoring the cession or the "resale agreement",[178] as appropriate, the cedent or seller is denied the exemption from dividends, although if such cedent or seller is resident in a jurisdiction which has a DTA with South Africa, it may qualify for a reduction in the dividends tax rate. These deeming provisions also apply to securities lending arrangements where listed shares are borrowed temporarily after the announcement or declaration of dividends. Because legal title is transferred to the borrower in terms of these arrangements, the borrower becomes beneficial owner of the listed shares, entitled to all dividends in respect of the borrowed shares. Typically the dividends are transferred back to the lender by way of "manufactured dividends". In terms of section 64EB(2), the dividends in respect of borrowed shares are deemed to have been paid by the borrower to the lender and the lender is deemed to have received a dividend equal to the amount so paid.

Irrespective of the characterisation of the payment received by A Co from B Co, A Co would qualify for a rebate against its South African tax liability in respect of

[177] Operative from 1 September 2012 in respect of transactions entered into on or after that date, and amounts paid on or after 1 October 2012 in respect of transactions entered into before 1 September 2012.

[178] A "resale agreement" for purposes of section 64EB is "the acquisition of a share by any person subject to an agreement in terms of which that person undertakes to dispose of that share or any other share of the same kind and of the same or equivalent quality at a future date."

foreign taxes paid on such payment in terms of section 6*quat* of the Act.[179] Section 6*quat* of the Act grants relief to South African tax residents for foreign tax paid on foreign source income (i.e. A Co would be entitled to section 6*quat* relief against its South African tax liability if the payment it received from B Co was subject to tax in Country B).

Section 8E and 8EA

The discussion above has dealt with the provisions that deem interest in respect of hybrid debt instruments (debt instruments bearing certain equity features) or hybrid interest to be dividends *in specie.* It is also important to consider whether the instrument issued by B Co to A Co would constitute a "hybrid equity instrument" or a "third-party backed share" in terms of either section 8E or section 8EA of the Act and what the tax implications of such characterisation would be.

The provisions that deal with hybrid equity instruments[180] seeks to align the tax treatment of financial instruments with their economic substance. If the financial instrument giving rise to the dividends or foreign dividends constitutes a "hybrid equity instrument" as defined in section 8E, or a section 8EA "third-party backed share", the relevant provision will operate to deem the dividends earned on such instruments to be income taxable in the hands of the payee/holder, leaving the dividend nature intact vis-á-vis the payer/issuer. As such, the payer/issuer will be denied any deduction in the determination of its taxable income in consequence of the payment of such dividends. No dividends tax will be due in respect of such deemed income on which the payee/holder will be subject to normal tax.

A hybrid financial instrument which combines expected time value returns as well as exposure to changes in the value of a company (unexpected gain or loss attributable to a risk element) poses problems in determining whether the instrument should be characterised as debt or equity. These mixed features are designed to obtain the best of both worlds so that the economic substance of the instrument often differs from its tax characterisation.

Although section 8E applies to both domestic and foreign shares, the original provision[181] was amended in 2003 to prevent foreign round-tripping schemes designed to generate South African source interest deductions along with tax-free foreign dividends. The purpose of the section was to counter tax avoidance by

179 Many DTAs that South Africa has concluded with other countries have articles eliminating double taxation of amounts subject to tax in the foreign jurisdiction with which South Africa has concluded the relevant DTA. Unless the DTA stipulates that the foreign tax paid (duly converted to South African currency (ZAR)) must be credited against any South African tax liability in accordance with South African tax law (i.e. section 6*quat* of the Act); the taxpayer may choose whether to use section 6*quat* or claim a tax credit under the DTA.

180 Sections 8E and 8EA of the Act

181 Inserted into the Act in 1989 in terms of which dividends on certain types of shares were deemed to be interest.

ensuring that debt was not disguised as short-term redeemable preference shares.

The ambit of section 8E[182] has been extended over time such that in its current form section 8E(2) provides that:

> "any dividend or foreign dividend received by or accrued to a person during any year of assessment in respect of a share must be deemed in relation to that person to be an amount of income accrued to that person if that share constitutes a hybrid equity instrument at any time during that year of assessment."

A "hybrid equity instrument" is defined in section 8E(1) as:

> "(a) any share, other than an equity share, if – (i) the issuer of that share is obliged to redeem that share in whole or in part; or (ii) that share may at the option of the holder be redeemed in whole or in part, within a period of three years from the date of issue of that share; (b) any share, other than a share contemplated in paragraph (a), if – (i)(aa) the issuer of that share is obliged to redeem that share in whole or in part within a period of three years from the date of issue of that share; (bb) that share may at the option of the holder be redeemed in whole or in part within a period of three years from the date of issue of that share; or (cc) at any time on the date of issue of that share, the existence of the company issuing that share – (A) is to be terminated within a period of three years; or (B) is likely to be terminated within a period of three years upon a reasonable consideration of all the facts at that time; and (ii)(aa) that share does not rank pari passu as regards its participation in dividends or foreign dividends with all other ordinary shares in the capital of the relevant company or, where the ordinary shares in such company are divided into two or more classes, with the shares of at least of one such classes; or (bb) any dividend or foreign dividend payable on such share is to be calculated directly or indirectly with reference to any specified rate of interest or time value of money;[183] or (c) any preference share[184] if that share is – (i) secured by a financial instrument;[185] or (ii)

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182 The amended section 8E of the Act applies in respect of years of assessment commencing on or after 1 January 2013. An additional anti-avoidance provision applies to dividends or foreign dividends accrued in respect of hybrid equity instruments on or after 1 April 2012 but received three months or more after the accrual. If such dividends or foreign dividends are received in a year of assessment commencing on or after 1 April 2013, then the amended section 8E will apply to deem such dividends to be income (as opposed to interest) subject to tax for the recipient.

183 Paragraph (*b*)(ii)(*bb*) may apply to the payment received by A Co from B Co, since B Co considers the instrument to be debt, so the payment thereon would ordinarily be calculated directly or indirectly with reference to a specified rate of interest or the time value of money.

184 A "preference share" is defined in section 8EA of the Act as "any share – (a) other than an equity share; or (b) that is an equity share, if an amount of any dividend or foreign dividend in respect of that share is based on or determined with reference to a specified rate of interest or the time value of money."

185 A "financial instrument" is defined for purposes of section 8E as an interest-bearing arrangement or a financial arrangement based on or determined with reference to a specified rate of interest or the time value of money. In section 1 of the Act, a "financial instrument" is defined as including "(a) a loan, advance, debt, bond, debenture, bill, share, promissory note, banker's acceptance, negotiable certificate of deposit, deposit with a financial institution, a participatory interest in a portfolio of collective investment scheme, or a similar instrument; (b) any repurchase or resale agreement, forward purchase agreement, forward sale agreement, futures contract, option contract or swap contract; (c) any other contractual right or obligation the value of which is determined directly or indirectly with reference to – (i) a debt security or equity; (ii) any commodity as quoted on an exchange; or (iii) a rate index or a specified index; (d) any interest-bearing arrangement; and (e) any financial arrangement based on or determined with reference to the time value of money or cash flow or the exchange or transfer of an asset."

> subject to an arrangement in terms of which a financial instrument may be disposed of, unless that share was issued for a qualifying purpose."

In addition, section 8EA[186] of the Act applies to equity that resembles debt by virtue of the provision of security, where the dividend yield in respect of shares is secured or guaranteed by third party balance sheet. The provision operates by defining a "third-party backed share" as "any preference share in respect of which an enforcement right[187] is exercisable by the holder of that preference share or an enforcement obligation[188] is enforceable as a result of any amount of any specified dividend, foreign dividend, return of capital or foreign return of capital attributable to that share not being received by or accruing to any person entitled thereto." The provision targets funding structures where the issuer/payer does not require a tax deduction in respect of the cost of borrowing in the form of interest, and the sole reason for using a third-party backed share as opposed to debt funding is to return interest to the holder/payee as exempt dividends. If the hybrid equity instrument in question constitutes a third-party backed share, the dividends received by the holder/payee of such share will be deemed to be income subject to tax in its hands. The corresponding deduction will be denied to the issuer/payer, the income deeming applying only to the dividends vis-á-vis the holder/payee.

Notwithstanding the hybrid financial instrument constituting a "hybrid equity instrument" in terms of section 8E or a "third-party backed share" as defined in section 8EA of the Act, the income deeming provisions will not apply if the instrument is issued for a "qualifying purpose" in terms of section 8EA. Should the issue proceeds be applied for a qualifying purpose, then it is permissible for the holder of the preference shares to secure the dividend yield through an enforcement right against or enforcement obligation from certain stipulated persons without the preference share constituting a "hybrid equity instrument"[189] or a "third-party backed share" and triggering adverse tax consequences.

A share which would otherwise constitute a "hybrid equity instrument" or a "third-party backed share" will not constitute such a share if the preference shareholder is entitled to an enforcement right against or enforcement obligation from one or more of the persons detailed in section 8EA(3)(*b*)[190] of the Act and the subscription

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[186] The concern of SARS and National Treasury is that preference shares (and other similar shares) guaranteed by third parties have debt-like features and should be taxed accordingly.

[187] An "enforcement right" means any fixed or contingent right of the holder of a share or a connected person vis-á-vis such holder to require any person other than the issuer of the share to acquire it from the holder; make payment in respect of that share in respect of a guarantee, indemnity or similar arrangement; or procure such acquisition or payment.

[188] An "enforcement obligation" means any fixed or contingent obligation upon any person other than the issuer of the share to acquire it from the holder; make payment in respect of that share in respect of a guarantee, indemnity or similar arrangement; or procure such acquisition or payment.

[189] Paragraph (*c*) of the definition of "hybrid equity instrument" in section 8E of the Act.

[190] That is: "(i) the operating company to which the qualifying purpose relates; (ii) any issuer of a preference share if that preference share was issued for the purpose of the direct or indirect acquisition by any person of an equity share in an operating company to which that qualifying

proceeds are used for a “qualifying purpose”. A “qualifying purpose” in relation to the funds derived from the issue of a preference share means:

“(a) (t)he direct or indirect acquisition of an equity share by any person in an operating company,[191] other than a direct or indirect acquisition of an equity share from a company that, immediately before that acquisition, formed part of the same group of companies as the person acquiring that equity share;

(b) the partial or full settlement by any person of any –

(i) debt incurred for one or more of the following purposes:

(aa) The direct or indirect acquisition of any equity share by any person in an operating company, other than a direct or indirect acquisition of an equity share from a company that, immediately before that acquisition, formed part of the same group of companies as the person acquiring that equity share;

(bb) a direct or indirect acquisition or a redemption contemplated in paragraph (c);

(cc) the payment of any dividend or foreign dividend as contemplated in paragraph (d); or

(dd) the partial or full settlement, directly or indirectly, of any debt incurred as contemplated in item (aa), (bb) or (cc); or

(ii) interest accrued on any debt contemplated in subparagraph (i);

(c) the direct or indirect acquisition by any person or a redemption by any person of any other preference share if –:

(i) that other preference share was issued for any purpose contemplated in this definition; and

(ii) the amount received by or accrued to the issuer of that preference share as consideration for the issue of that preference share does not exceed the amount outstanding in respect of that other preference share being acquired or redeemed, being the sum of –

(aa) that amount; and

(bb) any amount of dividends, foreign dividends or interest accrued in respect of that other preference share; or

(d) the payment by any person of any dividend or foreign dividend in respect of the other preference share contemplated in paragraph (c).”[192]

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purpose relates; (iii) any other person that directly or indirectly holds at least 20% of the equity shares in - (aa) the operating company contemplated in subparagraph (i); or (bb) the issuer contemplated in subparagraph (ii); (iv) any company that forms part of the same group of companies as – (aa) the operating company contemplated in subparagraph (i); (bb) the issuer contemplated in subparagraph (ii); or (cc) the other person that directly or indirectly holds at least 20% of the equity shares in the operating company contemplated in subparagraph (i) or the issuer contemplated in subparagraph (ii); (v) any natural person; or (vi) any organisation – (aa) which is – (A) a non-profit company as defined in section 1 of the Companies Act; or (B) a trust or association of persons; and (bb) if – (A) all the activities of that organisation are carried on in a non-profit manner; and (B) none of the activities of that organisation are intended to directly or indirectly promote the economic self-interest of any fiduciary or employee of that organisation, otherwise than by way of reasonable remuneration payable to that fiduciary or employee.”

191 An “operating company” is defined in section 8EA as “(a) any company that carries on business continuously, and the course or furtherance of that business provides goods or services for consideration; (b) any company that is a controlling group company (defined in section 1 of the Act as a company which holds shares in at least one other company provided inter alia that the controlling group company holds at least 70% of the equity shares in the other company) in relation to a company contemplated in paragraph (a); or (c) any company that is a listed company.”

192 The stated definition of “qualifying purpose” applies in respect of dividends or foreign dividends received in a year of assessment commencing on or after 1 April 2013, and to dividends or foreign dividends accrued on or after 1 April 2012 but received three months or more after the

The complexity of these provisions is perhaps attributable to their evolution. While it appears that they were originally conceived using the "bottom-up" approach by defining what fell within their scope; they have evolved over time in a convoluted manner which has sought to capture an ever-increasing variety of hybrid financial instruments so that they now appear to have been crafted in terms of the "top-down" approach. This has created a complicated carve-out or an escape hatch, excluding from their application "hybrid equity shares" or "third-party backed shares" the issue proceeds from which are used to acquire equity shares in an operating company; to repay bridging finance used to acquire equity shares in an operating company; or the refinancing (other than in the case of third-party backed shares) of finance originally used for a qualifying purpose. The escape hatch underwent considerable legislative refinement in 2013, the objective being to ensure that third-party backed shares used to facilitate Black Broad Based Economic Empowerment (BBBEE) activities were placed beyond the ambit of the provision. As such the section 8EA escape hatch may be availed of in circumstances where the third-party backed share subscription proceeds are used for a "qualifying purpose" as defined.

Notwithstanding the 2013 refinements, the provisions of section 8EA of the Act have continued to adversely affect the implementation of commercial transactions and taxpayers have been struggling with their practical application. A welcome announcement was made in the 2014 Budget Speech[193] in terms of which it is proposed that the escape hatch be broadened to allow for the refinancing of third-party backed shares, originally used to finance the acquisition of equity shares in an operating company; and for the limited provision of security to the funder (equity shares held by the acquiring company equity shareholders directly or indirectly in the underlying operating company).

The lesson the OECD may glean from this process is perhaps to give due consideration to the approach it adopts in framing the hybrid financial instrument rule because changing course *en route* leads to undue legislative complexity. In addition, the South African hybrid equity tax regime illustrates how legislating from the "bottom-up" enables taxpayers to structure around the defined scope of the legislation by exploiting gaps in the definitions and operative terms of the provisions. In addition, the hybrid equity provisions of section 8E and hybrid debt provisions of section 8F may operate in a contradictory manner. The more complicated the legislation, the greater the scope for ambiguity and interpretational discrepancies and consequently, the more time and resources expended by revenue authorities and taxpayers on respectively enforcing and circumventing such legislation.

Applying the complex hybrid equity tax regime to the facts of Example 2: If South

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accrual. If such dividends or foreign dividends are received in a year of assessment commencing on or after 1 April 2013, then such dividends will be deemed to be income subject to tax for the recipient.

193 Annexure C (miscellaneous tax amendments)

African tax resident A Co is the holder/payee of a section 8E “hybrid equity instrument” or a section 8EA “third-party backed share” issued by B Co, the subscription proceeds which are not used for a “qualifying purpose” as defined; the dividends received by A Co will be deemed to be income subject to tax in its hands at the normal corporate income tax rate of 28%. The corresponding deduction will be denied to B Co from a South African tax perspective, the income deeming applying only to the dividends vis-á-vis A Co.

### 8.5 Recommendations on Hybrid Instrument Mismatches for South Africa

The pertinent question for South Africa with regard to hybrid mismatches is the lack of local and international matching of a deduction in one country to the taxability in another, especially as this relates to the participation exemption (section 10B of Income Tax Act) and the potential for a new interpretation by the OECD. The likelihood of re-negotiating treaties is slim and this thus brings into question whether existing treaties are sustainable.

- South Africa’s legislation with regard to hybrid investments is keeping up with the pace among the G20.
- The legislators should consider introducing or revising specific and targeted rules denying benefits in the case of certain hybrid mismatch arrangements. In doing so, the legislators should ensure that the rules must be simplified to deal with legal principles rather than specific transactions.
- SARS should introduce or the revise disclosure initiatives targeted at certain hybrid mismatch arrangements. It should be noted however that disclosure programs are never successful and are overly burdensome from a compliance perspective.
- The hybrid debt and interest rules require attention as they are not linked to the tax treatment in the hands of the counterparty and may themselves lead to mismatches and double taxation. A rule needs to be put in place that links the hybrid rules to the treatment in foreign counties. This would prevent tax abuse in cases where there is a denial of deduction in South Africa but not in other countries.
- The rules governing the deductibility of interest need to be developed holistically and without a proliferation of too many sections within the Act. The focus should be based on a principle rule and one should not have to apply too many different sections to a transaction when assessing whether or not interest is deductible. The key policy requirement is an emphasis on mismatch rather than merely attacking a particular type of instrument.
- From the analysis of the international jurisdictions, it is clear that OECD rules and in particular, the UK rules, focus on a deductibility mismatch or other clear tax leakage. This is, it is submitted, correct and is a different

approach from what was adopted in sections 8E to 8FA of the Act which looks purely at substance over form, without enquiring whether mischief exists. In other words, it makes no sense to alter the tax treatment of an instrument where no obvious leakage arises – such as in circumstances where a deduction is matched by a taxable receipt, or a non-deductible payment is exempt.

- NT contends that the rules do not concern themselves with specific tax structures but rather look to those terms of an instrument and/or arrangement that would not be ordinarily be found in either an equity instrument or debt instrument. Nevertheless, there is need to ensure that sections 8E to 8FA do not overly place emphasis on the type of mischief being controlled rather than on the substance of the instrument in question. NT further contends that sections 8E-8FA are structured to capture the "low-hanging" fruit. Hurdles for the application of these provisions range from the presence of guarantees and assurances that are only necessary in debt arrangements (8EA) to unreasonably long repayment periods for debt (8F) and the non-payment of obligations or increases in payment obligations (8FA) when the debtor attains financial stability. However these provisions are quite very complex and unclear.
- Section 23M is a mismatch measure as contemplated in the OECD requirements. However, in its structure it also operates as a matching measure for interest deductions. In other words, an interest deduction is limited (and not denied) until that point in time that the corresponding interest income is subject to South African tax in the hands of the recipient of the interest. However the provision is quite complex and its workings unclear.
- It is strongly recommended that South Africa moves away from anti-avoidance sections aimed at particular transactions and establish anti-avoidance principles which can be applied to a broad range of transactions without undue technicality; even if there is a risk that one or two transactions fall through the cracks, a principle approach to drafting legislation is significantly preferential to a transaction-by-a-transaction approach which we currently appear to have. An example of this as explained in the sub-heading on ss 8F and 8FA, is that ss 8F and 8FA unintentionally provide a solution to the problems encountered in 8E and 8EA. This is type of unintentional tax effect only arises due to overly complex and poorly thought out tax legislation.
- The inconsistencies between hybrid debt and hybrid equity rules should be addressed. For instance there should be alignment with respect to security for equity as is the case for debt.
- There is need for specific double tax treaty anti-avoidance clauses. It is however import that the rules are in line with international best practices otherwise they would result in double taxation or double non-taxation of income.

- South Africa needs to monitor OECD recommendations on hybrid mismatches and adapt domestic provisions as appropriate. There is a danger of moving too quickly and undertaking unilateral changes no matter how small, considering the potential knock-on impact for foreign investment.

## 9 HYBRID TRANSFERS

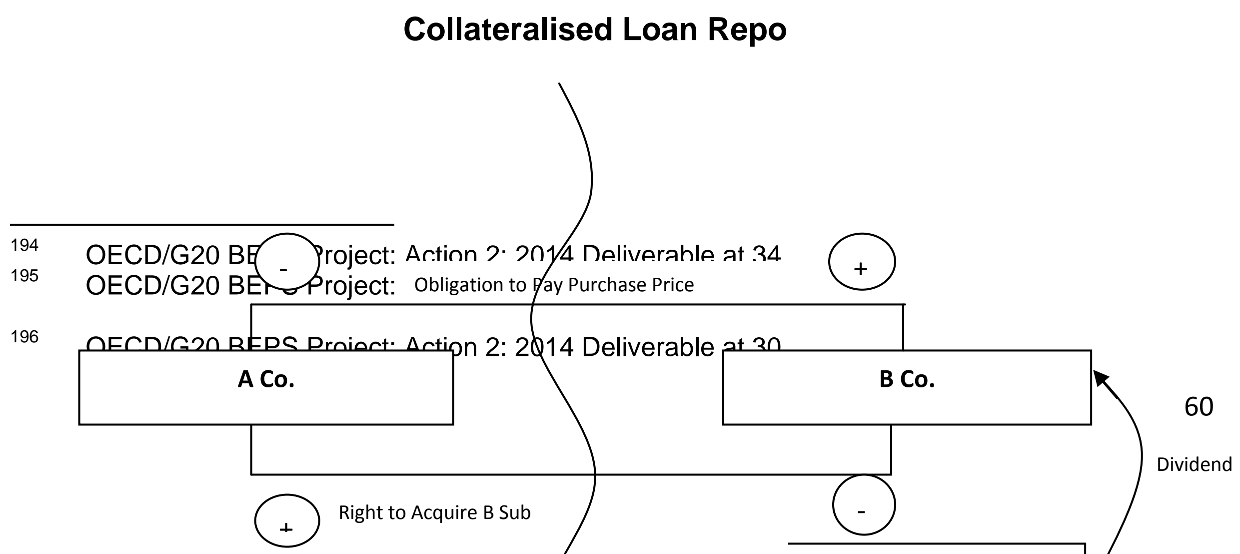
The OECD September 2014 Report on Hybrid Mismatches also refers to hybrid transfers as an example of hybrid mismatches that can cause base erosion and profit shifting.[194] This report defines hybrid transfers are arrangements pertaining to an asset where taxpayers in two jurisdictions assume mutually incompatible stances relative to the ownership of such asset, e.g. the transfer qualifies as a transfer of ownership of the asset in one jurisdiction for tax purposes but as a collateralised loan in the other jurisdiction.[195]

Hybrid transfers are typically collateralised loans or derivative transactions in terms of which both parties to the self-same arrangement in different jurisdictions consider themselves to be the owner of the loan collateral or subject matter of the derivative. The differences in the characterisation of the arrangement may cause payments made in terms of the arrangement to generate deduction/no inclusion outcomes.

The most common transaction used to achieve a tax mismatch under a hybrid transfer is a sale and repurchase arrangement (colloquially termed a "repo") of an asset where the repo terms result in the arrangement constituting the economic equivalent of a collateralised loan. The legal mechanism used to structure the repo generally results in one jurisdiction treating the arrangement as a sale and repurchase in accordance with its form; while the other jurisdiction classifies the arrangement according to its economic substance – as a loan secured by an asset. In most instances the collateral for such arrangements comprises shares of controlled entities but the repo mechanism can also be used with any asset that generates an exempt yield or some other tax benefit under the law of both jurisdictions.

Example 3 below illustrates a hybrid transfer structure and is taken from the OECD Report.[196]

**Collateralised Loan Repo**




194 OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 34.
195 OECD/G20 BEPS Project:
196 OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 30.

The structure illustrated in above involves a company in Country A (A Co) which owns a subsidiary (B Sub). A sells the shares of B Sub to B Co under an arrangement that A Co (or an affiliate) will acquire those shares at a future date for an agreed price. Between sale and repurchase, B Sub makes distributions on the shares to B Co. The net cost of the repo to A Co is treated as a deductible financing cost. A Co's cost includes the B Sub dividends that are paid to and retained by B Co. Country B will typically grant a credit, exclusion, exemption or some other tax relief to B Co on the dividends received. B Co also treats the transfer of the shares back to A Co as a genuine sale of shares and may exempt any gain on disposal under an equity participation exemption or a general exclusion for capital gains. The combined effect of the repo transaction is, therefore, to generate a deduction for A Co in respect of the aggregate payments made under the repo with no corresponding inclusion for B Co. [197]

### 9.1 OECD recommendation to curtail hybrid transfers

To prevent such mismatches, the OECD's recommendation is to neutralise the effect of hybrid mismatches that arise under hybrid transfers, through the adoption of a linking rule that aligns the tax outcomes for the payer and payee under a financial instrument. This OECD September 2014 Report on Action 2 recommends that the primary response should be to deny the payer a deduction for payments made under a hybrid financial instrument, with the payee jurisdiction applying a defensive rule that would require a deductible payment to be included in ordinary income in the event the payer was located in a jurisdiction that did not apply a hybrid mismatch rule to eliminate the mismatch. [198]

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[197] OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 35.
[198] OECD/G20 BEPS Project: Action 2: 2014 Deliverable at 36.

## 9.2 Provisions in South Africa that deal with Hybrid Transfers

Section 24J

For South African tax purposes, section 24J[199] of the Income Tax Act is relevant. An "instrument" is defined in section 24J as including, *inter alia*,

> "(e) any repurchase agreement or resale agreement,...but excluding any lease agreement (other than a sale and leaseback arrangement as contemplated in section 23G)"[200]

A "repurchase agreement" as defined in section 24J:

> "means the obtaining of money (which money shall for the purposes of this section be deemed to have been so obtained by way of a loan) through the disposal of an asset by any person (seller) to any other person (purchaser) subject to an agreement in terms of which such person (seller) undertakes to acquire from such other person (purchaser) at a future date the asset so disposed of or any other asset issued by the issuer of, and which has been so issued subject to the same conditions regarding term, interest rate and price as, the asset so disposed of."

A "resale agreement" is similarly defined in section 24J to mean:

> "the provision of money (which money shall for the purposes of this section be deemed to have been so provided in the form of a loan) through the acquisition of an asset by any person (purchaser) from any other person (seller) subject to an agreement in terms of which such person (purchaser) undertakes to dispose of to such other person (seller) at a future date the asset so acquired or any other asset issued by the issuer of, and which has been so issued subject to the same conditions regarding term, interest rate and price as, the asset so acquired."

While the above definitions have given rise to some interpretational anomalies, the vagaries of which exceed the scope of this report, they however have potential application to hybrid transfers. Should a hybrid transfer constitute either a repurchase or resale agreement as defined in section 24J, it will fall within the definition of an "instrument" (i.e. an "income instrument" for corporate persons) and as such all amounts payable and receivable thereunder will be deemed to be interest[201] accruing to the holder and incurred by the issuer on a day-to-day basis.

[199] Section 24J deals with the incurral and accrual of interest

[200] Section 23G is an anti-avoidance provision which effectively treats sale and leaseback arrangements involving payments to lessors or lessees that do not constitute income in their hands under the Act, as financing arrangements and denies any capital allowances that would otherwise be available in respect of the asset sold and leased back.

[201] "Interest" as defined in section 24J "includes the — (a) gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement; (b) amount (or portion thereof) payable by a borrower to the lender in terms of any lending arrangement as represents compensation for any amount to which the lender would, but for such lending arrangement, have been entitled; and (c) absolute value of the difference between all amounts receivable and payable by a person in terms of a sale and leaseback arrangement as contemplated in section 23G throughout the full term of such arrangement, to which such person is a party, irrespective of whether such amount is — (i) calculated with reference to a fixed rate of interest or a variable rate of interest; or (ii) payable or receivable as a lump sum or in unequal instalments during the term of the financial arrangement."

As such, for purposes of section 24J the repurchase or resale agreement will be treated as a loan secured by an asset, the sale and repurchase[202] of which will be ignored.

Section 23G

Section 23G of the Income Tax Act is an anti-avoidance provision that deals with sale and leaseback arrangements. The provision effectively treats the "sale and leaseback arrangement"[203] in respect of an "asset"[204] as a financial arrangement where:

> "the receipts or accruals of…a lessee or sublessee in relation to a sale and leaseback arrangement, do not for the purposes of (the) Act constitute income of such person", in which case "any amount which is received by or accrues to any lessor in relation to such sale and leaseback arrangement, shall be limited to an amount which constitutes interest as contemplated in section 24J; and such lessor shall, notwithstanding the provisions of (the) Act, not be entitled to any deduction in terms of section 11(e), (f) or (gA), (gC), 12B, 12C, 12DA, 13 or 13quin in respect of an asset which is the subject matter of such sale and leaseback arrangement"; and where "the receipts or accruals of…a lessor in relation to a sale and leaseback arrangement, arising from such arrangement do not for the purposes of (the) Act constitute income of such person, any deduction to which a lessee or sublessee in relation to such sale and leaseback arrangement is entitled under the provisions of (the) Act shall, subject to the provisions of section 11(f), be limited to an amount which constitutes interest as contemplated in section 24J." "Interest" for purposes of section 23G is defined in section 24J the "absolute value of the difference between all amounts receivable and payable by a person in terms of a sale and leaseback arrangement as contemplated in section 23G throughout the full term of such arrangement, to which such person is a party, irrespective of whether such amount is – (i) calculated with reference to a fixed…or a variable rate of interest; or (ii) payable or receivable as a lump sum or in unequal instalments during the term of the financial arrangement."

Effectively the sale of the asset is disregarded and where the lessee or sublessee is not subject to tax under the Act (e.g. a non-resident); the accruals and receipts of the lessor under the arrangement are limited to section 24J "interest" and the lessor is prohibited from claiming any tax allowances in terms of the Act. Conversely, if the lessor is not subject to tax under the Act (e.g. as a non-resident); the deductions available to the lessee or sublessee are limited to section 24J "interest" as defined for purposes of section 23G.

Applying the provisions of the South African tax regime to Example 2: Assume

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[202] Any difference between the purchase price and sale price will in all likelihood be deemed to be interest although it is not specifically included in the definition of "interest," and as such the purchaser will be prohibited from claiming an allowance based on any increased purchase price of the asset. See TE Brincker "Taxation Principles of Interest and Other Financing Transactions" Issue 9 May (2011) *Derivatives*

[203] Defined in the section as "Any arrangement whereby - (a) any person disposes of any asset (whether directly or indirectly) to any other person; and (b) such person or any connected person in relation to such person leases (whether directly or indirectly) such asset from such other person."

[204] Defined for purposes of section 23G as "any asset, whether movable or immovable, or corporeal or incorporeal"

South Africa is Country A. A Co, resident in South Africa, owns a subsidiary, B Sub; tax resident in Country B. A sells its shares in B Sub to B Co in terms of an arrangement that entitles A Co to acquire those shares at a future date for an agreed price.

How would South Africa treat the hybrid transfer? A Co has obtained money through the disposal of the B Sub shares to B Co subject to an agreement in terms of which A Co is entitled to acquire from B Co the B Sub shares originally disposed of at a future date for a predetermined price. It appears that the hybrid transfer would constitute a "repurchase agreement" as defined in section 24J and be treated as the obtaining of money by way of a loan secured by the B Sub shares. As such it will fall within the definition of an "instrument" which is interest-bearing by virtue of the payments A Co is required to make to B Co for the duration of the repo. We are not advised whether or not the agreed repurchase price will carry a premium on the original price paid by B Co.

Since B Sub is a foreign company, one may assume that the yield on the shares A Co holds in B Sub will resemble foreign dividends. As such the payment will fall into A Co's gross income in terms of paragraph (*k*) of the definition of "gross income" in section 1 of the Act being an "*amount received by or accrued by way of a...foreign dividend*". Section 10B of the Act would then operate to either exempt the payment in its entirety (e.g. by virtue of the participation exemption) or in terms of the formula-driven exemption for foreign dividends, resulting in the effective rate of tax applicable to so much of the foreign dividend payment as does not qualify for exemption, being 15% - the dividends tax rate.[205]

A Co would not qualify for the participation exemption in respect of the foreign dividend received from B Sub if B Sub is permitted a tax deduction in determining its liability to any tax on companies in Country B where it is resident and presumably has its place of effective management.

If the payments due by A Co to B Co on the obtaining of money from B Co by way of a loan have been incurred in the production of A Co's income from carrying on its trade, they will be tax deductible and their incurral will be determined in accordance with the provisions of section 24J.

As regards such payments in respect of the instrument to B Co, interest withholding tax at the rate of 15% will apply to South African sourced interest paid to a non-resident with effect from 1 January 2015. B Co will be exempt from normal tax on the interest payment unless the loan in respect of which the interest is paid is effectively connected to a PE of B Co in South Africa. B Co may in any event qualify

[205] While the recipient of the foreign dividend may be liable to tax to the extent that the foreign dividend does not qualify for exemption, section 23(*q*) of the Act denies "*any expenditure incurred in the production of income in the form of foreign dividends*" as a deduction in the determination of taxable income.

for exemption from tax on the South African sourced interest if a DTA exists between South Africa and Country B unless the interest is attributable to a South African PE of B Co.

If a controlling relationship exists between A Co and B Co, since B Co is in all likelihood not subject to tax under Chapter II, *Part I* of the Act, section 23M will impose a formula-driven limitation[206] on A Co's entitlement to deduct the interest payments to B Co with effect from 1 January 2015.

Now transpose South Africa as Country B in Example 2. What are the tax implications? If it can be said that the agreement between B Co and A Co constitutes the provision of money through the acquisition of B Sub shares by B Co from A Co subject to an agreement in terms of which B Co is obliged to resell to A Co at a future date the B Sub shares it originally acquired; one could reasonably conclude that such agreement constitutes a "resale agreement" within the meaning of section 24J. As such it will fall within the definition of an "instrument" which is interest-bearing by virtue of the payments A Co is required to make to B Co for the duration of the repo.

The sale of the B Sub shares to B Co will be ignored for purposes of section 24J and all payments made to B Co in terms of the provision of money to A Co by way of a loan will be deemed to be interest subject to tax as such in B Co's hands. Since South Africa taxes on a residence basis, the fact that the payment from A Co is foreign sourced will be of no consequence. If a DTA exists between South Africa and Country A, which operates to withhold tax on the interest payment due by A Co to B Co, B Co may qualify either for DTA relief or a rebate against or deduction in its South African tax liability in respect of foreign taxes paid on such payment in terms of section 6*quat* of the Act.[207]

## 10 CONCLUSION AND RECOMMENDATIONS

From the above, it is apparent that South Africa has anticipated several of the recommendations in the OECD September 2014 Report on Hybrid Mismatch Arrangements, as it has incorporated provisions into the Act which achieve or are designed to achieve the objectives of OECD with regard to BEPS Action 2. As such

[206] The annual deduction will be limited to the amount of interest received by or accrued to A Co plus 40% of A Co's adjusted taxable income as defined, less any amount of interest incurred by A Co in respect of debt other than that contemplated in section 23M (i.e. between A Co and a creditor in a controlling relationship where the creditor is not subject to tax under Chapter II, Part I of the Act). Should the average repo rate exceed 10% in any year of assessment, the percentage of adjusted taxable income of A Co (40%) will be increased proportionately.

[207] Many DTAs that South Africa has concluded with other countries have articles eliminating double taxation of amounts subject to tax in the foreign jurisdiction with which South Africa has concluded the relevant DTA. Unless the DTA stipulates that the foreign tax paid (duly converted to ZAR) must be credited against any South African tax liability in accordance with South African tax law (i.e. section 6*quat* of the Act); the taxpayer may choose whether to use section 6*quat* or claim a tax credit under the DTA.

it is submitted that South Africa has been proactive and is ahead of the curve.

- However, legislative simplicity is critical in this complex area of tax. Thus while South Africa may be considered at the forefront in achieving OECD objectives with regard to BEPS Action 2, caution should be exercised around the complicated hybrid equity provisions (sections 8E and 8EA) of the Act, which may operate in a contradictory fashion vis-á-vis the hybrid debt provisions (sections 8F and 8FA) and create the risk of potential abuse with reference to section 8F.
- As regards the commerciality of sections 23M and 23N of the Act, there is a concern that the limitation on interest deductibility embodied in these sections may unduly impede business transactions to the potential detriment of the economy. If South Africa hopes to attract foreign direct investment and be competitive on the African continent, it must not hamper trade unnecessarily. In this regard one must view with circumspection the Draft Public Notice recently issued by SARS listing transactions [208] that constitute reportable arrangements for purposes of section 35(2) of the Tax Administration Act;[209] which once finalised is intended to be supplementary to any previous notices issued in this regard, and extends the existing listed reportable arrangements, which include certain hybrid equity and debt instruments in terms of sections 8E and 8F of the Act.
- Further, as regards balancing the BEPS risk and attracting foreign direct investment, South Africa should aim to increase its pull on and compete for a larger stake in the investments flowing into its BRIC counterparts.
- Since it remains essential to achieve equilibrium between nurturing cross-border trade and investment while simultaneously narrowing the scope of tax avoidance, some guidance may be gleaned from the UK's recent approach to "manufactured payments" where it removed the anti-avoidance legislation and instead focussed on applying the matching principle. This approach is preferable for revenue authorities and taxpayers alike.
- It is noted that to date emphasis has been predominantly on interest deductibility and the receipt of interest and/or dividends, with minimal focus on other forms of income and/or deductions. As a port of last call to combat base erosion and profit shifting as envisaged in BEPS Action 2, South Africa may

[208] The Draft Notice lists several reportable arrangements including share buy-backs for an aggregate amount of at least ZAR10 million, if the company issued any shares within 12 months of entering into the buy-back agreement; any arrangement that is expected to or has given rise to a foreign tax credit exceeding an aggregate amount of ZAR10 million; an arrangement in which a resident contributes to or acquires a beneficial interest in a non-resident trust, where the value of contributions or payments to the trust exceed ZAR10 million, with certain exclusions; an arrangement where one or more persons acquire a controlling interest in a company that has or expects to carry forward an assessed loss exceeding ZAR20 million from the preceding year of assessment or expects an assessed loss exceeding ZAR20 million in the year of assessment in which the relevant shares are bought; and an arrangement involving payments by a resident to an insurer exceeding ZAR1 million, if any amounts payable to any beneficiary, are determined with reference to the value of particular assets or categories of assets held by or on behalf of the insurer or another person.

[209] No 28 of 2011

resort to the GAAR,[210] which is designed to capture tax avoidance that is not caught by the specific anti-avoidance provisions of the Act. The Commissioner's discretion in determining the tax consequences of any impermissible avoidance arrangement is virtually unfettered, which one hopes will be limited by the courts in practice. Reference may also be had to the body of case law dealing with simulated or disguised transactions - the substance over form debate and the requirement that a transaction is required to be underpinned by a commercial purpose.[211]

- It is submitted for South African purposes, that focus should be honed on mismatches that erode the South African tax base within the DTA context.

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210 Section 80A – L of the Act, which must be read in conjunction with the reportable arrangements provisions in the Tax Administration Act.

211 *Roschcon (Pty) Ltd v Anchor Auto Body Builders CC* (49/13) [2014] ZASCA 40 (31 March 2014) in which the court held that in determining whether a transaction was simulated or disguised, it was necessary to "establish whether the parties to the transaction actually intended the agreement that they had entered into should have effect in accordance with its terms; whether the parties to the contract intended to give effect to it according to its tenor." It commented obiter that one of the most common forms of tax avoidance is where the parties to a contract attempt to disguise its true nature in order to qualify for a tax benefit that would not have been available if the true contract between them were revealed. Shongwe JA, citing Zandberg v Van Zyl 1919 AD 302 at 309, stated that "(o)ur courts require no statutory powers to ignore pretence of this kind, and the law will always give effect to the real transaction between the parties"