

The Taxation of Company Distributions in Respect of Hybrid Instruments in South Africa: Lessons from Australia and Canada

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Abstract

Tax legislation traditionally distinguishes between returns on investment paid on equity and debt instruments. In the main, returns on debt instruments (interest payments) are deductible for the paying company, while distributions on equity instruments (dividends) are not. This difference in taxation can be exploited using hybrid instruments and often leads to a debt bias in investment patterns. South Africa, Australia and Canada have specific rules designed to prevent the circumvention of tax liability when company distributions are made in respect of hybrid instruments. In principle, Australia and Canada apply a more robust approach to prevent tax avoidance and also tend to include a wider range of transactions, as well as an unlimited time period in their regulation of the taxation of distributions on hybrid instruments. In addition to the anti-avoidance function, a strong incentive is created for taxpayers in Australia and Canada to invest in equity instruments as opposed to debt. This article suggests that South Africa should align certain principles in its specific rules regulating hybrid instruments with those in Australia and Canada to ensure optimal functionality of the South African tax legislation. The strengthening of domestic tax law will protect the South African tax base against base erosion and profit shifting through the use of hybrid instruments.

Keywords

Hybrid instrument; hybrid equity instrument; hybrid debt instrument; third-party backed share; non-equity share; non-share equity; term preferred share; guaranteed share; collateralised share; dividend rental agreement; taxable preferred share; taxation of equity investment; taxation of debt instruments; debt bias; economic double taxation; tax avoidance.

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1 Introduction

Economic globalisation and the development of innovative investment instruments in modern financial markets tend to outpace the domestic legislative frameworks regulating their taxation.¹ Investors and companies attempt to minimise their tax liability through innovative tax planning and complex corporate finance structures.² In reaction, increasingly complex domestic tax rules are designed to support the state's need to collect higher amounts in revenue and to protect its tax base.³ These laws are often ineffective, resulting in yet more innovative tax avoidance schemes.⁴ As a result of the mismatch between the rapidly changing economy and the legislation, many opportunities arise to avoid tax liability, especially in the context of hybrids, derivatives and the many varied instruments of investment available.

Tax factors can influence the choice of investment instrument and the method of returning funds to owners.⁵ In many jurisdictions, returns on equity instruments such as dividends or capital gains are not deductible at corporate level, but are taxable at both corporate and shareholder level.⁶

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¹ De Wilde 2016 *BIT* 182; Oguttu *Offshore Tax Avoidance* 1-3, 60; SARS *Strategic Plan* 51-53.

² Abbas *et al. Partial Race to the Bottom* 3; Mirrlees *et al. Tax by Design* 429; OECD 2013 http://www.oecd.org/ctp/BEPSActionPlan.pdf_9; Thuronyi *Tax Law Design* 826-827; Martens-Weiner *EU Company Tax Reform* 80-81; Feldstein, Hines and Hubbard *Effects of Taxation on Multinational Corporations* 1.

³ Tanzi "Taxation of High Net Worth Individuals" 2-3; Mirrlees *et al. Tax by Design* 3; Olivier and Honiball *International Tax* 8; Sullivan *Corporate Tax Reform* 1.

⁴ Oguttu *Offshore Tax Avoidance* 7.

⁵ Mirrlees *et al.* 2012 *NTJ* 674.

⁶ McIntyre *Deduction of Interest Payments* 399; Shaviro 2008 *Financial Crisis* 45-46; Helminen *Concept of Dividend* 163; Simon *Optimal Debt Bias in Corporate Income Taxation* 1; Teixeira *Taxing Corporate Profits* 1; Cnossen 2015 *Osgoode Hall LJ* 517.

Interest paid on debt instruments is mostly deductible (principally at corporate level) and subject to only one level of taxation.⁷

The distortion created by the different tax treatment of equity distributions and debt repayments can be exploited through instruments combining elements of equity and debt.⁸ A hybrid instrument enables investors to separate the fundamental economic principles of their actions from the tax consequences, causing the substance of the instrument to differ from its legal form.⁹ Shareholders might, for example, be able to invest in a hybrid instrument that is called an equity instrument, but is nevertheless not exposed to the risks associated with legal restrictions on equity distributions that typically link the return on investment to the performance of the company.¹⁰ Conversely, taxpayers could structure a "debt instrument" to receive returns linked to the performance of a company in a manner typical of equity investments. Further tax problems associated with hybrid instruments include inconsistency in treatment, the different treatment of gains and losses, and the deduction of payments without an inclusion on the counter side.¹¹

When a company distributes a return on a hybrid instrument the tax consequences can be difficult to determine, given that tax legislation is mostly designed to tax debt and equity returns separately. Countries thus frequently enact specific anti-avoidance rules such as thin capitalisation¹² provisions, rules limiting the deductibility of interest payments, detailed classification rules, or provisions that re-classify the distributions made on such instruments.¹³ The South African *Income Tax Act* 58 of 1962 (hereafter the ITA), in the main, re-classifies the distributions in the hands of the recipient without altering the nature of the payment for other parties.¹⁴ The Davis Tax Committee did not address the taxation of distributions in respect of hybrid instruments but stated that an incentive to receive dividends is

⁷ McIntyre *Deduction of Interest Payments* 399; Shaviro 2008 *Financial Crisis* 45-46; Helminen *Concept of Dividend* 163; Simon *Optimal Debt Bias in Corporate Income Taxation* 1; *Taxing Corporate Profits* 1; Cnossen 2015 *Osgoode Hall LJ* 517.

⁸ Kahlenberg and Kopec 2016 *WTJ* 38; Diamond 2010 *NTJ* 1; De Mooij 2015 *Fiscal Studies* 491-500; Simon *Optimal Debt Bias in Corporate Income Taxation* 1-4.

⁹ Van der Zwan "Investment" 559.

¹⁰ SARS *Explanatory Memorandum* 2013 27.

¹¹ Shaviro 2008 *Financial Crisis* 17-18; Messere *Tax Policy in OECD Countries* 332-333.

¹² The term "thin capitalisation" refers to the corporate funding of a business being more debt-based than equity-based. See Oguttu 2011 *SAYIL* 79.

¹³ Sections 31 and 24J of the *Income Tax Act* 58 of 1962 (the ITA); Oguttu 2011 *SAYIL* 80.

¹⁴ Sections 8E, 8EA, 8F and 8FA of the ITA.

present for taxpayers that are subject to a marginal tax rate above 42,4% (the combined effective corporate and dividend tax rate).¹⁵

This article analyses the taxation of company distributions on hybrid instruments in South Africa from a functional perspective. It considers the application of these rules in comparison with similar provisions in Australia and Canada to determine whether the principles applied in these jurisdictions could be adjusted for South Africa in order to protect the tax base and curb tax avoidance whilst adhering to the principles of fair taxation and stimulating equity investment. Australia and Canada, as representative of two corporate tax structures different from the South African system, have been selected because they are known for their robust approaches to tax avoidance and for incentivising equity investment. Although the Australian and Canadian corporate tax structures differ from that of South Africa, the rules on hybrid instruments have a similar aim as the expressed intention of the Minister of Finance in South Africa, namely to reduce the debt bias¹⁶ in investment patterns, which is considered undesirable.¹⁷ We consider Australia and Canada first.

2 The taxation of distributions on hybrid instruments in Australia

2.1 The corporate tax structure in respect of company distributions

The Australian corporate tax system alleviates economic double taxation on equity instruments by integrating corporate and shareholder-level tax in a full dividend imputation system and granting relief from double taxation at shareholder level.¹⁸ When a shareholder receives a dividend, the income

¹⁵ Davis Tax Committee 2018 <https://www.taxcom.org.za/docs/20180411%20Final%20DTC%20CIT%20Report%20-%20to%20Minister.pdf> 10-11.

¹⁶ The phrase "debt bias" refers to the preference of investors to invest in debt instruments (such as debentures, loans, and hybrid instruments) as opposed to equity instruments (such as shares). See Shaviro 2008 *Financial Crisis* 4-9; Helminen *Concept of Dividend* 163; Simon *Optimal Debt Bias in Corporate Income Taxation* 1-4; De Mooij 2015 *Fiscal Studies* 491-500; Kahlenberg and Kopec 2016 *WTJ* 38.

¹⁷ Davis Tax Committee 2018 <https://www.taxcom.org.za/docs/20180411%20Final%20DTC%20CIT%20Report%20-%20to%20Minister.pdf> 10-11. McIntyre is of the view that debt finance is treated too favourably in every tax system to his knowledge (McIntyre *Deduction of Interest Payments* 399-402), and this treatment is widely criticised as not being an optimal design of a corporate tax system. See Kahlenberg and Kopec 2016 *WTJ* 38; Diamond 2010 *NTJ* 1; De Mooij 2015 *Fiscal Studies* 491-500.

¹⁸ CCH *Australian MTG* 150; Twite 2001 *Int Rev Finance* 217-218; Gilders *et al. Understanding Taxation Law* 852.

that the company is distributing, as well as the tax already paid by the company on that income, is attributed to the shareholder. The shareholder receives a "franked dividend", which consists of the dividend plus a notional amount representing the value of the corporate tax that was paid by the company.¹⁹ This adding of a notional amount to the assessable income of the shareholder as recipient is referred to as the gross-up mechanism.²⁰ This increased amount is offset by "franking credits" also transferred to the recipient shareholders.²¹ The value of these franking credits, that essentially represent the tax already paid at corporate level, may be set off against the recipient shareholder's remaining tax liability.²² As a result it reduces the tax liability of the shareholder and eliminates economic double taxation.²³

Returns on debt instruments do not qualify for the benefits of the imputation system. Australia thus incentivises investment in equity instruments.

2.2 The classification of investment instruments as either debt, equity or hybrid

Australia applies a specific test to classify hybrid instruments as either debt or equity.²⁴ It also addresses the use of hybrid instruments in combination with other instruments.²⁵

2.2.1 The distinction between debt and equity interests in tax law

The legislation emphasises the economic substance of debt or equity interests and not their apparent legal form.²⁶ It considers elements in a wider arrangement (for example, stapled interests²⁷) as a whole to determine the true economic character of the instruments or transactions, referred to as a blanket approach or integration rule.²⁸ This means that all schemes or

¹⁹ CCH *Australian MTG* 172.

²⁰ Section 207.20 of the *Income Tax Assessment Act, 1997* (hereafter the ITAA 1997).

²¹ Section 207.20(1) of the ITAA 1997 read with s 44(1)(a) of the *Income Tax Assessment Act, 1936* (hereafter the ITAA 1936).

²² Section 207.20(2) of the ITAA 1997; Taylor *et al. Taxation Law* 877; Twite 2001 *Int Rev Finance* 219-222.

²³ CCH *Australian MTG* 171-172.

²⁴ Taylor *et al. Taxation Law* 751.

²⁵ Orow 2001 *DFI* 322.

²⁶ Section 974.5(1) of the ITAA 1997; Murphy 2016 *AT Rev* 21-22.

²⁷ The phrase "stapled interests" refers to investment instruments that are linked to each other as the facts in *Mills v Commissioner of Taxation* 2012 HCA 51 (the *Mills* case) indicated, where a hybrid instrument that consisted of a promissory note issued by a New Zealand bank was stapled to an Australian preference share; *Mills* case paras 29-42.

²⁸ Orow 2001 *DFI* 322-323; s 974.155 of the ITAA 1997. See Murphy 2016 *AT Rev* 24-25.

instruments are classified as either equity or debt without any apportionment between debt and equity elements.²⁹

Two tests determine whether an interest is classified as debt or equity, namely the debt test and the equity test.³⁰ The distinction is based on whether investment returns depend on the performance of an entity.³¹

An interest is classified as a debt interest if the return does not depend on the company's economic performance, the making of a distribution, or on any other event, situation, or condition.³² The debt test requires a reciprocal obligation (that the entity receive a benefit and provide a benefit in return) that is non-contingent.³³ The test captures the very essence of debt and is based on simple terminology promoting certainty. To satisfy the debt test, an asset must be provided to finance the entity, which is liquid or a monetary asset, or a sum of money.³⁴

Under the equity test, a scheme or interest qualifies as equity if the interest exists, cannot be characterised as a debt interest in terms of the debt test, and is not part of the larger debt interests in the company or a connected party to the company.³⁵ In contrast with the debt test, which is based on principles and concepts normally used in legislation, the equity test does not identify guidelines for classification and is supplemented by section 974.75 of the ITAA 1997 that lists the types of interest classified as equity.³⁶ This could, however, also have the limiting effect of excluding transactions based on hybrid equity but not listed in section 974.75. Interests are classified as equity only if created as part of a scheme constituting a financing arrangement in relation to the company.³⁷ If an interest can be classified as both debt and equity, it is taxed as a debt interest only.³⁸ When one type of interest is converted into the other, the nature of the new interest is decisive.³⁹

2.3 Hybrid equity instruments or non-share equity

²⁹ *Mills* case paras 29-42, 73, 76; Orow 2001 *DFI* 322-323.

³⁰ Taylor *et al. Taxation Law* 751; Orow 2001 *DFI* 322; Murphy 2016 *AT Rev* 20-21.

³¹ Section 974.135 read with s 974.120 of the ITAA 1997; Murphy 2016 *AT Rev* 26.

³² Section 974.20(1) of the ITAA 1997; Joseph 2015 *DFI* 2-3.

³³ Section 974.20(1) of the ITAA 1997.

³⁴ Section 974.25(1) of the ITAA 1997.

³⁵ Section 974.70(1)(a)-(b) of the ITAA 1997.

³⁶ Table 12.1 in s 974.75 of the ITAA 1997.

³⁷ Section 974.75(2) of the ITAA 1997.

³⁸ Section 974.1 of the ITAA 1997; CCH *Australian MTG* 1428.

³⁹ Taylor *et al. Taxation Law* 752; Orow 2001 *DFI* 324.

As it remains possible for taxpayers to develop hybrid instruments that are neither non-contingent (debt) nor listed as equity in tax legislation, rules were developed to classify instruments as either non-equity shares or non-share equity interests. Specific rules impose tax liability based on the dominant features of the hybrid instrument.

Equity interests other than shares are classified as non-share equity interests.⁴⁰ Returns on these are treated as non-share dividends and included in the holder's assessable income.⁴¹ They are frankable, thus a notional gross-up amount is added to the shareholder's assessable income and a tax credit applied to reduce the tax payable in terms of the imputation system.⁴² The dividends need not be paid from profit because a deeming rule regards them as paid out of profit for tax purposes irrespective of their source.⁴³ However, if a company has not made a profit, this is an unfrankable distribution and no gross-up and credit is applied.⁴⁴ This results in only the dividend being added to the assessable income of the taxpayer, and no reduction of economic double taxation. This rule effectively links the taxation to a profit requirement. This could discourage the use of hybrid instruments as an investment choice as there is no tax relief upon distribution on a non-share equity instrument, unless the company earns a profit. It thus adds an element of risk that is normally associated with equity investments to the tax rule, which is an innovative approach to the taxation of hybrid equity instruments.

2.4 Hybrid debt instruments or non-equity shares

A share is classified as a hybrid debt interest if the legal form of the investment is a share but the underlying economic substance is one of debt.⁴⁵ This is referred to as a non-equity share.⁴⁶ A distribution on a non-equity share is not frankable,⁴⁷ so there is no tax credit to reduce the recipient's tax liability. The approach is thus similar to that which applies to

⁴⁰ For example, perpetual debt or limited non-recourse debt can be classified as equity in terms of the debt versus equity rules. See Gilders *et al.* *Understanding Taxation Law* 746; Taylor "Australia" 10.

⁴¹ Section 974.120 of the ITAA, 1997; CCH *Australian MTG* 1433.

⁴² Section 44(1)(a)(ii) of the ITAA 1936, read with s 202.45(2) of the ITAA 1997.

⁴³ Section 44(1)(a)(ii) read with s 44(1A) of the ITAA 1936.

⁴⁴ Sections 202.45(f), 215.10, 215.15 of the ITAA 1997; Taylor "Australia" 10.

⁴⁵ Taylor *et al.* *Taxation Law* 752.

⁴⁶ Section 202.45 of the ITAA 1997.

⁴⁷ Section 202.45 of the ITAA 1997.

hybrid equity where no profit is earned by the company. Investors are thus discouraged from using hybrid debt instruments.

3 The taxation of distributions on hybrid instruments in Canada

3.1 *The corporate tax structure in respect of company distributions*

Like Australia, Canada integrates corporate and shareholder level tax in respect of certain dividends on equity shares.⁴⁸ However, this integration leads only to the partial reduction of economic double taxation in Canada.⁴⁹ The manner of integration depends on the nature of each corporation, the shareholder, and the type of distribution. Dividends are classified into certain categories depending on the nature, source, and timing of the payment of the dividend, as well as the type of shares held.⁵⁰ The rules of the integration system apply only to taxable dividends and eligible dividends as defined,⁵¹ and different gross-up percentages and tax credits are allocated to each of these types of dividend.⁵² Taxable dividends received by Canadian resident individuals are subject to the integration rules and a gross-up and credit mechanism.⁵³ Partial integration is achieved by including the dividend in the income of the shareholder and adding a gross-up (a notional amount) to the dividend.⁵⁴ This gross-up is calculated at a percentage of the value of the cash dividend,⁵⁵ which is fixed in legislation and adjusted from time to time.⁵⁶ The percentage depends on the type of corporation making the distribution, and the classification of the dividend as a taxable dividend or an eligible dividend.⁵⁷ The tax payable is calculated on this higher amount, which exceeds the actual income of the

⁴⁸ Duff and Loomer *Taxation of Business* 223-225.

⁴⁹ Duff and Loomer *Taxation of Business* 223-225; Tobias *Taxation of Corporations* 211.

⁵⁰ CCH *Canadian MTG* 584.

⁵¹ For the definitions of "taxable dividend" and "eligible dividend" see s 89(1) read with s 248 (1) of the *Income Tax Act*, 1985 (the ITA 1985); Friedlander *Taxation of Corporate Finance* 5-25-5-26; Bleiwas, Hutson and Kellough *Taxation of Private Corporations* 18:7; CCH *Canadian MTG* 585.

⁵² CCH *Canadian MTG* 584.

⁵³ CCH *Canadian MTG* 584; Tobias *Taxation of Corporations* 253.

⁵⁴ Section 121 read with s 82(1)(b) of the ITA 1985; Duff and Loomer *Taxation of Business* 234-236; Friedlander *Taxation of Corporate Finance* para 5-43; CCH *Canadian MTG* 585.

⁵⁵ Section 121 of the ITA 1985.

⁵⁶ Section 121 of the ITA 1985.

⁵⁷ Section 89(1) read with s 248 (1) of the ITA 1985; Friedlander *Taxation of Corporate Finance* 5-25- 5-26; Bleiwas, Hutson and Kellough *Taxation of Private Corporations* 18:7; Duff and Loomer *Taxation of Business* 234-237.

shareholder.⁵⁸ The shareholder may then subtract a non-refundable dividend tax credit (as determined in legislation)⁵⁹ once the normal computation of income has been made.⁶⁰ This amount is not linked to the corporate tax actually paid, but offsets the tax assumed to have been paid by the corporation, ensuring that an individual shareholder receives relief proportionate to this presumed tax.⁶¹ A gross-up and credit are not available to resident corporate shareholders, but such shareholders are entitled to an intercorporate deduction that in the main corresponds to the amount of that dividend.⁶² The discrimination between individual shareholders and corporate shareholders is partially remedied by the rules that allow tax-free dividends between corporations, which also reduce double taxation,⁶³ as these dividends are usually distributed further by the shareholder corporation.

A return on a debt instrument is not subject to the rules of the integration system. The Canadian tax system thus incentivises equity investment.

3.2 The classification of investment instruments as either debt, equity or hybrid

Although the integration system partially eliminates double taxation for individuals, it does not prevent the use of planning strategies involving hybrid instruments.⁶⁴ Payments in relation to hybrid instruments could lead to an interest deduction and the use of tax credits.⁶⁵ Unlike Australia, Canada has no general classification rule to distinguish between equity and debt for taxation purposes.⁶⁶ Each transaction is judged on its own facts.

Given the advantages of using equity instruments in Canada, it is not surprising that most of the specific rules for the taxation of hybrid instruments focus on hybrid equity instruments that do not involve the risks normally attached to equity investments.

⁵⁸ Duff and Loomer *Taxation of Business* 234-237.

⁵⁹ Section 121 of the ITA 1985; Kerr 1989 *UT Fac L Rev* 671-672.

⁶⁰ Section 121 of the ITA 1985; Friedlander *Taxation of Corporate Finance* 5-43; Mckenzie 2006 *CTJ* 636; Kerr 1989 *UT Fac L Rev* 675.

⁶¹ Section 121 of the ITA 1985; CCH *Canadian MTG* 1683; Duff and Loomer *Taxation of Business* 234-236.

⁶² Section 112(2) read with s 248(1) of the ITA 1985.

⁶³ Krishna *Income Tax Law* 453.

⁶⁴ Krishna *Income Tax Law* 417-418.

⁶⁵ Krishna *Income Tax Law* 417-418.

⁶⁶ Edgar 1990 *CTJ* 1141-1188.

3.3 Hybrid equity instruments

Distributions on equity instruments containing debt elements are subject to specific rules. Where a non-corporate shareholder receives a return on a hybrid equity instrument, there will be no credit that can be offset against the receipt as the return falls outside the integration rules which apply to taxable dividends.⁶⁷ In respect of corporate shareholders who receive dividends in relation to term preferred shares, guaranteed shares, and collateralised shares, the denial of the intercorporate deduction ensures the Canada Revenue Agency (hereafter the CRA) some protection from the abuse of the tax system.⁶⁸ In addition, the rules on taxable preferred shares (namely Part IV.I and Part VI.I tax) ensure that an appropriate amount of tax is paid on distributions on “preferred shares”.⁶⁹

3.3.1 The denial of the intercorporate dividend deduction

A dividend received by a Canadian resident corporation is usually included in the net income of the recipient and a specific deduction is granted, subject to specific requirements.⁷⁰ In effect, dividends paid from a Canadian corporation to another Canadian corporation (as shareholder) are usually received tax-free.⁷¹ However, specific rules exclude the intercorporate deduction based on the nature of the corporations involved,⁷² the type of shares held,⁷³ and the nature of the underlying agreement in respect of the share.⁷⁴ These provisions prevent the avoidance of tax liability by specific types of corporation that enter into after tax financing arrangements or develop instruments exploiting the difference in the tax treatment of interest and dividends.⁷⁵

Equity instruments coupled with agreements that secure repayment of the original investment are particularly attractive to taxpayers who cannot otherwise claim interest deductions.⁷⁶ The repayment can be secured by

⁶⁷ Section 82 read with s 12(1)(j) of the ITA 1985.

⁶⁸ Duff and Loomer *Taxation of Business* 243; Friedlander *Taxation of Corporate Finance* para 5-44; CCH *Canadian MTG* 581-582; Kerr 1989 *UT Fac L Rev* 671-672.

⁶⁹ Duff and Loomer *Taxation of Business* 260.

⁷⁰ Section 82 read with s 12(1)(j) and s 112(1) of the ITA 1985.

⁷¹ Section 112(6) of the ITA 1985; CCH *Canadian MTG* 581-582. Although the same result may be achieved in respect of intercorporate dividends in South Africa, it must be noted that s 64F of the ITA relies on a different mechanism, namely an exemption.

⁷² Section 112(2) read with s 248(1) of the ITA 1985, defining “dividend”.

⁷³ CCH *Canadian MTG* 581-582.

⁷⁴ Section 112(1) of the ITA 1985; Duff and Loomer *Taxation of Business* 243, 247-248; Friedlander *Taxation of Corporate Finance* para 5-44.

⁷⁵ Duff and Loomer *Taxation of Business* 247-248; Krishna *Income Tax Law* 423-424.

⁷⁶ Krishna *Income Tax Law* 423-424.

granting the shareholder rights to redeem, cancel or reduce share capital⁷⁷ or through less formal guarantees against risks.

The intercorporate deduction is denied mainly when dividends are paid by certain corporations on term preferred shares,⁷⁸ shares having protection or a guarantee attached to it,⁷⁹ collateralised preferred shares that allow the transfer of losses,⁸⁰ or shares that are part of a dividend rental agreement where one party carries the risk of loss while another party is entitled to the dividend.⁸¹

3.3.2 *The taxation of intercorporate dividends paid in respect of taxable preferred shares and short-term preferred shares*

Instead of denying the intercorporate deduction, two specific types of tax (Part IV.I and Part VI.I tax) apply to dividends paid in respect of taxable preferred shares⁸² and short-term preferred shares.⁸³ Part VI.I imposes tax on the paying corporation, irrespective of whether the recipient is an individual or corporation, whereas Part IV.I levies a tax on the recipient corporation in respect of dividends on taxable preferred shares.⁸⁴ The purpose is to prevent the transfer of losses, deductions and tax credits to corporate shareholders of taxable preferred shares in respect of which an appropriate amount of tax was not paid.⁸⁵ These taxes also prevent the use of after tax financing arrangements to obtain tax free distributions between

⁷⁷ Section 248(1) of the ITA 1985 defining "term preferred share" para (a)(iii); CCH *Canadian MTG* 583; Duff and Loomer *Taxation of Business* 248; Friedlander *Taxation of Corporate Finance* paras 5-48-5-49.

⁷⁸ Section 112(2.1) of the ITA 1985; s 248(1) of the ITA 1985 defining "term preferred share" para (a)(iii). The courts usually require a formal legal guarantee or indemnity by the corporation for the shares to be classified as term preferred. See *Citibank Canada v R* 2001 CanLII 592 (TCC) paras [21]-[22]; *Esplen v R* 1996 DTC 1272 (TCC) 1276; CCH *Canadian MTG* 582-583; Duff and Loomer *Taxation of Business* 247-248; Friedlander *Taxation of Corporate Finance* paras 5-48-5-49.

⁷⁹ Section 112(2.2)(a) read with s 112(2.4) of the ITA 1985.

⁸⁰ Section 112(2.4)-112(2.9) of the ITA 1985. However, the prohibition of the intercorporate deduction will not apply to exempt shares as defined; s 112(2.4)-112(2.9) of the ITA 1985.

⁸¹ Section 112(2.3) of the ITA 1985; s 248(1) of the ITA 1985, defining "dividend rental agreement" para (a)(i) and (ii); *Doris Trucking Company Limited v Minister of National Revenue* 1968 2 Ex CR 501, 505; *Jordan's Rugs Ltd v Minister of National Revenue* 1969 CTC 405 409-410; *CP Loewen Enterprises Ltd v Minister of National Revenue* 1993 1 CTC 2153; *McAllister Drilling Ltd v R* 1994 2 CTC 211.

⁸² Section 248(1) of the ITA 1985, defining "taxable preferred share".

⁸³ Section 248(1) of the ITA 1985, the definition of "short-term preferred share"; CCH *Canadian MTG* 583, 1314; Friedlander *Taxation of Corporate Finance* 5-69; Duff and Loomer *Taxation of Business* 260.

⁸⁴ Section 187.2 of the ITA 1985; Friedlander *Taxation of Corporate Finance* 5-77; CCH *Canadian MTG* 1278; Duff and Loomer *Taxation of Business* 260.

⁸⁵ Friedlander *Taxation of Corporate Finance* 5-77.

corporations in circumstances where certain guarantees are attached to shares.⁸⁶

The combined effect of the Part VI.I and Part VI.I taxes is that the tax paid corresponds to the rate at which interest would have been taxed if the recipient corporation were taxable at a rate of 28.5 per cent.⁸⁷ This tax rate reflects the approximate combined federal and provincial tax rate.⁸⁸ This tax treatment is appropriate as the substance of the taxable preferred shares often corresponds with debt instruments.

3.4 Hybrid debt instruments

When a distribution is made by a resident corporation on a hybrid debt instrument such as an income bond or debenture in respect of interest, it is treated as a deemed dividend for tax purposes – unless it is deductible for the company making the payment.⁸⁹ These deemed dividends are taxed like any other taxable dividend.⁹⁰ If the recipient is a corporation, the normal intercorporate dividend rules apply, and the dividend is deductible in terms of section 112 of the ITA 1985.⁹¹ However, if this interest is received as part of a return on an income bond granted to provide relief to a party experiencing financial difficulty, it is not deductible by the corporation paying it.⁹²

4 The taxation of company distributions on hybrid instruments in South Africa

4.1 The corporate tax structure in respect of company distributions

In South Africa, company and shareholder taxation is not integrated, but a hybrid dual rate system is applied.⁹³ The company first pays income tax on the amounts it receives, and then another layer of taxation – dividend

⁸⁶ Friedlander *Taxation of Corporate Finance* 5-77.

⁸⁷ CCH *Canadian MTG* 260.

⁸⁸ CCH *Canadian MTG* 260.

⁸⁹ Section 15(3) of the ITA 1985; Krishna *Income Tax Law* 429.

⁹⁰ Krishna *Income Tax Law* 429.

⁹¹ Krishna *Income Tax Law* 429.

⁹² Indirect transfers of value are regulated in s 51(2) of the ITA 1985, which deals with the conversion of shares or the debt of a corporation to shares in the corporation. Section 85(1)(e.2) of the ITA 1985 contains rules for the transfer of eligible property in exchange for shares; s 86(2) of the ITA 1985, addresses the exchange of shares by a shareholder in the course of the reorganisation of capital; and s 87(4) of the ITA 1985 deals with the exchange of shares on amalgamation, see s 18(1)(g) of the ITA 1985.

⁹³ Olivier and Honiball *International Tax* 76-77.

application of tax legislation.¹⁰⁴ The specific anti-avoidance measures seldom re-classify an instrument as either debt or equity, but may re-classify the income or capital distributed in relation to such instruments for tax purposes without altering the nature of the payment for other parties.¹⁰⁵ This re-classification is based on objective criteria and does not expressly depend on a determination by the Commissioner, although the Commissioner might invoke the GAAR or exercise other discretions under the *Tax Administration Act 28 of 2011* (hereafter the TAA), when appropriate.¹⁰⁶ The re-classification of the instruments or the returns usually ensures that distributions are taxable in accordance with their substance and not their form.¹⁰⁷ The ITA regulates hybrid equity instruments, third-party-backed shares, and hybrid debt instruments.

4.3 Hybrid equity instruments

A taxpayer may benefit from a distribution on a hybrid equity instrument as it cannot be classified as an amount transferred "in respect of a share" as required for dividends tax liability.¹⁰⁸ This distribution may escape dividend tax on this basis, or be subject to income tax only, depending on the circumstances.¹⁰⁹ However, the holder's right to a return may not be contingent on the company's performance or profits (as is generally the case for shares), but is based on agreement between the parties.¹¹⁰ The hybrid equity rules in section 8E prevent tax avoidance when a distribution is made on an equity instrument which contains elements of debt.¹¹¹ It targets the taxation of short-term investments redeemable by the investor, as these are essentially considered to be loans.¹¹²

The definition of hybrid equity instrument covers three alternatives. Firstly, it includes a share that is not an equity share, which places the issuer under an obligation to redeem the share within a three-year period from the date of its issue, or where the share may be so redeemed, in whole or in part,¹¹³

¹⁰⁴ West and West "Debt-Equity Conundrum" 640.

¹⁰⁵ Sections 8E, 8EA, 8F and 8FA of the ITA.

¹⁰⁶ West and West "Debt-Equity Conundrum" 640.

¹⁰⁷ Van der Zwan "Investment" 558.

¹⁰⁸ A causal link to the share is required. See s 1 of the ITA, definition of "dividend".

¹⁰⁹ Van der Zwan "Investment" 558.

¹¹⁰ De Koker and Williams *Silke on SA Income Tax* para 9.1; Clegg and Stretch *Income Tax* para 12.14; Stiglingh *et al Silke: SA Income Tax 2018* 518.

¹¹¹ De Koker and Williams *Silke on SA Income Tax* para 9.1; Clegg and Stretch *Income Tax* para 12.14; Van der Zwan "Investment" 558-559.

¹¹² Seligson 2011 *BTCLQ* 1.

¹¹³ Section 8(1)(a)(i) of the *Taxation Laws Amendment Act 34 of 2019* amended the phrase "in whole or in part" and replaced it with the distribution of a return of capital or foreign return of capital, which can also be done in whole or in part. This broadens

at the option of the holder.¹¹⁴ Secondly, it includes shares, redeemable within three years¹¹⁵ that either do not rank equally with equity shares or any dividend which is determined with reference to the time value of money.¹¹⁶ The third alternative includes preference shares¹¹⁷ secured by a financial instrument¹¹⁸ or linked to a financial arrangement which prohibits the disposal of the share if it is not issued for a "qualifying purpose".¹¹⁹ Preference shares issued for a qualifying purpose are not classified as hybrid equity instruments.¹²⁰

An amendment to extend the three-year period in paragraph (a) of the definition to ten years was contained in the *Draft Taxation Laws Amendment Bill, 2011* but not included in the final legislation.¹²¹ The definition of "date of issue" was amended to include redemption at a date in the future.¹²² The definition in paragraph (c) addresses this timing rule by extending its application to any preference share irrespective of the three-year redemption period.¹²³ In this part redemption is not mentioned. One could argue that the date of issue becomes irrelevant as any redeemable preference share could still be classified as a hybrid equity instrument in terms of paragraph (c) of the definition. Paragraph (c), however, is limited to preference shares secured by a financial instrument. This instrument is specifically defined as an interest-bearing arrangement, or an arrangement which applies a specified rate of interest or the time value of money.¹²⁴ Other forms of security will not suffice. If the share is secured by an interest-free arrangement, it does not fall within paragraph (c),¹²⁵ and the three-year

the scope of this definition to include the redemption of shares and returns of capital. Consequential amendments were also promulgated in s 8 of this Amendment Act to include arrangements that provide for the exercise of an option which requires a distribution of a return on capital, or foreign return of capital, in the definition of a hybrid equity instrument.

¹¹⁴ Section 8E(1) of the ITA, defining "hybrid equity instrument" para (a); Kruger *et al. Tax Strategy* 229-230.

¹¹⁵ Section 8E(1) of the ITA, defining "hybrid equity instrument" para (b)(i) (aa)-(cc).

¹¹⁶ Section 8E(1) of the ITA, defining "hybrid equity instrument" para (b).

¹¹⁷ Section 8E(1) of the ITA defining "preference share".

¹¹⁸ A "financial instrument" is defined in s 8E(1) of the ITA.

¹¹⁹ Section 8E(1) of the ITA, defining "hybrid equity instrument" para (c). S 8E(1) defines "qualifying purpose" by simply referring to the definition in section 8EA(1) of the ITA.

¹²⁰ Rudnicki 2013 *BTCLQ* 8.

¹²¹ Seligson 2011 *BTCLQ* 1, 2-3, 7 and 9 criticises the three-year limitation.

¹²² Section 8E(1) of the ITA, defining "date of issue".

¹²³ Rudnicki 2013 *BTCLQ* 2.

¹²⁴ Section 8E(1) of the ITA, 1962, defining "financial instrument".

¹²⁵ Rudnicki 2013 *BTCLQ* 3.

limitation in paragraph (a) will still apply as the subsections are disjunctive.¹²⁶

A dividend declared on a hybrid equity instrument is deemed to be income accruing to the recipient.¹²⁷ No exemptions from income tax are allowed as the amount already constitutes income as defined.¹²⁸ Because it is re-classified as income, amounts may be deducted from it as part of the normal computation of taxable income. No adjustment or re-classification is allowed in respect of this distribution in the hands of the company.¹²⁹ The company is treated as if a dividend has been paid, yet no dividend tax consequences arise from this transaction.¹³⁰ The tax treatment of hybrid equity is thus similar to the tax treatment of debt, which makes sense. Save for the amendment of the time limit, we find it appropriate that distributions received in respect of hybrid equity instruments be taxed as income.

4.4 Third-party-backed shares and instruments

In essence, a third-party-backed share is a preference share in respect of which the return or yield is guaranteed by another party.¹³¹ A specific anti-avoidance rule ensures that the substance of the transaction is taxable.¹³² This rule targets special-purpose vehicles using artificial financial arrangements.¹³³ It prevents the receipt of a tax-free dividend where a lender receives a return from the borrower, instead of interest.¹³⁴ The definition of a preference share does not include all equity shares, but only those which specifically determine the dividend payable at a specified interest rate, or with reference to the time value of money.¹³⁵

¹²⁶ See ss 8E(1)(b) and (c) of the ITA, defining "hybrid equity instrument", that are separated by the conjunction "or".

¹²⁷ Section 8E(2) of the ITA.

¹²⁸ Van der Zwan "Investment" 558-559. The interest exemption for natural persons under s 10(1)(i), for example, would not apply.

¹²⁹ De Koker and Williams *Silke on SA Income Tax* paras 9.1, 9.31A.

¹³⁰ De Koker and Williams *Silke on SA Income Tax* paras 9.1, 9.31A.

¹³¹ Clegg and Stretch *Income Tax* para 12.15; De Koker and Williams *Silke on SA Income Tax* para 9.34.

¹³² Section 8EA(1) of the ITA applies where a specific dividend or foreign dividend, return of capital, or foreign return of capital is guaranteed, or a return of capital is guaranteed in respect of a preference share by a third party who is not the party that issues the shares.

¹³³ De Koker and Williams *Silke on SA Income Tax* para 9.32.

¹³⁴ De Koker and Williams *Silke on SA Income Tax* para 9.32.

¹³⁵ Section 8EA(1) of the ITA.

The anti-avoidance rules in section 8EA of the Income Tax Act, 1962, apply to preference shares and equity instruments¹³⁶ in terms of which an enforcement right¹³⁷ is exercisable if a dividend or a return of capital is not received by, or does not accrue to the person entitled to it, and the holder has a right to enforce the payment of a dividend.¹³⁸ If the recipient receives an exempt dividend, or foreign dividend income in cash, on a third-party-backed share at any time during the year of assessment, it is deemed to be income of only that specific recipient and the paying company is treated as if a dividend has been paid.¹³⁹ No exemptions from income tax apply, and this distribution is not subject to the dividends tax provisions.¹⁴⁰ This "deemed conversion rule" applies to the income and not the instrument.¹⁴¹

A so-called "safe haven" rule applies if the consideration paid is used to acquire equity shares in an operating company.¹⁴² This exception allows the use of debt finance to acquire preference shares.¹⁴³ If the amounts are obtained from the issuing of preference shares for certain qualifying purposes¹⁴⁴ and by certain persons,¹⁴⁵ the shares will not be classified as third-party-backed shares.¹⁴⁶

The definition of equity instrument still limits the application of the provisions to situations where preference shares are involved, which, in turn, are defined to include only specific types of equity share. In the 2017 Budget Speech it was announced that the exceptions to this section are too narrow

¹³⁶ The value of the rights obtained under an equity instrument must be determined with reference to a preference share or an amount derived from it. See s 8EA(1) of the ITA, defining "equity instrument".

¹³⁷ The term "enforcement right" is defined in s 8EA(1) of the ITA.

¹³⁸ Section 8EA(1) of the ITA, defining "third-party backed share" read with s 8EA(3) of the ITA. The definition of equity instrument is wide as it refers to any instrument in respect of which an enforcement right is exercisable due to an amount not being received or not accruing to a person who is entitled to such an amount. See s 8EA(1) of the ITA, definition of "third-party backed instrument".

¹³⁹ Section 8EA(1) of the ITA, defining "third-party backed share". If the instrument no longer complies with the definition in the following tax year, the transaction will not be subject to the deeming rules. See De Koker and Williams *Silke on SA Income Tax* paras 9.1 and 9.34; Rudnicki 2012 *BTCLQ* 4.

¹⁴⁰ Section 8EA(2) of the ITA, read with s 8EA(1) of the ITA, defining "third-party backed share".

¹⁴¹ De Koker and Williams *Silke on SA Income Tax* paras 9.1, 9.32.

¹⁴² Section 8EA(3) of the ITA.

¹⁴³ De Koker and Williams *Silke on SA Income Tax* para 9.32; Van der Zwan "Investment" 563.

¹⁴⁴ Section 8EA(1) of the ITA, defines "qualifying purpose"; Rudnicki 2013 *BTCLQ* 6-8.

¹⁴⁵ In terms of s 8EA(3) of the ITA. See De Koker and Williams *Silke on SA Income Tax* para 9.32; Van der Zwan "Investment" 563; Rudnicki 2012 *BTCLQ* 5.

¹⁴⁶ Section 8EA(3) of the ITA, read with s 8EA(1) of the ITA, defining "qualifying purpose".

and may prevent legitimate transactions.¹⁴⁷ At the time of writing this article no amendments had yet been proposed.

4.5 Hybrid debt instruments and hybrid interest

A hybrid debt instrument is labelled as debt, but contains equity elements.¹⁴⁸ The specific anti-avoidance rules applicable to hybrid debt instruments entail a two-level approach.¹⁴⁹ First, the form and true nature (substance) of the instrument is evaluated.¹⁵⁰ Secondly, the return on that instrument is adjusted to be more closely aligned with the true substance of the payment.¹⁵¹ This prevents the company from structuring payments that are similar to dividends to resemble tax deductible interest payments.¹⁵² Otherwise the tax base would be eroded by a mismatch between the amounts deducted and the income inclusions or dividends.¹⁵³

A hybrid debt instrument is an interest-bearing arrangement or debt in terms of which the company owes an amount and there is an arrangement¹⁵⁴ to convert the instrument for shares, or the obligation to pay an amount is conditional on the market value of the assets exceeding the market value of the liabilities of the company, or the company owes an amount to a person connected to it and the company is not obliged to convert the amount.¹⁵⁵

The classification of an instrument as a hybrid debt instrument depends on the conversion rights or obligations exercisable under the instrument as a whole, and each tax year requires its own determination.¹⁵⁶ The deduction of interest incurred by a company in respect of a hybrid debt instrument is denied.¹⁵⁷ The instrument remains a debt instrument for all other purposes.¹⁵⁸ The interest is deemed to be a "dividend *in specie*" paid on the

¹⁴⁷ Anon 2017 *Taxgram* 3.

¹⁴⁸ SARS *Explanatory Memorandum* 2013 27.

¹⁴⁹ SARS *Explanatory Memorandum* 2013 27-28.

¹⁵⁰ SARS *Explanatory Memorandum* 2013 27-28.

¹⁵¹ SARS *Explanatory Memorandum* 2013 27-28.

¹⁵² SARS *Explanatory Memorandum* 2013 27-28.

¹⁵³ SARS *Explanatory Memorandum* 2013 27-28.

¹⁵⁴ An arrangement here refers to an arrangement as defined in s 80L of the *ITA*.

¹⁵⁵ Section 8F(1) of the *ITA*, defining "hybrid debt instrument"; Kruger *et al. Tax Strategy* 228.

¹⁵⁶ Section 8FA of the *ITA*. In terms of s 8F(3)(a) of the *ITA*, this classification is not applicable to a small business corporation in terms of s 12E, or certain tier 1 or 2 capital instruments as listed in the *Banks Act* 94 of 1990, the *Short-Term Insurance Act* 53 of 1998, and the *Long-Term Insurance Act* 52 of 1998. See ss 8F(3)(b) and 8F(3)(c) of the *ITA*.

¹⁵⁷ Section 8F(2)(a) of the *ITA*.

¹⁵⁸ SARS *Explanatory Memorandum* 2013 27-28.

last day of the year of assessment.¹⁵⁹ This payment is an exempt payment for income tax purposes.¹⁶⁰

The classification of a hybrid debt instrument is supplemented by the classification rules on hybrid interest.¹⁶¹ If an amount is classified as hybrid interest, its payment is re-classified as a "dividend *in specie*", irrespective of the nature of the underlying instrument.¹⁶² Hybrid interest is defined as interest determined without reference to a specific rate of interest or the time value of money.¹⁶³ In addition, if the rate of interest of a specific instrument increases on the basis of the increase in profit of the company,¹⁶⁴ the interest is re-determined at the increased rate less the lowest amount of interest on the instrument during that year of assessment and the previous five years.¹⁶⁵

The conversion of interest into a dividend *in specie* applies to the issuer of the instrument who will be taxable under normal income tax provisions, but is denied an interest deduction, whereas the recipient will be treated as having received a dividend *in specie*.¹⁶⁶ The instrument as a whole is considered, the classification is made in every year of assessment and not only when the instrument is issued, and a wide criterion for classification is used.¹⁶⁷ The interest will not be deductible from the time it becomes indebted.¹⁶⁸

Although both the issuer and the holder of the instrument are affected, the tax consequences for these two parties differ significantly. De Koker and Williams state that the conversion has tax consequences applicable only to the issuer of the hybrid debt instrument. This leaves the hybrid debt instrument as a debt in legal form, while for tax purposes the substance of

¹⁵⁹ Section 8F(2)(b) of the ITA. For an overview of the tax consequences see Da Silva 2015 *Without Prejudice* 23-24; Van der Zwan "Investment" 565; De Koker and Williams *Silke on SA Income Tax* para 9.32C.

¹⁶⁰ Section 10(1)(k)(i) of the ITA.

¹⁶¹ See s 8FA of the ITA for amounts incurred after 1 April 2014. For policy reasons, small businesses, bank-regulated capital, regulated insurers, certain pension funds, REITS, and long-term insurers are excluded from the hybrid interest rules and the hybrid debt instrument classification; see s 8FA(3) of the ITA.

¹⁶² Section 8F(2)(b) of the ITA.

¹⁶³ Section 8FA(1) of the ITA, defining "hybrid interest".

¹⁶⁴ Section 8FA(1) of the ITA, defining "hybrid interest".

¹⁶⁵ De Koker and Williams *Silke on SA Income Tax* para 9.32.

¹⁶⁶ De Koker and Williams *Silke on SA Income Tax* para 9.32C.

¹⁶⁷ Stiglingh *et al. Silke: SA Income Tax 2018* 555-556; De Koker and Williams *Silke on SA Income Tax* para 9.32C.

¹⁶⁸ Section 8FA the definition of "hybrid interest" and the definition of "issue".

the transaction is classified as equity.¹⁶⁹ This view is relevant as the taxation of a distribution of an asset *in specie* differs significantly from that of interest or a cash dividend. SARS regards this interest payment as potentially subject to dividends tax.¹⁷⁰ Although there is no specific definition of the phrase "dividend *in specie*" in the ITA, this SARS interpretation is correct, as the definition of a dividend in section 64E includes "any" dividend as defined, which also includes dividends *in specie*.¹⁷¹

5 Comparative analysis

5.1 Comparison of taxation of hybrid debt and hybrid equity in Australia, Canada, and South Africa

The comparative table below attempts to provide a practical illustration of the treatment of hybrid debt instruments and hybrid equity instruments in the three legal systems under consideration. It shows the effect where a distribution is made to individual (non-corporate) taxpayers resident for tax purposes in the same country as the company and taxed at marginal rates of 18% and 45% respectively. These rates represent the minimum and maximum marginal rates for South Africa¹⁷² and are comparable with those for Australia (19% - 45%).¹⁷³ Canada has both federal and provincial taxes on income and while federal rates range from 15% to 33%, the combined federal and provincial rate could be as much as 54% (Nova Scotia).¹⁷⁴ Given the diverging tax treatment of hybrid equity and hybrid debt at corporate tax level, the table shows the amount a company must earn in order to distribute the notional figure of 100 to the investor in each instance, although in practice return rates on debt and equity tend to differ in response to the tax consequences for the company and the investor. The calculation uses applicable corporate tax rates for companies not qualifying for special lower rates in Australia and Canada. For Canada, we assume the corporation is taxed in Ontario and thus apply the effective combined federal (15%) and provincial (11.5%) corporate tax rate.¹⁷⁵ Accordingly, we also apply the combined federal (15%) and Ontario (10%) imputation credit to

¹⁶⁹ De Koker and Williams *Silke on SA Income Tax* para 9.32C.

¹⁷⁰ SARS *Explanatory Memorandum 2013* 30.

¹⁷¹ See s 64E read with s 1 of the *ITA*, defining "dividend". Also see Van der Zwan in Stiglingh *et al. Silke: SA Income*.

¹⁷² Stiglingh *et al. Silke: SA Income Tax 2020* 21.

¹⁷³ Section 5 of the *Income Tax Act*, 1986; CCH *Australian MTG 2036-2037*.

¹⁷⁴ Duff and Loomer *Taxation of Business* 226-231.

¹⁷⁵ Government of Canada 2020 <https://www.canada.ca/en/revenue-agency/services/tax/individuals/topics/about-your-tax-return/tax-return/completing-a-tax-return/deductions-credits-expenses/line-40425-federal-dividend-tax-credit.html>.

the grossed-up amount.¹⁷⁶ Although the deductibility of interest-like payments depends on detailed rules based on factors such as the purpose to which the borrowed funds is applied, we assume that such returns on hybrid equity instruments will indeed be deductible by the distributing company. Our notional calculation is an over-simplification that disregards other corporate and personal income and does not consider taxes on capital gains. In both Australia and Canada, the investment income of the recipient of the distribution forms part of the normal income tax computation and may thus be further reduced by other deductions and exemptions.¹⁷⁷ This is not the case in South Africa, where the dividend is mostly exempt from income tax and the withholding tax levied on dividends applies, as a final tax on the gross amount of the dividend.¹⁷⁸

¹⁷⁶ Section 121(b)(iv) of the Canadian ITA 1985 provides that the credit is 6/11 of the amount added as a gross-up. This equates to 15.0198% of the total grossed-up value of the dividend, $(6/11 \times 38) / 138 = 15.0198\%$, which we rounded to 15%.

¹⁷⁷ Section 12(1)(j) and (k) read with s 82 of the Canadian ITA 1985; CCH *Canadian MTG* 178; s 44(1)(b) of the Australian ITAA 1936; Taylor "Australia" 6.

¹⁷⁸ S 10(1)(k) of the ITA; Stiglingh *et al Silke: SA Income Tax 2020* 701-702.

Table 1: Comparative illustration of tax on hybrid instruments

Type of instrument	Hybrid debt instruments										Hybrid equity instruments	
	Australia		Ontario Canada		South Africa		All three jurisdictions					
	18%	45%	18%	45%	18%	45%	18%	45%	18%	45%	18%	45%
Jurisdiction												
Individual marginal tax rate												
<u>Corporation level tax:</u>												
Corporate income	143	143	136	136	136	136	139	139	100	100	100	100
Corporate deduction	0	0	0	0	0	0	0	0	100	100	100	100
Pre-tax income	143	143	136	136	136	136	139	139	0	0	0	0
Corporate tax	43 (30%)	43 (30%)	36 (15% + 11.5%)	36 (15% + 11.5%)	36 (15% + 11.5%)	36 (15% + 11.5%)	39 (28%)	39 (28%)	0	0	0	0
Corporate income after tax	100	100	100	100	100	100	100	100	100	100	100	100
<u>Investor level tax:</u>												
Distribution	100	100	100	100	100	100	100	100	100	100	100	100
Dividends tax (SA)							20 (20%)	20 (20%)				
Gross-up	43 (100% franked)	43 (100% franked)	38 (38% of 100)	-	-	-	-	-	-			
Individual taxable income	143	143	138	138	138	138			100	100	100	100
Individual tax	25.7 (18% of 143)	64 (45%)	24.8 (18% of 138)	62 (45%)	62 (45%)	18 (18% of 100)	18 (18% of 100)	18 (18% of 100)	45 (45% of 100)			
Imputation credit	43	43	34.5 (15% + 10% of 138)	-	-	-	-	-	-			
Net investor/withholding tax	0 (-17.3)	21	0 (-9.7)	0 (-9.7)	0 (-9.7)	0 (-9.7)	20 (final)	20 (final)	18	18	45	45
Investor net income	100	79	100	100	100	100	80	80	82	82	55	55
Combined tax (rate)	43 (30% of 143)	64 (45% of 143)	36 (26.5% of 136)	36 (26.5% of 136)	36 (26.5% of 136)	63.5 (46.7% of 143)	59 (42.4% of 139)	59 (42.4% of 139)	18 (18% of 100)	18 (18% of 100)	45 (45% of 100)	45 (45% of 100)

5.2 The effect of the corporate tax structure

The corporate tax structure in both Australia and Canada creates an incentive to invest in equity as opposed to debt, as certain shareholders are able to apply a tax credit to reduce their eventual tax liability if dividends were distributed to them. The integration of shareholder and corporate level tax in these two jurisdictions nevertheless results in the taxation of dividends at the marginal tax rates of the individual shareholders (or the flat rate that applies to companies in Australia only). In South Africa, by contrast, dividends are taxed at a flat rate of 20%. The exemption for dividends under s 10(1)(k) results in their exclusion from income taxed at the taxpayer's marginal tax rate. The Davis Committee is correct in its analysis that for shareholders taxed at a marginal rate in excess of the effective combined corporate and dividend rate of 42,4 per cent, there is an incentive to receive dividends. But most taxpayers are subject to lower marginal rates and are disincentivised from equity investment. Unlike in Australia and Canada, the application of the rules of the corporate tax structure in South Africa results in a compromise of progressivity, which undermines the principle of equity. South Africa would do well to consider a more equitable corporate tax structure.

5.3 The classification of hybrid instruments for tax purposes

All three of the jurisdictions analysed rely on specific rules to prevent the circumvention of the normal tax consequences of company distributions through the use of hybrid instruments. Different approaches were observed.

Australia classifies most instruments as either debt or equity, which is a commendable approach from the perspective of simplicity. The classification of a debt instrument is based on whether the payment of a return depends on the performance of the entity or is contingent in any way, while equity instruments are classified in terms of a list of characteristics contained in legislation. Classification depends on clear principles and normal legal terminology which is easier to apply than the unique terminology in the South African legislation. The Australian effort of enhancing clarity through specific classification lists for equity instruments enables legislators to better align the law with the speed at which new instruments are developed, as such lists can be changed reactively to include new transactions without changing the underlying legal principles. The specific rules regulating distributions on hybrid instruments provide added protection for the tax base.

In contrast, Canadian tax legislation requires that each transaction be judged based on the nature of the underlying agreement. It then re-classifies amounts, or applies other rules in respect of specific types of shares. If an amount is paid to an individual in respect of a hybrid debt instrument, this distribution is re-classified as a deemed dividend in relation to certain hybrid instruments. If a dividend is paid to a corporation on shares that are guaranteed, or issued with preferential terms, or that contain debt-like elements, the inter-corporate dividend deduction is denied. This discourages the use of hybrid instruments. The Canadian rules are quite varied, complex and comprehensive, leaving very little room for tax planning through distributions on hybrid instruments.

The South African ITA, like the Canadian ITA 1985, regulates the taxation of hybrid instruments without classifying the nature of the instrument as either debt or equity. In most cases the distribution is re-classified only so as to calculate the tax liability of the recipient, while the nature of the payment remains unchanged from the company's perspective.

As South African tax legislation defines hybrid instruments as either hybrid equity instruments, hybrid debt instruments, or third-party-backed shares, and applies different rules to the reclassification of distributions on them, the comparison below considers the treatment of each of these in the different jurisdictions, despite differences in terminology.

5.4 Hybrid equity instruments

The jurisdictions observed use different terminology to classify hybrid equity instruments. Australia refers to these as non-equity shares while Canada classifies them as term preferred shares, taxable preferred shares, or guaranteed shares, and South Africa uses the term hybrid equity instrument. The tax rules for distributions on these instruments also differ. Although the general rules in Australia classify an instrument as either debt or equity, specific anti-avoidance rules apply to non-equity shares, which is the Australian equivalent of South Africa's hybrid equity instruments. A distribution made on non-equity shares is taxable as a frankable dividend if a company derived profit corresponding to the taxation of dividends on "normal" equity instruments. However, if no profit was derived, this dividend is not frankable and the rules of the imputation system will not apply to it. These rules send a clear message that the policy rationale is to link the normal risks of investing in equity instruments to the tax consequences that apply to a distribution in respect of hybrid equity instruments. This could encourage investment in equity shares where the gross-up and credit

mechanism applies to all dividends, irrespective of whether or not the company actually derived profit.

In Canada, the inter-corporate dividend deduction is denied for dividends paid to corporate shareholders on term preferred shares or guaranteed shares (hybrid equity instruments). When a distribution is made to an individual or a corporation on such an instrument, the taxable preferred share rules might apply. The definition of a taxable preferred share is wide and includes the granting of conversion or redemption rights, a guarantee arrangement, or other preferences or conditions attached to these shares that are not ordinarily available to equity shares. This wider approach is commendable and an approach which South Africa could consider in future to broaden its tax base. In contrast, the hybrid equity rules in South Africa have many exclusions and limitations (such as the qualifying purpose exclusion, the linking of the equity share definition to preference shares and limitation of the form of security to instruments linked to the specified interest rate or time value of money), which could lead to distributions on hybrid equity escaping tax liability.

In terms of section 8E of the South African ITA, dividends paid in relation to hybrid equity instruments are re-classified as income in the hands of the recipient. Section 8E applies to hybrid equity instruments as defined. Amongst other requirements, this definition demands that the instrument must not be an equity share and must contain an obligation or option for redemption within three years. This requirement creates anomalies and restricts the ambit of the rules regulating hybrid equity. We think that shares redeemable at any stage should be classified as hybrid equity instruments. This corresponds to the Canadian approach to term preferred shares and taxable preferred shares, which, although subject to different rules, in principle attaches no time limit to the conversion or redemption of the hybrid equity instruments. Both short-term and long-term arrangements are targeted in Canada, and the characteristics of the instrument and extent of control of the investor are emphasised, while specific additional rules apply to short-term preferred shares. South Africa could learn much from Canada's approach. The removal of a time limit will clarify the perceived uncertainty concerning the time of the redemption and broaden the tax base to include both short- and long-term arrangements. This would enhance neutrality and horizontal equity and also align with the timing rules for hybrid debt instruments, which require continuous evaluation for each year of assessment.

5.5 *Third-party-backed shares*

In addition to hybrid equity instruments, distributions made in respect of a further category of hybrid instruments, third-party backed shares, are separately regulated in South Africa. If a share is defined as a third-party-backed share (a share with an enforcement right attached to it), a distribution made in relation to it is re-classified as income in South Africa. In Australia, the rules on non-equity shares would apply in respect of such an instrument. The Canadian approach is to regard distributions made in respect of shares with a guarantee against loss as taxable in principle. This is achieved by denying the inter-corporate dividend deduction. Similarly, the rules on taxable preferred shares, which could include an obligation to pay a return on the investment, impose tax liability for distributions on such shares in a manner similar to interest on debt instruments. Thus, although the detailed rules may differ, the basic principles in all three jurisdictions correspond. This makes sense as the substance of the investment agreement is closer to a debt instrument.

The South African rules applicable to distributions on third-party-backed shares pertain to "equity instruments". This concept includes preference shares only. We consider an even wider approach to be necessary, and that any share which includes a guarantee against loss or an enforceable right to claim a distribution attached to it should be subject to these rules. This would broaden the scope of the third-party-backed share rules significantly. Once again, South Africa could learn from the wider ambit of the Canadian inter-corporate dividend deduction and taxable preferred share rules.

Further, the exclusion from the third-party-backed share rules that apply to trusts, associations, non-profit organisations, and operating companies in the mining industry as well as listed companies, limits the scope of application of these rules and could be reconsidered. Such anomalies could be avoided if South Africa followed the Australian approach.

5.6 *Hybrid debt instruments*

While the terminology and mechanisms differ, the specific rules on hybrid debt instruments achieve a similar goal in each jurisdiction. In Australia, returns on non-share equity instruments are taxable as non-share dividends, are included in assessable income and are frankable as part of the imputation system, and so taxed similarly to returns on regular equity instruments. Canada also taxes returns on hybrid debt instruments in the same way as other returns on equity instruments through a deemed-

dividend rule. Both of these approaches make sense as the substance of the instrument resembles equity despite its formal debt instrument label. In South Africa, the payment of hybrid interest or a distribution made in respect of a hybrid debt instrument is deemed to be a "dividend *in specie*" for the recipient. The company making the distribution is taxed as if interest had been paid. However, this interest is specifically disallowed as a corporate deduction, as is also the position in Australia and Canada.

In principle, the Canadian approach of taxing such a distribution as a deemed dividend is one we suggest South Africa adopt. We recommend that the phrase "dividend *in specie*" be replaced with "dividend". As the payment of interest is, in the main, an amount rather than an asset, we also recommend that a return on a hybrid debt instrument be treated as a deemed dividend. This will result in the tax liability falling onto the recipient, while the company would not qualify to deduct the distribution as interest – in other words, the normal tax treatment of a distribution of dividends in respect of equity shares. Following the Canadian approach would improve the clarity of the South African legislation and would also align the South African rules with those in Australia.

Further, to ensure that the payment of interest in the form of assets such as convertible notes or negotiable instruments is included in the deeming provision, we suggest that assets paid as "interest" be taxable as a distribution of an asset *in specie*. This would align the taxation of assets distributed in relation to hybrid debt instruments with that applicable to shares. It would also promote certainty and equity, as the tax implications would follow the substance rather than the form of the instrument.

6 Conclusion

It remains challenging to develop tax rules for distributions on the many possible variants of hybrid instruments. Shaviro and Messere state that the only sensible way of reforming tax legislation in this context is to apply a reactive piecemeal method that discourages specific transactions.¹⁷⁹ This approach is evident from the tax legislation of Australia, Canada and South Africa, where rules were developed and adjusted from time to time to suit each jurisdiction's unique tax environment.

Despite their having differing corporate tax structures, the rules in Australia, Canada and South Africa perform a similar function of taxing distributions

¹⁷⁹ Shaviro 2008 *Financial Crisis* 17-18; Messere *Tax Policy in OECD Countries* 332-333.

on hybrid instruments in accordance with their substance and not their form. This enhances certainty for both the taxpayer and the *fiscus*, conforming to this well-known maxim of taxation. As the SARS is faced with an economic crisis in South Africa and specific revenue collection targets to address the budget deficit, there is a risk that tax collection might become more aggressive in future. Taxpayers should therefore not be ignorant of the rules on the taxation of distributions in respect of hybrid instruments. Similarly, caution should be exercised before an investor is lured into investing in instruments or schemes that promote the possibility of escaping tax, no matter how lucrative the tax planning might seem at face value. The application of the specific rules in this context requires expert analysis, which could also significantly increase the costs of compliance for investors.

Unless investment in equity instruments is incentivised, taxpayers will continue using hybrid instruments in tax avoidance schemes and legislatures will respond by adjusting existing anti-avoidance measures. South Africa can learn two important lessons from Australia and Canada. First, noting the more prominent incentivising of equity investment in Australia and Canada, it should revisit its corporate tax structure to incentivise broad-based equity investment. Secondly, it should aim for a more robust approach to curbing the avoidance of the normal tax rules. In this regard, the comparative perspective indicates that Australian and Canadian principles such as the removal of time limits in classification rules and a broadening of the instruments to which the rules apply, would strengthen the current South African approach to the taxation of hybrid instruments.

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List of Abbreviations

AT Rev	Australian Tax Review
BTCLQ	Business Tax and Company Law Quarterly
BIFD	Bulletin for International Fiscal Documentation
BIT	Bulletin for International Taxation
BTR	British Tax Review
CTJ	Canadian Tax Journal
CRA	Canada Revenue Agency
DFI	Derivatives and Financial Instruments
GAAR	General Anti-Avoidance Rule
IFA	International Fiscal Association
Int Rev Finance	International Review of Finance
ITA	Income Tax Act 58 of 1962
ITAA 1936	Income Tax Assessment Act 1936
ITAA 1997	Income Tax Assessment Act 1997
MTG	Master Tax Guide
NTJ	National Tax Journal
OECD	Organisation for Economic Co-operation and Development
Osgoode Hall LJ	Osgoode Hall Law Journal
REITS	Real Estate Investment Trusts
SARS	South African Revenue Service
SAYIL	South African Yearbook on International Law
TAA	Tax Administration Act 28 of 2011
UT Fac L Rev	University of Toronto Faculty of Law Review
WTJ	World Tax Journal