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# Global Tax Alert

## South African National Treasury proposes targeted anti-avoidance rules for certain preference share arrangements and muddies scope of hybrid equity instrument definition

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The Taxation Law Amendment Bill No 18 of 2019 (the Bill) was tabled in Parliament on 30 October 2019 by the South African Minister of Finance. The Bill which will be considered and eventually adopted by Parliament proposes an amendment to section 8E of the *Income Tax Act* (s8E) that neither reflects the proposed change in the draft version of the Bill published for comments in July 2019 nor appears to have invited adequate public consultation.

s8E deems dividend receipts in respect of an equity instrument that would ordinarily be treated as exempt dividend income as income subject to normal tax where such instrument constitutes a "hybrid equity instrument."[1] The July draft of the Bill had sought to re-characterize dividends to normal income for holders of preference shares where those distributions constituted a return of capital within three years of the issue date of the underlying instrument. The targeted anti-avoidance measures had sought to prevent preferential tax treatment for synthetic preference share redemptions that had no corresponding redemption of the referenced share instrument and were broadly welcomed during the public consultation process.[2]

The surprise amendment to s8E in the October Bill stems from inserted wording that seemingly extends the *hybrid equity instrument* treatment to distributions "determined with reference to the issue price of that share" (the Amendment). The Amendment applies to all years of assessment ending on or after 21 July 2019.

There is uncertainty as to whether the Amendment is to be accorded ordinary literal interpretation (in which case a dividend calculated as a yield on issue price, a common feature of preference shares, would be included) or given purposive interpretation in line with the July draft of the Bill targeting distributions of a capital nature that reduce contributed tax capital in relation to a share and hence qualify as a return of capital. Literal interpretation will mean that holders of qualifying preference shares will be subject to normal tax on the tainted distributions in years of assessment ending on or after 21 July 2019 instead of the exempt dividend treatment that would otherwise apply.[3] Such re-characterization will present a fundamental and deliberate change to how these instruments have been taxed historically. It will also represent a fundamental departure from taxpayer expectation of the contemplated change to s8E in the October Bill being limited to the July proposals targeted at capital distributions in the first three years.

Given these concerns and the lack of clarity to date, it is possible that the draughtsman had not intended the ensuing interpretation of the Amendment.

If there was however a deliberate intention to expand the scope of the *hybrid equity instrument* definition then it is unclear at this stage what National Treasury's policy rationale is and why it has not followed due process. Holders of preference shares who receive distributions calculated as a yield on issue price should monitor developments in this area in the lead up to the Bill being promulgated into law.

## Endnotes

1. s8E(2) ITA 1962.
2. The July draft of the Bill and accompanying draft Explanatory Memorandum clarified references to the *hybrid equity instrument* definition in s8E(1) to include obligations to redeem *part of a share* within three years from the date of issue. A *part redemption of a share* referred to *a distribution of an amount constituting* ***a return of capital or a foreign return of capital***, i.e., a return of capital originally contributed by the holder.
3. All funding preference shares that commonly determine dividends on a subscription price with reference to a specified rate of interest or the time value of money will be caught by the proposals.

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