



# DAUDS ADVISORY

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## The Debt/Equity Conundrum : Tax

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### Introduction

1. In an environment of rapid financial innovation, this a question that continues to battle many a practitioner in several jurisdictions, South Africa being one of them. Taxpayers are generally familiar with the traditional attributes of, for instance, debt. They include:
  - the right to periodic payments until maturity of the debt obligation (equity investments do not usually make periodic payments – dividend declarations are at the discretion of the company’s board);
  - the right to enforce the payment of interest and principal (equity holders do not have the right to force a company to declare a dividend or return capital);
  - in the case of bankruptcy, the right of the debtholder to whatever is left of the proceeds of the company ahead of the shareholders.
2. However, it is not uncommon for debt covenants to accord lenders the right to:

- appoint some of the directors of the borrowing company;
  - share in the profits of the company; and
  - attend and vote at general meetings (although the JSE Listing Requirements may well declare that these votes are, in certain circumstances, not to be counted)
3. The point is, these rights bear the hallmarks of equity capital.
4. On the other hand, you have the traditional attributes of equity capital which include:
- the assumption of risk which is associated with embarking on a corporate venture;
  - the equity holder's right to appointed the company's directors and to vote on important matters pertaining to the company (however, with the advent of the class of non-voting shares, a fairly common phenomenon in the US, the significance of voting rights in the determination of whether an issue is debt or equity has been reduced to a large degree); and
  - the right of equity holders to, as residual claimants, appropriate the profits of the company to the exclusion of the creditors once all the liabilities had been settled.

#### **Relevance of the distinction between the two instruments**

5. The distinction between debt and equity is an important one in view of the radically different tax treatment each is accorded. The servicing of debt capital in the form of interest payments is tax deductible since our Income Tax Act [more particularly, section 11(a) read with section 23(g)] generally views such an expenditure as one incurred in the production of income. By contrast, the servicing of equity capital in the form of dividend payments is not considered a deductible expense. The relief for this form of treatment comes in the form of the non-taxation of dividends.

6. The thing that brings capital raisers and investors together is the fact that the one needs what the other is willing to offer at a return. Beyond this the parties will differ on their desired treatment of the payments made and received in respect of the servicing of the capital. From the capital provider's point of view, he would prefer not to be taxed on any receipts, and this is achievable where the receipts constitute dividends. Since the dividends are not taxable in the hands of the recipient, they are not deductible by the payer either. The capital raiser would prefer to have any payments made towards the servicing of the capital deducted, which is only achievable if the capital constitutes debt. In this case though, the recipient of the payments under the debt obligation cannot escape tax on those receipts.
  
7. These competing preferences have given rise to all sorts of variations to debt and equity capital in pursuit of parties' objectives. An early variation included the conversion of a medium-term loan into redeemable preference shares. The variation was made easy by the persistence of our tax laws to treat preference shares as equity when they exhibit all the hallmarks of debt. In the case of redeemable preference shares, the term of redemption often coincides with what would otherwise have been the period of the loan. And, in fixing the dividend rate applicable to the shares, the parties will often take account of the fact that the dividend is tax-exempt in the hands of the recipient and the capital raiser will therefore bargain for a dividend rate that is lower than the interest rate on an equivalent medium-term loan would have been. However, as bright an idea as this might have seem 20 years ago, the many options now available to tax practitioners make the use of redeemable preference shares, instead of medium-term loans (which the shares actually are), look ancient.
  
8. Neither our tax law nor the companies law provides any guidance on how to distinguish between debt and equity. In the absence of any assistance from the legislature, the next port of call is case law. However, case law has not been helpful

either. This means that parties who enter into commercial transactions are left to their own devices. This has led to several permutations of debt and equity, with the tax authority accusing tax practitioners of pushing the boundaries and the practitioners declaring that they are merely doing what the current legislative environment permits them to. In any event, the tax authority can no longer simply look for the tell-tale attributes in an instrument and then conclude on the basis of only that the instrument constitutes either debt or equity. Such an approach does not accord with commercial reality. In fact, it might well be considered archaic, lacking the ability to move with the times.

9. Consider the following scenario:

A company or financial institution approaches the capital market to raise capital. It ponders its options and, with the input of its advisers, decides to issue debt securities with a 100-year maturity. The debt pays interest at 10% per annum and ranks senior, i.e. in the event of default, the debtholder beats the other creditors to the front of the queue to grab whatever cash is left of the sinking ship until the holder's claim is satisfied whereafter it will be the other creditors' turn. In the event of default, the debtholder may accelerate the payment of principal and force the issuer into bankruptcy if the demand for payment is not satisfied. The debtholder is not accorded any voting rights in the debt covenant, and has no right to appoint any of the directors of the issuer. Furthermore, the debt is not convertible into ordinary shares nor are payments to the holder computed with reference to the profitability of the issuer. The question is, how should the instrument be characterized – as debt or as equity?

10. The tax authority would probably make much of the fact that the security only matures in 100 years, contending that it is an unreasonably long maturity. Their argument will probably go along the lines that, presumably, a person who lends

money wants it back, at least in the foreseeable future, but there appears to be no expectation from the long maturity that the money would ever be paid back. Furthermore, that a person who chooses to provide debt capital instead of equity capital does so to avoid the risks associated with equity investment. And, the longer the term of the loan, the more exposed the lender is to the risk that the issuer might default on its debt obligations, the type of risk a debt capital provider would preferably avoid. Therefore, the tax authority would probably argue, even though the instrument might exhibit a good number of debt attributes, it is really equity since the lender and borrower must have been agreed at the outset that the principal would never be repaid. The consequence of this characterization is that payments toward the servicing of the debt, which the issuer thought were interest, would suddenly not be allowed as a deduction by the South African Revenue Service (SARS).

11. On the face of it, the debt attributes outweigh the equity attributes. The bone of contention, though, is the 100-year maturity. This is so because time value of money is ignored. The value of an amount that has to be repaid in the future diminishes over time, and the more distant the future the more significant the reduction in value. By way of illustration, take R100 million debt that pays interest at 10% per annum and matures in 100 years. The amount that has to be repaid upon maturity will today only be worth R7,256.58. This comes from the following computation:

$$PV = \frac{C_t}{(1+r)^t}$$

Where,

$C_t = R100m$

$r = 10\%$

$t = 100 \text{ years}$

PV is therefore = R7,256.58

12. The amount to be paid at maturity is therefore a mere fraction of the initial investment. Most of the value of a long-term debt instrument derives from the periodic interest payments and not so much the principal repayment since the latter will be quite insignificant at maturity. However, the insignificance of the principal at maturity does not, without more, convert the debt capital into equity capital, with the concomitant denial of interest deductions. Besides, self-amortizing home loans and several other instalment obligations retain their debt character even when no principal is payable at maturity.
  
13. Probably the most fallacious assumption is, for instance, that a R100 million debt obligation which pays interest at 10% per annum and matures in 100 years has an actual life of 100 years. It doesn't.