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Tax and Legal News

June 2020

COVID-19 cash flow management and debt subordinations

Implementing subordination agreements due to cash flow difficulties may result in tax consequences.

The global community is going through unprecedented financial difficulties due to the effects of COVID-19. It is also not surprising that revenue authorities are seeking to preserve their tax base as much as possible, especially in light of the stimulus packages that are being implemented. One such method Revenue Authorities, of which the South African Revenue Service (**SARS)** is no exception**,** may apply is to closely monitor and review transactions entered into during this difficult period.

One mechanism that taxpayers may employ to manage cash flows could be to (re)negotiate for payment deferrals and enter into subordination agreements on current loan agreements. These agreements may assist taxpayers to ease their liquidity burdens and usually contain an undertaking by the creditor of a struggling debtor to refrain from demanding payment until the occurrence of a specified future event (or any undertaking of a similar nature). The issue, however, from the perspective of SARS, is that these arrangements may exhibit characteristics of hybrid instruments, ie debt having the characteristics of equity. As a result, the anti-avoidance provisions in the Income Tax Act[1] (**the Act**) that seek to negate the effects of any hybrid debt instruments may be triggered.

What are the tax implications for subordination agreements?

[1] No 58 of 1962, as amended

The Act[2] provides that any interest incurred in respect of a hybrid debt instrument (**HDI**) is non-deductible. Furthermore, any interest incurred in relation to a HDI is deemed to constitute a dividend *in specie*[3] which attracts dividends tax at a rate of 20%.

There are three types of HDIs and one of the three envisaged in the Act applies where the taxpayer's obligation to pay an amount has been deferred in terms of a subordination agreement and the deferral is a function of the market value of the taxpayer's assets exceeding its liabilities.

In what situations will the aforesaid anti-avoidance provisions not apply?

Apart from the matters highlighted above you would also need to consider:

— Whether there is certification from a registered auditor[4] providing that the payment, by the taxpayer, in terms of an instrument has been deferred by reason of the taxpayer's market of assets being less than the amount of liabilities. If the aforesaid certification is available then the tax implications indicated may not apply.

— Due to the wording of the definition of the HDI, and with reference to the specific terms and conditions of the subordination agreement, there are circumstances in which merely having a subordination agreement in place may not necessarily result in the HDI anti-avoidance provisions finding application.

How can we help?

We are have a team of highly skilled and experienced tax practitioners that can help you to review transactions entered into during this time of uncertainty for any adverse tax implications.

Contact us

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[2] Section 8F

[3] In the hands of the creditor, the dividend is deemed to be an exempt dividend.

[4] As contemplated in the Auditing Profession Act, 2005 (Act No. 26 of 2005)

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Regards
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FOOTNOTES

[1] No 58 of 1962, as amended

[2] Section 8F of the Act

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