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AN ANALYSIS OF THE FACTORS LEADING TO DIVERGENCE BETWEEN THE TAX AND FINANCIAL REPORTING CLASSIFICATION OF FINANCIAL INSTRUMENTS ISSUED BY CORPORATE TAXPAYERS

by

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Abstract

AN ANALYSIS OF THE FACTORS LEADING TO DIVERGENCE BETWEEN THE TAX AND FINANCIAL REPORTING CLASSIFICATION OF FINANCIAL INSTRUMENTS ISSUED BY CORPORATE TAXPAYERS

by

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Determining with certainty how the tax authorities will treat a particular financial instrument issued is not straightforward, and this poses a risk to corporate taxpayers tasked with generating shareholder value and predictable shareholder returns.

The tax classification of financial instruments, as either debt or equity instruments, may have a profound impact from a corporate taxation perspective and the reclassification of financial instruments by a tax authority, in an unanticipated manner, can alter expected tax consequences.

Previous studies have placed less emphasis on the potential discrepancies between the debt or equity classification of financial instruments from a tax-versus-corporate-reporting perspective and the reasons for such potential discrepancies.

This study aims to identify potential factors, giving rise to divergent financial instrument classifications between tax and financial reporting, in order to gain insight into the reasons for the potential divergence.

The research objectives of the study are to determine whether there is incongruity between the tax and accounting classification of selected financial instruments; to identify the factors giving rise to a possible incongruent outcome; and to evaluate the reasons for

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incongruity, in order to gain insight into the differing objectives of taxation and corporate reporting.

Case studies were obtained from the technical department of a large accountancy firm in South Africa to analyse specific fact patterns.

It was found that incongruence exists between the financial reporting and taxation classification of financial instruments from the perspective of the issuer of those instruments. This incongruence was attributed to the impact of contingent settlement provisions and the rules-based approach adopted by tax authorities, as opposed to the principle or substance-based approach favoured by financial reporting.

The incongruence noted suggests that, based on their differing objectives, financial reporting favours the classification of financial instruments as debt whilst taxation favours the classification of financial instruments as equity.

Although the approaches currently followed by financial reporting and taxation are different, recent taxation amendments have incorporated financial reporting guidance into the Income Tax Act 58 of 1962. Future research can be conducted to determine the impact of aligning financial reporting and taxation principles on tax certainty from a taxpayer perspective.

Keywords:

financial instruments

financial reporting

tax

corporate tax

debt instruments

equity instruments

tax classification

accounting classification

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Abstrak

‘N ANALISE VAN DIE FAKTORE WAT AANLEIDING GEE TOT DIE UITEENLOPENDE KLASSIFISERING VAN FINANSIËLE INSTRUMENTE UITGEREIK VIR FINANSIËLE VERSLAGDOENING EN BELASTINGDOELEINDES VANUIT DIE KORPORATIEWE BELASTINGBETALER SE PERSPEKTIEF

deur

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Die voorafbepaling van die hantering van finansiële instrumente deur die belastingowerhede is nie eenvoudig nie en verteenwoordig ‘n risiko vir korporatiewe belastingbetalers wat aandeelhouerswaarde en voorspelbare aandeelhoueropbrengste moet lewer.

Die klassifisering van finansiële instrumente as skuld- of ekwiteitsinstrumente het ‘n diepgaande impak vanuit ‘n korporatiewe belastingperspektief. Die herklassifisering daarvan deur die belastingowerhede op ‘n onvoorsiene wyse, kan onverwagte belasting-gevolge inhou.

Vorige studies het minder gefokus op die potensiële inkongruensie tussen die skuld- of ekwiteitklassifikasie van finansiële instrumente vanuit ‘n belasting- versus ‘n finansiële verslagdoeningsperspektief. Hierdie studie poog om groter insig te ontwikkel en faktore te identifiseer wat sodanige uiteenlopende klassifisering van finansiële instrumente veroorsaak.

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Die navorsingsmikpunte is as volg: om te bepaal of verskille opgemerk word tussen die onderskeie belasting- en rekeningkundige klassifiserings van geselekteerde finansiële instrumente; om die faktore te identifiseer wat aanleiding gee tot die potensiële verskille, en om die onderliggende redes vir potensiële uiteenlopende klassifikasie te ontleed ten einde insig te kry tot die verskil in oogmerke van die dissiplines van belasting en korporatiewe verslagdoening.

Gevallestudies is van die tegniese afdeling van ‘n groot rekeningkundige firma in Suid-Afrika verkry ten einde spesifieke feitestelle daarin te analiseer.

Die gevolgtrekking van die studie is dat, vanuit die uitreiker van ‘n finansiële instrument se perspektief, daar beduidende verskille tussen die finansiële verslagdoening- en belastingklassifikasie van geselekteerde finansiële instrumente bestaan.

Die verskille is toegeskryf aan die impak van voorwaardelike skikkingsvoorwaardes, asook die reël-gebaseerde benadering van belastingowerhede, teenoor die wese-bo-vorm -beginsel wat in finansiële verslaggewing toegepas word.

Die waargenome verskille suggereer dat, vanweë die verskil in oogmerke, finansiële verslagdoening neig om finansiële instrumente eerder as skuld te klassifiseer, terwyl belastingwetgewing ekwiteitklassifikasie aanmoedig.

Alhoewel die benaderings van die dissiplines van belasting en korporatiewe verslagdoening wesenlik verskil, is onlangse belastingwysigings aangebring, soos byvoorbeeld die inkorporasie van finansiële verslagdoeningkonsepte en definisies in die belastingwet, wat daarop dui dat beter doelwitooreenstemming moontlik in die toekoms verwag kan word. Toekomstige navorsing kan fokus op die impak op belastingsekerheid van beter sporing tussen finansiële verslaggewing- en belastingbeginsels vanuit die oogpunt van die korporatiewe belastingbetaler.

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Sleutelwoorde:

finansiële verslagdoening
finansiële instrumente
belasting
korporatiewe belasting
skuld-instrumente
ekwiteit-instrumente
belasting klassifisering
rekeningkundige klassifisering

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CHAPTER 1: INTRODUCTION

1.1 BACKGROUND

"*The tax which each individual is bound to pay, ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person... The certainty of what each individual ought to pay is, in taxation, a matter of so great importance, that a very considerable degree of inequality, it appears, I believe, from the experience of all nations, is not near so great an evil as a very small degree of uncertainty.*"

- Adam Smith

The tax classification of financial instruments as either debt or equity instruments may have a profound impact from a corporate taxation perspective and the reclassification of financial instruments by a tax authority can alter expected tax consequences (Dauds, 2007: 28; Chiang, Hui & Hanke, 2010:417). Uncertainty about how tax authorities will view a particular mode of financing has given rise to many court cases – and even in the courts it has been shown that the factors considered in making a decision can result in significantly different outcomes depending on the context in which they are applied (Chiang *et al.*, 2010: 412).

Returns (e.g., interest) on an instrument classified as debt are typically deductible in arriving at the taxable income of the taxpayer, whilst returns on equity instruments (e.g., dividends) are generally not deductible and must be paid out of after-tax profits (Emmerich, 1985:118).

Corporate entities prefer to deduct the maximum allowable deductions from their taxable income and for this reason structuring instruments in a manner that they are neither clearly debt nor equity instruments has been popular for an extended period of time. This is

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because companies hope that the taxation authority will allow payments made on the instruments as a tax deduction (Emmerich, 1985:120). A fine balance is typically sought – to obtain debt classification on the instrument from a tax perspective, whilst at the same time avoiding the fixed payment obligations that normally accompany debt (Emmerich, 1985:120).

Although the distinction is theoretically simple, many instruments do not represent "ordinary" debt or equity (Emmerich, 1985:118). Instruments exhibiting characteristics of both debt and equity are often termed "hybrid" instruments (see for example section 8F of the Income Tax Act No. 58 of 1962 (the "ITA")). Such characteristics often take the form of long maturities, deep subordination and dividend deferral options (Engel, Erickson & Maydew. 1999:255). It is these characteristics that often complicate the classification of the instrument and gives rise to tax uncertainty (Chiang *et al*., 2010: 412).

In South Africa, tax law does not provide definitive guidance on distinguishing debt instruments from equity instruments and this has resulted in many battles between taxpayers and the tax authority (Dauds, 2007:29). However, the South African Revenue Service (SARS) has recognised that there are structures, particularly those involving preference shares, where the "label" of the instrument differs from its substance (Explanatory Memorandum on the Taxation Laws Amendment Bill (2011:56)) and have responded with amendments to the ITA.

From a financial reporting perspective, an entity may issue a particular financial instrument which will be classified as debt or a "financial liability" (International Accounting Standard (IAS) 32, paragraph 11) for accounting purposes but which is seen as equity for tax purposes. This is often achieved by modifying the terms of an instrument to mostly mimic debt whilst retaining the tax treatment applicable to an equity instrument (Explanatory Memorandum on the Taxation Laws Amendment Bill (2012a:56). As a consequence, it is possible to have incongruity between the classification of a financial instrument in the financial statements of a company (i.e., from an accounting perspective) and the manner in which the tax authority classifies the instrument.

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It is generally understood that taxation and financial reporting have different objectives. Financial reporting seeks to fairly represent transactions in line with their economic substance whilst taxation may have the objective of raising revenue and stimulating economic growth. For example, whilst an asset such as a renewable energy power plant must be depreciated over its expected useful life for accounting purposes (IAS 16, paragraph 50) the tax authority may allow the taxpayer to deduct/write the entire amount off for tax purposes during the first year that the asset is used – or even to deduct an amount in excess of that actually spent. This is illustrated by the example in Table 1.

Table 1: Practical example of tax objectives versus financial reporting objectives

	Taxation treatment	**Accounting treatment**
Cost of power plant (Rand)	100,000,000	100,000,000
Depreciation rate for accounting purposes (estimated useful life)		50 years
Depreciation rate for tax purposes	150% of qualifying expenditure in the year the plant is brought into use	
Tax deduction/income statement expense	150,000,000[1]	20,000,000[2]

[1] 100,000,000 x 150%

[2] 100,000,000/50 years

In this example, financial reporting seeks to match the expenditure incurred on the construction of the renewable energy plant with the economic benefits (e.g., revenue) generated from its use. Tax, on the other hand, incentivises spending on renewable energy plants by making it tax efficient and thereby stimulating this economic activity.

A further difference lies in the conceptual approaches taken in financial reporting versus that adopted for tax purposes. The financial reporting treatment of a transaction or event in terms of International Financial Reporting Standards follows a principles-based approach where the substance is reported rather than the legal form (IASB, 2010). Taxation is typically rules-based with legislation setting out the exact treatment of a transaction or event. It is therefore submitted that it may be simpler to structure transactions from a tax perspective than it is to structure them from a financial reporting perspective.

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Despite the differing objectives of tax and financial reporting, it is not immediately clear why there should be a significant difference conceptually between the two disciplines with respect to debt-equity classification. The shareholder-debt holder distinction is well entrenched in financial reporting and this same distinction, at least in principle, is envisioned from a tax perspective. In other words, it seems counterintuitive for there to be a difference in the classification of financial instruments between the two frameworks.

Understanding the reasons for divergence between the accounting and tax classification of financial instruments may provide insights into the different objectives of corporate reporting and taxation and may provide a better understanding of those contractual terms that are more likely to determine the classification of a financial instrument from a tax perspective.

Whilst there may not seem to be a rational reason for divergence between taxation and financial reporting in terms of the debt-equity classification of financial instruments, managers of corporations may be incentivised by other more entity-specific reasons to motivate and pursue a different classification of a financial instrument for tax purposes than what was achieved for financial reporting purposes. Alternatively, managers may even seek to achieve the same outcome for financial reporting and taxation to avoid questions being raised by the tax authority (Cloyd, Pratt, & Stock,. 1996:24). Aspects affecting the decision from a corporate reporting perspective include the impact of the classification on debt covenants, debt-equity ratios (gearing) and the cost associated with reporting lower income to shareholders (e.g., possible removal of non-performing managers by shareholders) (Cloyd, *et al*., 1996:24). From a taxation perspective, it seems rational that most managers would prefer to have the instrument classified in such a manner that returns to holders of the instrument will be tax deductible. Consequently it is clear that managers may have different incentives (and trade-offs) to consider when classifying instruments for tax purposes and for corporate reporting purposes and hence differences may be expected.

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1.2 PROBLEM STATEMENT

Previous studies have considered the criteria taken into account by tax authorities (Loughlin, 1994:24) and the courts (Burilovich, 2006:708) when classifying financial instruments as either debt or equity instruments. Prior research has also considered various tax and financial reporting issues associated with preference shares (Engel *et al*., 1999:249), the international variations between tax and financial reporting (Lamb, Nobes & Roberts, 1998:173), and the influence of tax on financial statements in Germany and the United Kingdom (Gee, Haller & Nobes, 2010:97). However, not much attention has been given to potential discrepancies between the debt or equity classification of financial instruments from a tax-versus-corporate-reporting perspective and the reasons for such potential discrepancies.

1.3 PURPOSE STATEMENT

This study aims to identify potential factors giving rise to divergent financial instrument classifications between tax and financial reporting in order to gain insight into the reasons for the potential divergence.

1.4 RESEARCH OBJECTIVES

The research objectives of the study are:

- To determine whether there is incongruity between the tax and accounting classification of selected financial instruments.
- To identify the factors giving rise to a possible incongruent outcome.
- To evaluate the reasons for incongruity in order to gain insight into the differing objectives of taxation and corporate reporting.

1.5 IMPORTANCE AND BENEFITS OF THE STUDY

From a theoretical perspective, the study will make a contribution to the existing body of knowledge with respect to the tax classification of financial instruments as it will provide

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insights into the differing goals and objectives of the separate disciplines of taxation and corporate reporting. The study will also facilitate the identification of those factors which could potentially lead to inconsistent outcomes between corporate reporting and taxation.

From a practical perspective, the conclusions reached and factors identified in the study may assist taxpayers in gaining a better understanding of those factors that are likely to contribute to a tax position that is not consistent with the reporting of a financial instrument from a corporate reporting perspective. This may be useful from a business point of view due to the uncertainty generally experienced when issuing instruments with characteristics of both debt and equity.

The next section of this study explains the delimitations that apply to the study. This is followed by a listing of key terms, definitions and abbreviations that are used throughout the study. Thereafter, the literature on the debt or equity classification of financial instruments from an accounting and a tax perspective, the objectives of financial reporting and taxation as well as the areas of difference between financial reporting and taxation is reviewed.

1.6 DELIMITATIONS

The study has several delimitations related to the context, constructs and theoretical perspectives of the study. The study will be performed from the perspective of the issuer of a financial instrument i.e., the party that has the potential obligation to honour payments or redemptions on the instrument. In addition, the study will consider only companies as defined in section 1 of the ITA and will exclude entities that are defined as banks, branches of bank or similar entities in terms of section 1 of the Banks Act of 1990, individual taxpayers and entities and persons that are exempt from tax.

The study considers the tax treatment applicable to financial instruments for the years of assessment ended 2012 and 2013. From a corporate reporting perspective, the research limits itself to the accounting guidance contained in International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB) as it

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would apply for reporting periods ended during 2012 and 2013. Guidance issued by other accountancy bodies has not been considered.

The study has been based on the tax regulations and corporate reporting guidance applicable in South Africa due to the fact that the application of accounting standards issued by the IASB is well established in the South African corporate landscape, as this has formed the basis of accounting in South African for more than a decade. It is therefore considered the ideal environment in which to perform the research without necessarily limiting its relevance in an international context.

Finally, the study will not consider financial instruments that have been issued to directors or employees of a company or financial instruments issued in terms of black economic empowerment initiatives.

1.7 DEFINITION OF KEY TERMS

The study entails the use of a number of key terms, most critically the concepts of financial, debt, equity and hybrid financial instruments. The manner in which these terms are used in the context of the study is outlined below.

Debt instrument: A debt instrument (or financial liability) is an instrument imposing a contractual obligation on the issuer of that instrument to transfer cash or another financial asset to another party (IAS 32, paragraph 11) for purposes of the proposed study. This will therefore include loans extended to the entity by others, trade payables as well as bonds and certain types of preference shares issued by an entity. In general it will be presumed that payments of returns on a debt instrument, therefore excluding the redemption of principal or capital, will be deductible for tax purposes unless indicated otherwise.

Dividend: For the purpose of this study, a dividend is to be understood simply as a return or distribution to the holder of an instrument that is classified as an equity instrument.

Equity instrument: An equity instrument should be understood as any instrument evidencing a residual interest in the assets of the entity issuing the instrument after

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deducting all of its liabilities (IAS 32, paragraph 11). In general it will be presumed that payments or distributions made on an equity instruments will not be deductible for tax purposes, regardless of whether the payment represents a return on the equity instrument (for example, a dividend) or a redemption of capital.

Financial asset: A financial asset is an equity instrument of another entity, cash and a right to receive cash or another financial asset from another party (IAS 32, paragraph 11). This will therefore include assets such as trade receivables, cash on deposit with banks and bonds purchased by an entity.

Financial instrument: A financial instrument should be interpreted as any contract that gives rise to the recognition of a financial asset by one party to a contract and to the recognition of a financial liability or equity instrument by another party to the contract (IAS 32, paragraph 11) for purposes of the proposed study.

Hybrid financial instruments: To be understood simply as an instrument exhibiting characteristics of both a debt instrument and an equity instrument.

IAS 16: "International Accounting Standard 16: Property, Plant and Equipment" outlines the accounting treatment for property, plant and equipment. Property, plant and equipment is initially measured at its cost, subsequently measured using either a cost or revaluation model, and depreciated so that its depreciable amount is allocated on a systematic basis over its useful life.

IAS 32: "International Accounting Standard 32 Financial Instruments: Presentation" outlines the accounting requirements for the presentation of financial instruments, particularly as to the classification of such instruments as financial assets, financial liabilities and equity instruments. The standard also provides guidance on the classification of the related interest, dividends and gains or losses as well as when financial assets and financial liabilities can be offset.

Interest: The term interest is used throughout this document and should be understood in a broad sense. Although interest is commonly understood to be an expense to

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compensate the lender for the time period during which money is lent to another party (ITC 1485 52 SATC 337) it has also been assigned a wider meaning. In CIR v Cactus Investments (Proprietary) Limited, 61 SATC 43, it was held that interest in not only compensation for the time value of money but rather the stipulated return a lender would require when borrowing money to someone else. It is in this wider sense that the term is generally used in this document. An amount would typically constitute interest where (Brincker, 2010):

- There is a debtor/creditor relationship;
- It is calculated with reference to a sum of money;
- It is payable for the use of money;
- It accrues over time.

1.8 ABBREVIATIONS USED

The following abbreviations are used in the body of the text of this research proposal.

Table 2: Abbreviations used in this document

Abbreviation	**Meaning**
Banks Act of 1990	Banks Act No. 94 of 1990, Republic of South Africa
GAAP	Generally Accepted Accounting Practice
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IRS	Internal Revenue Service
ITA	Income Tax Act No. 58 of 1962, as amended, Republic of South Africa
ITC	Income Tax Case
National Treasury	Department National Treasury: Republic of South Africa
SARS	South African Revenue Service
SATC	South African Tax Case
UK	The United Kingdom of Great Britain and Northern Ireland
US	The United States of America

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1.9 BRIEF OVERVIEW OF CHAPTERS

Below follows a brief overview of the remaining chapters of the study.

Chapter 2 contains the detailed literature review which contrasts the objectives and goals of financial reporting and taxation as two distinct disciplines. The chapter also deals with the principles used to classify financial instruments as either debt or equity instruments from a taxation and financial reporting perspective. This chapter also serves to highlight previous research performed.

The research design and method are outlined in chapter 3. This includes a discussion around sampling, data analysis and research ethics.

The data analysis, which forms the basis for the conclusions reached by the study, is included in chapter 4. This chapter interprets the work performed in the study so as to facilitate the drawing of reasoned conclusions.

Chapter 5 concludes from the analysis contained in chapter 4 and illustrates how the study has satisfied the stated research objectives. This chapter also makes recommendations for future research.

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CHAPTER 2: LITERATURE REVIEW

2.1 INTRODUCTION

Much research has been done with respect to the classification of financial instruments as either debt, equity or hybrid instruments from a taxation perspective. Previous research covers the issue in a number of territories including Ireland (Loughlin & FitzGerald, 1994:24) and the United States of America (Burilovich, 2006: 708). However, the tax treatment of a financial instrument exhibiting characteristic associated with both debt and equity instruments remains a fiscal grey area which is often decided by the courts – indeed some are of the view that tax legislation should completely abandon the pretence that it can correctly distinguish true debt from true equity (Polito, 1998:761). From an accounting perspective, detailed guidance and illustrative examples are available to guide preparers of financial statements to account for and present financial instruments as either debt, equity or a combination of both.

2.2 THE OBJECTIVES OF FINANCIAL REPORTING AND TAXATION

In many instances the tax treatment and financial reporting treatment of a particular transaction or event differs. Understanding the reasons for these differences may be found in the differing goals and objectives of the two distinct disciplines of taxation and financial reporting.

2.2.1 The objectives of financial reporting under IFRS

The objective of financial reporting, from an IFRS perspective, is to provide useful information to current and potential future investors, lenders and other creditors in making decisions regarding the provision of resources to an entity. These decisions are described as buying, selling or holding equity and debt instruments and providing or settling loans or other forms of debt (IASB, 2010). Generally many believe that IFRS is targeted at the consolidated financial statements of entities of which the equity or debt instruments are traded on public exchanges and capital markets. Financial reporting should therefore be

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occupied with the provision of information that is relevant to the decisions that need to be made by equity investors and suppliers of debt finance.

2.2.2 The objectives and functions of taxation

Taxation clearly has a different objective. In order to perform governmental functions and provide public goods such as water, sanitation and roads, revenue needs to be raised by the state. There is wide acceptance of the fact that taxation is necessary to enable the government to perform these duties (Avi-Yonah, 2006:3).

There are, however, also two more contentious functions of taxation. The first is the so-called redistributive function of tax. This function of tax is aimed at reducing the unequal distribution of wealth and income that is the result of a market-based economic system. The second is the regulatory function of taxation. This function describes the ability of government to use tax policy to manoeuvre the private sector in the directions governments require industry to go in order to meet their specific objectives (Avi-Yonah, 2006:3).

2.3 INCENTIVES FOR CLASSIFYING TRANSACTIONS DIFFERENTLY FOR ACCOUNTING AND TAX PURPOSES

In order to manage the volatility of earnings, potential share price volatility and adherence to debt covenants, it can be presumed that entities would prefer to achieve equity classification of a financial instrument for financial reporting purposes as this will have the least impact on the reported profit or loss for a particular period.

From a tax perspective, however, entities (depending on their particular tax strategy) may desire the instrument to be classified as debt in order to qualify for interest deductions which would be optimal from a tax efficiency point of view. Indeed many entities seek, at the greater risk of bankruptcy, to classify instruments as debt rather than equity from a tax perspective (Polito, 1998:761).

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Generally, and certainly in South Africa, there is no explicit requirement for tax reporting and financial reporting to be consistent. However, both frameworks report the same economic events with different objectives (Mills, 1998:345). Companies often investigate the opportunity cost when making financial reporting and tax reporting decisions such as the potentially higher tax cost when a decision is made to boost financial reporting figures or the potentially higher financial reporting cost when reporting lower profits to shareholders to minimise the tax cost (Frank, Lynch, & Olhoft-Rego, 2009:468).

However, recent trends have indicated that companies do not always trade-off these financial reporting and tax reporting decisions. Rather, some companies treat the decisions as being mutually exclusive. Entities adopting this approach would generally report higher profit information to shareholders whilst at the same time reporting lower taxable profit information to the tax authorities. In fact, since the early 1990s, some entities in the US have reported an increasing level in incongruity between what is reported to shareholders and what is reported to tax authorities (Frank *et al.*, 2009:468). This trend has also presented itself in the form of an increase in tax audit adjustments proposed by the Internal Revenue Service in the US in relation to increases in the excess of financial reporting profits over those profits reported to the tax authorities (Mills, 1998:343).

Related research, also in the US, has explored the reality that firms cannot manage financial reporting and tax reporting as two distinct worlds without incurring certain costs and that there has to be some degree of trade-off. Indeed the research has found explicit evidence that this is the case (Mills, 1998:344).

Other research has found empirical evidence that the probability that a transaction is audited by a tax authority increases when the treatment of the transaction is different for accounting purposes than for tax purposes – specifically where a deduction is claimed for tax purposes whilst the amount expended is capitalised as an asset for accounting purposes (Mills & Sansing, 2000:89). These differences between the two sets of ‘books’ act as flags to the revenue authorities to investigate further and frequently serve as the basis for tax audits (Mills & Sansing, 2000: 89).

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Research has shown that executives in certain industries recommend accounting practices that conform to aggressive tax approaches in order to increase the probability of successfully defending a position against the relevant tax authorities. In addition, research indicates that managers of public companies are less likely than their counterparts in private companies to choose conformity between the tax and accounting treatment of a transaction, probably because they face higher non-tax costs (e.g., from the shareholder perspective) associated with reporting lower income (Cloyd *et al*., 1996:23).

2.4 CLASSIFICATION OF FINANCIAL INSTRUMENTS FROM AN ACCOUNTING PERSPECTIVE

2.4.1 Authoritative IFRS guidance for the classification of financial instruments

The classification of financial instruments from a corporate reporting perspective, specifically under IFRS, focuses mainly on the degree of discretion an entity has with regard to payments it may be contractually required to make on an instrument. Significant guidance has been developed by the large global accountancy firms regarding debt, equity and hybrid (or compound) financial instrument classification and this has largely given rise to consistent outcomes between entities from a financial reporting perspective.

In terms of IFRS, matters of debt or equity classification are dealt with in IAS 32. IAS 32 is the accounting standard that governs the presentation of financial instruments in the financial statements and this classification will have a pervasive impact on the measurement and impact of the instrument in the financial statements in future.

2.4.2 Equity instruments: the financial reporting impact

Where an instrument is classified as an equity instrument it will not be remeasured subsequent to initial recognition. This means that no volatility will arise in the financial statements of the issuer of an equity instrument as changes in the fair value of an equity instrument are not recognised in the financial statements (IAS 32, paragraph 36). The classification of the instrument as an equity instrument will also determine where subsequent payments or distributions made in respect of the instrument will be

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recognised. Distributions on an equity instrument will be recognised within equity and will not affect the income statement of the entity.

An equity instrument will also be presented within shareholder's equity and not as a liability. This has an important impact from a debt covenant perspective as equity classification would decrease gearing ratios.

2.4.3 Debt instruments: the financial reporting impact

Conversely, where an instrument is classified as a debt instrument, it must subsequently be remeasured through the income statement on either a fair value basis or an amortised cost basis (IAS 32, paragraph 35). Any payments made on a debt instrument are therefore recognised in the income statement.

A debt instrument is presented as a current or a non-current liability outside of shareholders' equity. Debt classification therefore increases gearing ratios and interest cover ratios – hence their significance with respect to debt covenants.

2.5 THE IMPACT OF HARMONISED ACCOUNTING STANDARDS AND DIVERGENCE BETWEEN FINANCIAL REPORTING AND TAX PRINCIPLES

National accounting frameworks in several territories, including the European Union and South Africa, have been harmonised with IFRS for a number of years. This harmonised framework is considered more probable to give rise to incongruence between financial reporting and the underlying environments of entities – specifically with respect to taxation and regulation – than would be the case under distinct national reporting frameworks (De Jong, Rosselón & Verwijmeren, 2006:170). This is especially so as the IFRS framework is significantly influenced by the shareholder-focused Anglo-Saxon accounting model whilst local or national accounting frameworks may have been largely driven by tax conformity considerations (Hung & Subramanyam, 2007:624).

Notably in Germany, prior to the enforcement of IFRS reporting in the European Union in 2005, financial reporting was predominantly stakeholder and tax-driven (Hung &

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Subramanyam, 2007:624). It can therefore be expected that after the implementation of IFRS by German entities significant levels of divergence between the tax and accounting treatment of transactions and events would be noted. Some key differences noted between the previous German framework HGB (*Handelsgesetzbuch*) relate to fair value accounting under IFRS whilst HGB adopted prudent asset and liability valuation – i.e., measuring assets and liabilities at their lowest possible values to minimise tax liabilities – as well as accelerated asset depreciation in line with tax legislation under HGB whilst this is not allowed in terms of IFRS (Hung & Subramanyam, 2007:624).

The introduction of IAS 32 in Europe has had a profound impact on the accounting classification of preference shares, particularly in the Netherlands. Many preference shares issued in the Netherlands are now classified as debt instruments under IAS 32 whilst they were previously seen as equity instruments. This has resulted in significant changes to debt ratios (De Jong *et al.*, 2006). The main distinguishing factor in the Netherlands context relates to the treatment of conditional obligations under Dutch Generally Accepted Accounting Principles (GAAP) versus the treatment in terms of IFRS. For example, Dutch GAAP regards a condition that dividends must contractually be paid on a preference share in the event that the issuer makes a profit as sharing in the results of the issuer. IFRS would treat this as a contingency which is not within the absolute control of the issuer and this inability to unconditionally avoid a cash payment would result in debt classification (IAS 32, paragraph 25).

Accounting information is used to define debt covenants which are frequently an integral part of the terms of debt contracts (Ormrod & Taylor, 2004:72). Therefore, covenant breaches may be the result of changes in the financial reporting framework of a particular entity without actual environmental changes regarding the debt position of the entity taking place (Ormrod & Taylor, 2004:72).

Convergence between the tax and accounting treatment of economic events has been on the increase in countries such as the United Kingdom. In fact, in the United Kingdom, recent case law suggests that, where there is no specific tax law to the contrary, accounting practice will prevail in most circumstances in determining how to treat a particular transaction or event for tax purposes (Lamb, Nobes & Roberts, 1998:176).

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2.6 CLASSIFICATION OF FINANCIAL INSTRUMENTS FROM A TAX PERSPECTIVE

2.6.1 General attributes of debt and equity instruments

In the Explanatory Memorandum on the Taxation Laws Amendment Bill of 2012 (South Africa, 2012a), National Treasury discusses the differences in features of debt and equity instruments. National Treasury considers debt to constitute a claim on specified cash flows which, in its most basic form, is represented by interest – importantly, the amount is payable regardless of the financial position or performance of the debtor. Equity instruments, however, represent only a contingent claim on dividends and these payment are generally linked (either directly or indirectly) to the financial performance of a particular company.

The courts have long been summoned to determine whether a particular instrument should be considered a debt or equity instrument (Farber, 2007:635) and many characteristics have been laid down in the process.

Boltar (1995:253) draws a comparison between debt and equity instruments as follows:

- An equity holder has a say in the strategic decision-making of the company and can attend and vote at general meetings of the company whereas a creditor generally does not have a say in the company's affairs;
- The return on an equity holder's investment is uncertain as dividends are only declared out of the profits of the company. The return of the debt holder is more certain as he would be entitled to receive a return regardless of the success of the company;
- A company is under no obligation to repay equity capital whereas debt financing must be settled on a contractual maturity date or on demand;
- An investment in equity provides the investor with exposure to significant upside potential (unlimited share price appreciation) whilst a debt holder is only entitled to repayment of the amount advances (plus interest);
- Debt holders take preference over the equity holders of the company in the event of liquidation; and

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- Dividends (distributions to equity holders) are exempt from taxation (provided the legislative requirements are met) whilst interest (returns to debt holders) is taxable in the hands of the debt holder.

2.6.2 Debt-equity determination in the United States of America

2.6.2.1 *The "evaluation-of-relevant-factors" approach*

Notice 94-47, issued by the Internal Revenue Service (IRS) in the US (Notice 94-47), contains a set of criteria to be used by the IRS in classifying financial instruments as either debt or equity instruments. The general tone of the notice is that instruments are rather to be classified as equity as opposed to debt and it is emphasised that even where an instrument has a short contractual term, it would still be classified as equity if it contains equity characteristics (Brincker, 2010).

The listing of criteria contained in Notice 94-47 is known as the "evaluation-of-relevant-factors" approach and is effectively a "laundry-list" of factors considered to be relevant in characterising a security as debt or equity (Boltar, 1995:257). The application of the criteria is considered to be subjective as the analysis of the terms of instruments in line with the criteria has led to American courts reaching different conclusions on similar fact patterns (Boltar, 1995:257).

The following features are generally considered by the US tax courts when determining whether an instrument is a debt instrument (Farber, 2007:635; Brincker, 2010):

- Whether there is an unconditional commitment by the issuer to pay an amount on demand or at a fixed maturity date that is in the reasonably foreseeable future;
- Whether the holder has the right to enforce payment of capital and interest;
- Whether the rights of the holders are subordinate to the rights of general creditors;
- Whether the instrument gives the holder the right to participate in the management process of the issuer;
- Whether the issuer is thinly capitalised;

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- Whether there is an identity between the holders of the instrument and the ordinary shareholders of the issuer;
- The label (or name) placed on the instrument; and
- Whether the instrument is regarded as debt or equity for non-tax purposes (e.g. regulatory, rating agencies and financial reporting purposes).

Notice 94-47 contains an “all-or-nothing” approach (Boltar, 1995:259) as an instrument will either be debt or equity in totality. Another potential approach would be a bifurcated approach.

2.6.2.2 *The “bifurcation approach”*

The “bifurcation approach” recognises that a financial instrument may be made up of more than one part and that the components of a financial instrument could be classified separately with each component being treated as a separate security (Boltar, 1995:260). Although this approach is technically sound, it is considered potentially challenging to separate all instruments into their different components in a predictable manner which would greatly increase complexity and uncertainty (Boltar, 1995:260).

2.6.3 Debt-equity determination in Australia

In an Australian context, Subdivision 974-B of the Income Tax Assessment Act of 1997 (Australia, 2013) contains a “debt test” which sets out a test to be performed by taxpayers in determining whether an instrument issued should be considered a debt or an equity instrument.

For the returns to the holders of an instrument to be considered tax deductible as interest, the interest must meet the requirements to be classified as a “debt interest” as defined (Subdivision 974-15 of the Income Tax Assessment Act of 1997). The requirements to be classified as a “debt interest” are as follows:

- There must be a scheme;
- The scheme must be a financing arrangement;

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- There must be a financial benefit received;
- The issuing entity must have effectively have a non-contingent obligation to provide a future financial benefit; and
- It must be substantially more likely than not that the value of the financial benefit to be provided will at least equal or exceed the financial benefit received.

In addition to the characteristics of debt instruments, Subdivision 974-B sets out the circumstances under which an instrument would be regarded as an “equity interest”. This would be the case where the interest is (Subdivision 974-70 of the Income Tax Assessment Act of 1997):

- A share;
- An interest providing a return that depends on the issuer’s economic performance;
- An interest providing a return at the discretion of the issuer; or
- An interest that may or will convert into such an interest or share as detailed above.

The Australian approach appears to favour debt classification in the event that an instrument exhibits characteristics of both debt and equity as a security would be regarded as a debt interest where this situation arises (Brincker, 2010). The requirements and steps in applying the “debt test” are illustrated in figure 1.

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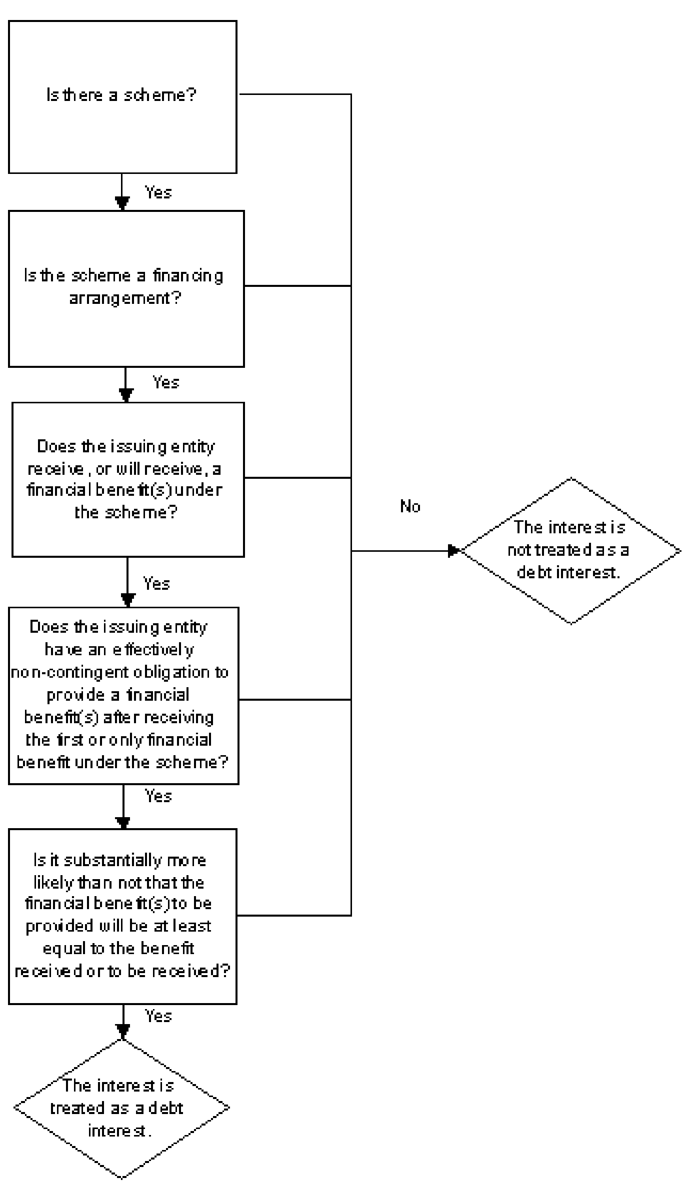
Figure 1: “Debt test” contained in Subdivision 974-B



Source: Australian Tax Office website (http://www.ato.gov.au/businesses/content)

2.6.4 The practical problem of distinguishing debt from equity from a tax perspective

Distinguishing debt instruments from equity instruments in a consistent and definitive manner is considered to be an ‘ancient and pernicious’ problem in tax law (Benshalom, 2010:1219). A reason for this difficulty is that tax law mandates a dramatically different

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treatment to transactions that are to a certain degree switchable or capable of being seen in a different light depending on how a particular court interprets subjective guidelines (Benshalom, 2010:1219). Over time, tax lawyers have found ways in which to exploit the vague debt or equity rules that have been laid down by legislation and in court cases (Benshalom, 2010:1222).

As noted above, a critical feature often considered in making the debt-equity distinction is that the shareholder, or holder of an instrument that represents equity, is exposed to the upside potential and downside risk of the entity that issued the instrument as they directly share in the residual net assets of the business. In addition, an equity instrument holder typically has voting rights and can elect the senior management of the business and set remuneration policies. However, some argue that the interests of debt holders in the operations of the business cannot be so clinically separated from those of ordinary shareholders. This can be demonstrated by the restrictive effect debt holders can have on the actions of the managers of entities through the debt covenants they are able to impose on the entity (Polito, 1998:761). In addition, debt holders do obtain voting rights in a business under certain circumstances – even if this is relatively rare (Polito, 1998:761).

It is challenging to see a 'bright line' or clear difference between shareholder's equity and some forms of long term debt where the funds obtained are used as a source of long term capital in the business with discretionary (or even non-existent) repayment schedules on the long term debt. Regardless of this challenge, corporate income tax is forced to view instruments as if these bright lines existed because interest on a debt instrument is generally tax-deductible whilst distributions on equity instruments are not. Wherever this bright line is drawn by the tax legislation and the tax courts, it may subject instruments that differ very little in terms of their characteristics and economic substance to tax outcomes that differ drastically (Polito, 1998: 761). In this respect, a key problem is the hybrid instrument or an instrument exhibiting qualities associated with both debt and equity instruments.

Consider, for example, the case of a redeemable preference share. This instrument contains a mandatory redemption provision whilst the holder of such an instrument does not have the ability to force the issuer into liquidation for the non-payment of a dividend or

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for failing to redeem the capital. This redemption clause is typical of a debt instrument, whilst the inability to force the issuer into liquidation for non-payment (discretionary payment features) is an equity feature (Kimmel & Warfield, 1995:152). The payment discretion predominantly arises when making a payment on the preference share would threaten the solvency of the issuer – in other cases it is doubtful that the issuer would be able to avoid making payment. There is no legal hindrance for an instrument that identifies with the legal form of an equity instrument to also contain numerous characteristics associated with a debt instrument (Polito, 1998:761).

As is evident from the above analysis of the corporate reporting requirements and the tax requirements, the principles are fairly similar and attempt to capture and identify similar characteristics. However, as discussed in the next section, tax legislation does create some explicit rules which may override these principles – thereby subjecting a principle to a rule.

2.6.5 South African tax legislation

The classification of financial instruments from a tax perspective is governed by the provisions of the ITA. 'Classification' refers to whether an instrument is regarded as a debt instrument or an equity instrument from the perspective of the party that has issued the instruments (the 'issuer'). Various sections of the ITA deal with financial instruments and section 1 of the ITA includes definitions of what is considered a financial instrument, an equity share, a share and an equity instrument as follows:

- An equity share is any share in a company that does not carry any right to participate beyond a specified amount in a distribution with respect to dividends and returns of capital.
- A share is any unit into which the proprietary interest in a particular company is divided.
- A financial instrument includes 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 a collective investment scheme, or a similar instrument.

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In addition, section 8F of the ITA defines, from the perspective of the issuer of certain financial instruments, a hybrid debt instrument as an instrument that, amongst other types listed in section 8F, is convertible into any shares of the issuer within a period of three year following the issuance of that instrument. This section aims to deny a taxpayer any interest deductions on such an instrument.

Section 8E of the ITA also makes reference to hybrid instruments – specifically hybrid equity instruments. The section is similar to section 8F of the ITA which is described in the immediately preceding paragraph and regards shares issued by an entity (whether ordinary or preferred shares) to be hybrid equity instruments. The result of this classification is that the recipient of a return on a hybrid equity instrument is deemed to have received an amount of income which is taxable. The issuer of a hybrid equity instrument is, however, not afforded a tax deduction with respect to distributions made on the hybrid equity instrument. An asymmetrical tax position therefore results as the recipient of the distribution is taxed on it as if it were interest whilst the party making the distribution is not allowed a tax deduction.

Tax provisions which alter the nature of financial instruments can also be found in those sections of the ITA that deal with reorganisations of a group of companies. These sections include section 23K and section 45 of the ITA.

Section 45 deals with intra-group transactions. Such intra-group transactions generally relate to an asset disposal and acquisition between companies that are both controlled by the same ultimate party.

Section 23K of the ITA limits the interest that a taxpayer may deduct in arriving at taxable income when that interest is incurred as part of a reorganisation transaction.

When a transaction is deemed as representing an intra-group transaction for purposes of section 45, then section 23K may find application, thereby potentially altering the nature of the financial instruments used in the transaction by characterising the interest incurred as dividends for all practical purposes. Whilst the interest is not legally a dividend, the substance of the interest is more akin to a dividend as it is not tax deductible.

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Section 24J of the ITA deals with the incurral and accrual of interest on an instrument. For purposes of section 24J an 'instrument' is defined as, *inter alia*, any form of interest-bearing arrangement or any debt. Prior to the Taxation Laws Amendment Bill of 2012, instruments with demand features (instruments that are repayable whenever the counterparty demands payment) were specifically dealt with in section 24J, however, as explained in clause 54 of the Explanatory Memorandum for the Taxation Laws Amendment Bill of 2012, this provision has now been deleted. As a consequence the basic deduction principles contained elsewhere in the ITA should be applied to demand instruments.

Instruments that comply with the legal definitions outlined above are not complex to categorise and the issuer of such an instrument would have a reasonable degree of tax certainty regarding the manner in which SARS will view the instrument. However, entities regularly structure instruments (for various commercial reasons) in such a manner that they do not exhibit the standard hallmarks and characteristics of a debt or equity instrument as defined in the ITA. It is this customisation of financial instruments that can introduce judgement and subjectivity into the tax classification of financial instruments and also bring about tax uncertainty.

These provisions contained in the tax legislation have the potential to create 'bright lines' or rules from which a taxpayer may not deviate whilst the corporate reporting regulations allow for latitude and interpretation (principle-based versus the rules-based tax law). These bright lines can therefore confuse the principles of true debt and true equity and whatever may lie in between.

2.7 EXAMPLES OF INSTRUMENTS THAT MAY BE CHALLENGING TO CLASSIFY FROM A TAX PERSPECTIVE

The difficulty of classifying financial instruments as either debt or equity instruments is widely recognised and results from the ability of issuers to incorporate a range of bespoke contractual terms and conditions into an instrument (Boltar, 1995:260). The impossibility of formulating definitions and rules for every conceivable instrument has been recognised by

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the American Senate Committee when it stated that such an attempt would be "*…frustrated by the numerous characteristics of an interchangeable nature which can be given to the instruments.*" (Boltar, 1995:261).

Below follows some examples of instruments that may be considered challenging to classify from a tax perspective.

2.7.1 Perpetual and very long maturity debt instruments

Deciding whether perpetual instruments or very long dated instruments are debt instruments and whether the finance costs associated with such instruments should be tax deductible can be contentious (Brincker, 2010).

An example of a very long maturity instrument is a debt instrument with a maturity of say a thousand years. This creates difficulty because the instrument technically contains a maturity date which is often seen as a critical feature of a debt instrument (Brincker, 2010).

A perpetual debt instrument is an instrument in terms of which the debtor is not obliged to repay the principal amount advanced other than in the event of liquidation. In the Australian tax case *Macquarie Finance Limited v FCT*, 2005 FCAFC 205, the revenue authority contended that the interest on a perpetual debt instrument should not be deductible for tax purposes as no debtor/creditor relationship existed.

2.7.2 Capitalisation of legal persons by way of debt

Instead of capitalising an entity via share capital, entities are often capitalised by way of loans which are subordinated to the claims of the other creditors of the entity (Brincker, 2010). In considering whether such instruments represent debt or equity instruments, a number of arguments can be raised against the deduction of interest on these instruments and thus against their true nature being that of debt (Brincker, 2010):

- The interest rate may be regarded as excessive (interest deductions could be disallowed to the extent it is excessive);

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- The proceeds of the loan should always be used for the productive purposes (interest deductions could be disallowed to the extent that the funds are not so utilised); and
- The interest could be seen as capital in nature or as a "disguised dividend".

2.7.3 Limited recourse loans

Limited recourse loans have historically been regarded with suspicion by the revenue authorities (Brincker, 2010). An example of such an instrument is a loan which is only repayable from the proceeds of some or other venture. To the extent that the proceeds are not sufficient to repay the loan, the remaining balance will never be repaid with the holder of the loan having no recourse. The holders are often promised a minimum turnover on the funds – although they do not have the contractual right to enforce payment of such returns should they not materialise.

Such loans can prove to be challenging to classify from a tax perspective as, in a sense, they could be seen as a capital contribution with no right to repayment.

2.8 CONCLUSION

This chapter discussed and contrasted the differing objectives of financial reporting and taxation and also touched on the incentives that may exist for seeking a different classification for tax purposes than that achieved from a financial reporting perspective. The literature review examined the rules applying to financial instrument classification from a financial reporting and a taxation perspective in a South African as well as an international context.

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CHAPTER 3: RESEARCH DESIGN AND METHODS

3.1 INTRODUCTION

The purpose of the study is to gain insights as to whether there is incongruity between the accounting and tax classification of financial instruments issued by an entity. In examining the research problem, the study will review case studies detailing the actual contractual terms of a selection of financial instruments issued by entities. These case studies will be independently analysed by a financial reporting specialist and by a taxation specialist and their final conclusions, based on the application of the authoritative guidance available in the respective disciplines of financial reporting and taxation, will be compared.

Finally, those factors giving rise to incongruity or congruity between the financial reporting and tax classification will be identified through a critical literature review of the conclusion documented by the independent financial reporting specialist and the independent taxation specialist.

3.2 DESCRIPTION OF INQUIRY STRATEGY AND BROAD RESEARCH DESIGN

3.2.1 General overview of and reasons for the chosen strategy of inquiry

The research design of the proposed study will take the form of a case study analysis (case study). One definition of a case study is that it entails the detailed analysis of a single example of a population of phenomena but which does not necessarily provide reliable information about the broader population (Flyvbjerg, 2006:220). However, a case study analysis may be useful in the preliminary phases of investigation of a particular research problem as it may provide the researcher with hypotheses which can be tested within a larger population of cases (Flyvbjerg, 2006:220).

Others believe that the conventional wisdom, as enshrined in the above mentioned definition, about case study research is 'grossly misleading' and may even be 'directly wrong' (Flyvbjerg, 2006:220). This is contended because existing definitions may be outdated – some believe that case study research can be used to provide information

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about the broader population of phenomena (Flyvbjerg, 2006:220). In other words, some degree of extrapolation of results obtained to a larger population might be possible.

Case study research has been chosen for purposes of the study as it allows for the detailed study of a discrete set of facts and the application of the applicable financial reporting and taxation principles to that set of facts in a structured manner without the need to consider aspects outside of the specific fact pattern investigated.

3.2.2 Source of data

Performing the proposed study will entail the collection of fact patterns to analyse. This will be secondary data and will be obtained from actual cases relating to the classification of financial instruments issued by entities. The case studies will be obtained from the technical department of a large accountancy firm in South Africa. The technical department from which the data will be collected is tasked with the interpretation of a discrete set of facts (fact pattern) and the drafting of technical accounting guidance based on those facts. The study will be performed by selecting certain case studies that relate to the classification of financial instruments as debt, equity or hybrid instruments from an accounting perspective.

Although this data is proprietary and confidential, it will be sanitised in such a manner that it merely portrays a fact pattern and contains no features which would enable a reader to identify the entity to which the fact pattern relates. Permission has been obtained from the accountancy firm to use the fact patterns of these cases for purposes of the research.

The case study research will take the form of a cross-sectional analysis of secondary data. Cross-sectional analysis is generally understood as the study of data at a particular point in time (sometimes referred to as a snapshot). This is because the financial reporting guidance and relevant tax provision will be applied to the case studies for a 2012/2013 year of assessment. The data is considered to be secondary data because it represents data that was collected by another party but this has not formed part of previous research. Although the data has been analysed by the accountancy firm for the purpose of drafting the accounting position papers, the data has not been analysed for purposes of research.

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3.2.3 Variables in secondary data to be studied

The focus of the proposed study will be on the variables that give rise to the classification of the financial instrument(s) contained in the secondary data fact pattern as a debt, equity or hybrid financial instrument. This will largely therefore be the summary of the contractual terms of the financial instrument and the purpose for which the entity has issued the instrument.

As the accounting/financial reporting classification of the financial instrument has already been performed and approved by a technical partner at a large accountancy firm, the accounting analysis will not be redone. The technical partner that performed the analysis is the head of the financial instruments topic team of the accountancy firm in Southern Africa and the chairperson of the debt/equity sub-group globally within the firm, with many years of technical experience.

The analysis supporting the tax classification of the financial instrument contained in the case studies will be performed by a former tax director at a large accountancy firm, where she provided tax consulting services and training for a period of ten years. This will consequently be an independent assessment.

Following the above process, the analyses performed by the financial reporting and tax specialists will then be evaluated by way of content analysis. This will involve the close examination of the content of both analysis as well as the conclusions reached under in terms of the two disciplines. The aim of this is to identify any incongruity between the classification of the financial instruments between financial reporting and taxation.

3.3 SAMPLING

The sampling method adopted for purposes of the proposed study is 'convenience sampling'. This method of sampling is not based on probabilities but rather on case studies known to contain aspects which may be challenging to classify from an accounting and

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taxation perspective due to the student's involvement in the technical department of the accountancy firm from which the case studies were obtained.

3.4 DATA ANALYSIS

3.4.1 Recording and storage of secondary data collected

The data collected for purposes of the study will be extracted from the accounting position papers prepared by the accountancy firm that has agreed to this study making use of the information. The data will be extracted from the fact pattern section of the accounting position papers and will be recorded and stored using a widely-used word processing software package.

3.4.2 Verification and evaluation of the accuracy and completeness of data

Data obtained from the accountancy firm is considered to be reliable and factual as it follows a rigorous process of validation and cross-checking with the context of the actual contracts, agreements and other information represented in the fact pattern. The typical process is depicted in figure 2 below and has been compiled from the practical experience of the student undertaking the proposed study as an employee of the accountancy firm from which the fact patterns have been obtained.

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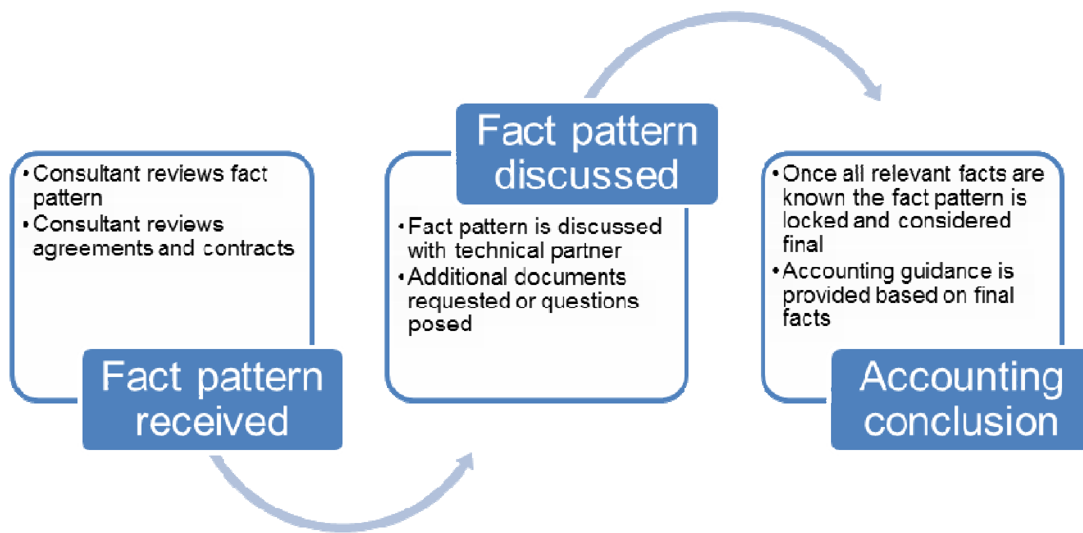
Figure 2: General process of validation of data contained in fact patterns



Data is considered complete for purposes of the study as the analysis from a taxation perspective will be restricted to those identical facts that were considered when the accounting analysis was performed.

3.4.3 Specific methods of data analysis

The data collected and analyses obtained from the financial reporting and taxation specialists will be analysed using the technique of content analysis.

For the purposes of the proposed study, the following definition of content analysis is considered appropriate: "…a research method for the subjective interpretation of the content of text data through the systematic classification process of coding and identifying themes or patterns." (Hsieh & Shannon, 2005:1278).

This method is considered appropriate as the proposed study will focus on the analysis of written facts and many researchers regard content analysis as a flexible technique for the analysis of text data (Hsieh & Shannon, 2005:1278). The method is generally understood as being a primarily qualitative research technique; however, it was frequently used as a

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quantitative technique during the latter part of the twentieth century (Hsieh & Shannon, 2005:1278).

Qualitative content analysis of text data typically focuses on the characteristics of language as communication with attention to the content of contextual meaning of the text and may have been obtained in a variety of ways including narrative responses, surveys, focus groups, observations and print media (Hsieh & Shannon, 2005:1278). Content analysis is more than the counting of words (Hsieh& Shannon, 2005:1278) as it entails the intense analysis of language with a view to categorising text into an efficient number of categories representing similar meanings (Hsieh & Shannon, 2005:1278).

The study will analyse the classification decisions made by the financial reporting and taxation specialists with the aim of identifying themes that are of significance in identifying potential incongruity between the financial reporting and taxation classifications of financial instruments as debt or equity instruments.

3.5 ASSESSING AND DEMONSTRATING THE QUALITY AND RIGOUR OF THE RESEARCH DESIGN

The research design of case study research is considered to be appropriate in the context of the study as the researcher is investigating (Cooper & Morgan, 2008:160):

- Complex and dynamic phenomena containing many variables;
- Actual practices (practical application of theoretical principles); and
- Phenomena in which the context is critical as the context affects the phenomena being studied.

Case study research can provide “how” and “why” answers to research problems (Cooper & Morgan, 2008:160) and for this reason it is considered to be relevant given the research objectives set out on this study.

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The rigorousness and quality of the study can be demonstrated as follows:

- A careful research design has been constructed and this design answers the questions posed by the study, the unit of analysis (defines the case studies being considered), and the criteria for interpreting the findings (the outcomes of the independent accounting and taxation assessment will be compared in light of the theory underpinning the two disciplines).
- The proposed research design has been discussed with the accountancy firm from which the case studies have been obtained and permission has been granted for the use of the data and the accounting assessment that has already been performed.
- The independent tax expert has agreed to perform the tax assessment on the case studies and has also indicated the suitability of a potential timeline for completion.
- Appropriate boundaries have been set within which the analyses of the case studies are to be performed and this will ensure that consistent theoretical guidance is applied to the case studies.
- The research objectives of the study are considered clear to ensure that the study remains focused on the research problem.

3.6 RESEARCH ETHICS

The research ethics aspects of the study have been considered under the following headings:

3.6.1 Copyright

Permission to use the case studies on an anonymous basis has been obtained from a large accountancy firm.

3.6.2 Maintaining confidentiality and anonymity

All case studies will be analysed on an anonymous basis after specific details and other aspects which may identify the parties to the case studies have been removed and the

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case studies edited so that the expert evaluating the case studies cannot discern their identity. The relevant facts and principles will, however, be retained.

3.6.3 Researcher's objectivity, honesty and integrity

The researcher is objective with respect to the case studies being analysed by the independent specialist and will not be involved in the analysis performed by the tax specialist nor will the researcher have any contact with the tax specialist. Although the researcher has certain expectations regarding the results of the assessment to be performed by the tax specialist, the actual findings will be documented independently of these expectations.

Appendix B contains the informed consent form that will be used in the study.

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CHAPTER 4: RESULTS

4.1 INTRODUCTION

Case studies that had been opined on by the large accounting firm were sent to the tax specialist for independent analysis. The tax specialist was not provided with the accounting conclusion reached by the accounting firm. This chapter details an analysis of the conclusions reached by the accounting specialist and the tax specialist respectively.

4.2 DATA ANALYSIS

The case studies that form the basis of the analysis performed in this study are detailed below. The following summary contains the instructions that were communicated to the tax specialist performing the tax analysis:

- Please provide a detailed analysis (with supporting references to applicable legislation and/or other guidance) of whether, in your opinion, the instruments issued in the below case studies would be classified as debt, equity or hybrid financial instruments from a tax perspective.
- Please comment on the amount of interest that, in your opinion, the below entities would be able to deduct from their gross income in arriving at the taxable income for the year of assessment ending 31 December 2012.

<u>*Note*</u>

It should be assumed that all instruments have been issued on 1 January 2012 and that all entities in the case studies have a financial year-end of 31 December 2012. The year of assessment for purposes of the analysis therefore spans the period 1 January 2012 to 31 December 2012.

4.2.1 Case study 1

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X is a mine situated in Country A and has the following preference shares in issue at 31 December 2012:

- P75,000,000 10% redeemable non-voting cumulative preference shares, issued on 1 January 2012.

Key terms of the 10% preference shares include:

- preference shares are mandatorily redeemable in cash out of accumulated profits which would otherwise be available for ordinary dividends after the payment of preference dividends; or
- at the option of the group, in cash raised by issuing new shares ("a fresh issue").

It should be noted that the option which the group has to redeem the preference shares in cash from the proceeds of a fresh issue of shares does not give the group the option to issue those shares to the preference shareholders as a manner of redemption. The cash realised from the issuance of ordinary shares will be used to redeem the preference shares.

4.2.1.1 *Key considerations when classifying the instrument from a financial reporting perspective*

X has issued cumulative redeemable preference shares. IAS 32 Financial Instruments: Presentation ("IAS 32") should be applied in determining whether the issued preference shares represent debt or equity instruments from the perspective of X.

IAS 32 paragraph 15 states that the issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument.
IAS 32 paragraph 16 sets out the distinction between an equity instrument or financial liability and states that an instrument is an equity instrument if, amongst other characteristics:

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“The instrument includes no contractual obligation to deliver cash or another financial asset to another entity; or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer.”

As can be established from the fact pattern, the preference shares issued by X are redeemable in the event that profits are available after the payment of preference dividends.

IAS 32 paragraph 25 states that a financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be a financial liability, in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument, such as a change in a stock market index, consumer price index, interest rate or taxation requirements, or the issuer's future revenues, net income or debt to equity ratio. These contingent events are referred to as ‘contingent settlement provisions’.

X is contractually obliged to redeem (i.e. to deliver cash) the preference shares issued by it in the event that it has additional profits available after the payment of dividends. The generation of profit is determined by a multitude of factors including macro-economic forces and trading conditions. All of the factors impacting on the availability of profits and hence the redemption of the preference shares are not within the control of X (issuer of the preference shares) and as such constitute “uncertain future events that are beyond the control of both the issuer and the holder...”. IAS 32 paragraph 25 also specifically lists the ‘future revenues’ of the entity as a variable which is not within the control of the issuer and this is a key building block of the ultimate profit for any given reporting period.

IAS 32 paragraph 25 determines that where the above applies, the issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset. Therefore, the instrument is a financial liability of the issuer unless:

a) the part of the contingent settlement provision that could require settlement in cash or another financial asset is not genuine;

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b) the issuer can be required to settle the obligation in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) only in the event of liquidation of the issuer; or

c) the instrument has all of the features and meets the conditions in paragraphs 16A and 16B.

IAS 32.AG 28 determines the following with respect to contingent settlement provisions that are not genuine:

"Thus, a contract that requires settlement in cash or a variable number of the entity's own shares only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur is an equity instrument. Similarly, settlement in a fixed number of an entity's own shares may be contractually precluded in circumstances that are outside the control of the entity, but if these circumstances have no genuine possibility of occurring, classification as an equity instrument is appropriate."

The generation of profit that would be available for dividends (after payment of accrued preference dividends) cannot be argued to have "no genuine possibility of occurring" and as such the contingent settlement provision is genuine. Furthermore, the generation of profit is not "extremely rare, highly abnormal and very unlikely" for a commercial enterprise.

Items (b) and (c) listed above (IAS 32 para 25) are not applicable given the fact pattern.

4.2.1.2 *Conclusion of the accounting firm on case study 1*

Based on the above analysis and the application of the provisions of IAS 32, the preference shares should be accounted for as financial liabilities.

4.2.1.3 *Key considerations when classifying the instrument from a tax perspective*

From a tax perspective, the preference shares issued would be equity, unless they were classified as a 'hybrid equity instrument'.

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Section 8E of the ITA defines a 'hybrid equity instrument', however, there is insufficient information in this first case study to determine whether or not the preference shares issued by X would be so classified. The case study does not indicate the time period during which the preference shares are redeemable by X, just that there is a mandatory redemption. It also does not indicate at whose request the redemption is – X or the preference shareholders.

The definition of 'hybrid equity instrument' in section 8E(1) paragraphs (a) and (b) makes reference to shares that are redeemable within a period of three years from the 'date of issue' as defined in section 8E(1).

It is important to note that if the preference shares are classified as 'hybrid equity instruments' the effect would be that the dividends paid to the preference shareholders would be deemed to be 'income' (section 8E(2)) and as such, not exempt from income tax in the shareholder's hands.

With effect from 1 April 2012, Section 64F(l) would exempt such a dividend from dividends tax in the hands of the shareholder. For dividends declared prior to this period, X would have had a Secondary Tax on Companies (STC) liability in relation to the dividends declared.

There would be no interest deduction for X, as X is paying a dividend.

4.2.1.4 *Conclusion of the tax specialist on case study 1*

Based on the above analysis and provided that the preference shares are not regarded to be 'hybrid equity instruments' the preference shares will be seen as equity instruments from a tax perspective.

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4.2.1.5 *Overall conclusion on case study 1*

On analysing case study 1, divergent conclusions were reached from a financial reporting versus a tax perspective as the tax specialist concluded that the instrument was an equity instrument whilst the accounting firm concluded that the instrument was a financial liability. A key aspect driving the accounting conclusion is the impact of contingent settlement provisions. The generation of profits is a trigger event for the redemption of the preference shares. The technical analysis emphasises that the fact that the generation of future profits by X is not within its control, results in X not having the unconditional discretion to avoid a contractual outflow of cash and this leads to classification of the instrument as a financial liability. The main driver of divergence in this case is the fact that no arbitrary time limit is placed on the period within which an instrument must be redeemed to be seen as a debt instrument from a financial reporting perspective. Even if the contractual obligation to deliver cash takes place at an undefined future time, debt classification still prevails. From a tax perspective, however, legally defined time periods can trigger a particular classification of the instrument.

4.2.2 Case study 2

X Ltd ("X") has entered into an agreement with BD Bank Limited ("BD") in terms of which it will issue cumulative redeemable class A preference shares (the "A shares") of R0,000001 each to BD. The issue of A shares serves to provide funding to X in order to settle existing debt and fund future growth. The preference shares were issued to BD Bank on 1 January 2012.

<u>Advance condition:</u>

This refers to various conditions that need to be met before BD Bank will subscribe for the preference shares and includes items such as:

- Amending the articles of association of X;
- Creating the preference shares;

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- Passing an ordinary resolution which places sufficient preference and ordinary shares under the control of the directors for purposes of fulfilling the terms of the agreement;
- Other administrative items such as providing BD Bank with specimen signatures of the directors of X.

Early redemption event:

Early redemption events include:

- a breach of obligations in terms of the agreement;
- a financial covenant calculation of less than two times the sum of the accrued value and the senior facility balance;
- the occurrence of a liquidity event (listing of X's shares, disposal of greater part of X's assets, acquisition of more than 50% of X's shares by a third party, shareholder A and B cease to hold 25% of the issued share capital of X between them);
- failure to rectify indebtedness;
- other similar event which could jeopardise the interest of BD.

Effective date:

The date of fulfilment or waiver of the last outstanding "advance condition.

Final settlement date:

This refers to the date on which all the A preference shares have been redeemed and X's entire indebtedness and obligations in terms of this agreement have been paid, settled and performed in full.

Maturity date:

Five years and one day from the effective date.

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Terminal date:

The earlier of the date of the happening of an early redemption event and the maturity date.

General terms of the preference shares issued

The A shares may be taken up by BD during the period commencing on the effective date and terminating on the earlier of the date of expiry of two years from the effective date and the date of the happening of an early redemption event.

The subscription price of the A shares amounts to R1,000 per share and BD will subscribe to a maximum of 40,000 A shares. The total issue proceeds could therefore amount to R40 million.

A shares accrue preference dividends as follows:

- from the effective date but excluding the terminal date, JIBAR plus 800 basis points (nominal annual compounded semi-annually in arrears);
- from and including the terminal date but excluding the final settlement date. JIBAR plus 1,600 basis points (nominal annual compounded semi-annually in arrears).

Dividend rights

The dividends above shall be calculated on a daily basis and are cumulative and payable upon redemption of the A shares. After the terminal date, dividends on the A shares will become due and payable semi-annually (in arrears) on the date of expiry of a period of six months after the terminal date and on the date of expiry of every six months thereafter until the final settlement date.

A dividend payment date is defined as the date on which a preference dividend or additional dividend becomes due and payable.

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Compulsory redemption

X is obliged to redeem the A shares on the maturity date. X is not entitled to redeem the A shares early unless an "early redemption event" occurs.

Conversion option

BD has the right to convert, on the maturity date, all or part of the A shares into ordinary share of X at a subscription price equal to the "conversion value" up to an aggregate price equal to the accrued value as at the date of subscription. However BD may not subscribe to more than 10% of the entire issued share capital of X.

The "conversion value" is the expected fair market value of the ordinary equity of X immediately after conversion divided by the number of ordinary shares expected to be in issue immediately after the conversion (i.e. the fair value of the X shares).

4.2.2.1 ***Key considerations when classifying the instrument from a financial reporting perspective***

IAS 32 Financial Instruments: Presentation ("IAS 32") paragraph 11 defines a financial liability as any liability that is:

A contractual obligation:

- to deliver cash or another financial asset to another entity; or
- to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

A contract that will or may be settled in the entity's own equity instruments and is:

- a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

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- a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

The terms of the A shares require X to both redeem the capital of the A shares and to pay cumulative preference dividends (and potentially additional preference dividends). The obligation to redeem the capital of the A shares may be settled by delivering cash, in an amount equal to the redemption amount payable at that stage, or to deliver as many shares, issued at the fair value of those shares, as would equal the redemption amount payable.

In terms of the agreement, X may therefore be required to either deliver cash (which would be a financial liability) or to deliver a variable number of its own equity instruments (which would also represent a financial liability). The settlement method is at the option of BD Bank.

4.2.2.2 *Conclusion of the accounting firm on case study 2*

Based on the above analysis and the application of the provisions of IAS 32, the preference shares should be accounted for as financial liabilities.

4.2.2.3 *Key considerations when classifying the instrument from a tax perspective*

The definition of 'hybrid equity instrument' in section 8E of the ITA includes, in relation to any share (sub-paragraph (c)(i) of the aforementioned definition), where 'any dividend payable on such share is to be calculated directly or indirectly with reference to any specified rate of interest'.

The dividends on the shares in the case study accrue as follows:

- from the effective date but excluding the terminal date, JIBAR plus 800 basis points (nominal annual compounded semi-annually in arrears); and

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- from and including the terminal date but excluding the final settlement date. JIBAR plus 1,600 basis points (nominal annual compounded semi-annually in arrears).

Therefore, the ‘A’ preference shares issued by X to BD Bank would be classified as ‘hybrid equity instruments’ for income tax purposes. Dividends payable by X will not be tax deductible, however the dividends will be deemed to be ‘income’ (section 8E(2)) in the hands of BD Bank and as such, are not exempt from income tax.

With effect from 1 April 2012, Section 64F(l) would exempt such a dividend from dividends tax in the hands of BD Bank. For dividends declared prior to this period, X would have had a Secondary Tax on Companies (STC) liability in relation to the dividends declared.

4.2.2.4 *Conclusion of the tax specialist on case study 2*

Due to the preference shares being seen as ‘hybrid equity instruments’ no income tax deduction will be permitted with respect to the dividends declared and paid on the instrument. This is the same as concluding that the tax authorities view the preference shares as equity from the perspective of the issuer.

4.2.2.5 *Overall conclusion on case study 2*

On analysing case study 2, divergent conclusions were reached from a financial reporting versus a tax perspective as the tax specialist concluded that the instrument was an equity instrument (for all intents and purposes) whilst the accounting firm concluded that the instrument was a financial liability. The divergence, in this instance, stems from triggering a tax law provision which deems a distribution on the instrument to be a dividend which is not tax deductible. The tax provision was triggered as a result of linking the returns on the instrument to an interest rate. From a financial reporting perspective, the instrument is considered to be a financial liability due to the obligation to redeem the instrument in cash or by delivering a variable number of shares (the entity is effectively using its shares as currency). Any distributions made on the instrument will be treated as interest for financial reporting purposes and will be deducted in arriving at the profit or loss for the period.

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4.2.3 Case study 3

B Ltd ("B") owns 74% of the issued share capital of C (Pty) Ltd ("C"). Both B and C applied IFRS in the preparation of their financial statements up to the end of their 2010 financial year and adopted the IFRS for SMEs for the first time for the year ended 31 December 2011.

On 1 January 2012, C completed a black economic empowerment transaction, whereby the empowered C bought the business of B from B. As a result of this transaction a loan arose between B and C as the consideration for the business was credited to a loan liability due to B. This loan liability is referred to as the "Business Sale Loan" ("BSL") in the agreements governing the transactions.

The terms of the BSL loan are as follows:

- interest rate of 0.5% per annum, compounded monthly (this is a market-related interest rate in Country A where B is domiciled);
- no fixed repayment terms; and
- a subordination agreement is in place which has the effect of subordinating the loan in favour of the other creditors of C until such time as the assets, fairly valued, exceeds the liabilities of C or the end of the next reporting period (whichever happens first).

The capital amount and accrued interest on the loan is therefore callable on C's return to solvency or, if earlier, the end of the next reporting period. However, C has no intention to call the loan.

4.2.3.1 *Key considerations when classifying the instrument from a financial reporting perspective*

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The loan amount owing to B by C is considered a financial liability as it imposes on C a contractual obligation to deliver cash which C does not have the unconditional right to avoid. This view is supported by the following contractual terms attaching to the loan:

- the amount owing between C and its parent B has been legally structured as a loan;
- the amount owing is interest bearing;
- reference is made in the subordination agreement to the parent as a creditor of C; and
- some repayment on the instrument has taken place in the recent past.

4.2.3.2 *Conclusion of the accounting firm on case study 3*

Based on the above analysis and the application of the relevant reporting framework, the loan should be accounted for as a financial liability.

4.2.3.3 *Key considerations when classifying the instrument from a tax perspective*

B and C form part of the same group of companies as defined in section 1 of the ITA.

The assumption is made that B is a company as defined in paragraph's (c), (d), or (e) of that definition and as such, the definition of group of companies as defined in section 41 of the ITA applies.

The disposal of the business of B to C on loan account will automatically fall within the ambit of section 45 of the ITA unless the taxpayer elects for it not to apply as it is an intra-group transaction. If the sale of business assets and trading stock meet the requirements of an intra-group transaction, then section 23K would find application to the loan from B to C.

Section 23K limits the deduction in respect of reorganization transactions (as defined and includes an intra-group transaction as defined in section 45(1)). In terms of this section, unless a directive (section 23K(3)) to the contrary is obtained, no deduction for interest paid from C to B would be allowed.

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The loan from B to C for the purchase of business is an 'instrument' as defined in section 24J and a 'debt instrument' as defined in section 23K, but would not be a hybrid debt instrument as defined in section 8F. The loan would therefore be classified as debt for income tax purposes. The payment of interest by C to B could be denied in accordance with the provisions of section 23K unless a directive is obtained from the Commissioner. If a directive is obtained from the Commissioner, the interest deduction that C could claim would be in accordance with section 24J of the ITA.

4.2.3.4 *Conclusion of the tax specialist on case study 3*

Based on the analysis of the fact pattern, the tax specialist concluded that the loan payable by C would be a debt instrument, however the interest payments made on the instrument are likely to be denied as deduction for tax purposes because the provisions of section 23K will apply unless the entity has obtained a tax directive allowing the deduction of interest. Therefore, in substance, the instrument is more akin to equity than it is to debt.

4.2.3.5 *Overall conclusion on case study 3*

Both the accounting specialist and the tax specialist reached similar conclusions that the instrument would be a debt instrument (financial liability). However, in substance, the instrument is not treated in a similar manner under the respective disciplines. Classifying the instrument as debt for financial reporting purposes results in interest being deducted in arriving at the entity’s profit or loss for the period. Although the instrument is also technically seen as debt from a tax perspective, its nature is more similar to equity as no interest deduction will be allowed. Therefore, when viewed in light of the implications of section 23K, divergent conclusions are reached for financial reporting versus tax purposes.

4.3 SUMMARY OF FINDINGS AND APPLICATION TO RESEARCH OBJECTIVE

As detailed in chapter 1, the study set out to reach the following research objectives:

- To determine whether there is incongruity between the tax and accounting classification of selected financial instruments.

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- To identify the factors giving rise to the incongruent outcome.
- To evaluate the reasons for incongruity in order to gain insight into the differing objectives of taxation and corporate reporting.

4.3.1 Determining whether there is incongruity between the tax and accounting classification of the selected financial instruments

Incongruity was identified between the tax and accounting classification of all three of the financial instruments in the case studies selected for analysis in that the tax classification differed from the accounting classification. These were noted in case studies 1, 2 and 3.

4.3.2 Identification of those factors leading to incongruent outcomes

4.3.2.1 *Contingent settlement provisions*

One of the key factors giving rise to divergent classifications in both case studies 1 and 2 is that tax law does not take account of contingent settlement provisions in the same way that financial reporting does when classifying and instrument as either debt or equity.

Specifically, where an instrument contains clauses that would obligate an entity to deliver cash (whether in the form of distributions on the instrument or redemption of the instrument) and the variable contained in that clause (the contingent event) is not within the entity's control, then that instrument would be a liability (or debt) from a financial reporting perspective regardless of the timelines involved. The only exception to this general rule in financial reporting is that where the contingency is not genuine, it is effectively ignored.

4.3.2.2 *Application of rules or 'bright lines' enshrined in tax law versus looking at the substance of the arrangement*

Financial instruments are generally taxed according to their legal form. Accordingly an instrument classified as debt usually qualifies for full debt treatment and an instrument classified as equity is usually subject to the treatment of equity share capital.

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Tax law contains several rules which have the effect of automatically classifying a financial instrument in a particular way when the rules are triggered. These 'bright lines' are typically anti-abuse mechanisms. However, due to the bespoke nature of financial instruments, a 'one-size-fits-all' rule cannot effectively capture the economic substance of all instruments. When a rule is triggered, it can have the effect of classifying the instrument as a 'hybrid' instrument and the revenue authorities may disallow the deduction of interest as such payments are viewed as dividends.

Financial reporting seeks to analyse the substance of an arrangement and to assess whether an obligation to deliver cash is present under any circumstances. Where such an obligation to deliver cash exists, and it is not entirely discretionary, then the instrument will be a financial liability. When liability classification is achieved, all distributions are seen as interest and are charged to the profit or loss statement.

It is therefore expected that in cases where the legal form of an instrument and the substance of the arrangement are in harmony, a consistent classification will be achieved for both tax and financial reporting purposes although, as outlined in the conclusion reached relating to case study 3, even where a loan, structured with commercial terms, was seen as debt (or a financial liability) for both tax and financial reporting purposes, section 23K of the ITA found application resulting in the instrument being more akin to equity for tax purposes than it is to debt in that interest deductions are likely to be denied.

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CHAPTER 5: CONCLUSION

5.1 INTRODUCTION

Raising finance is a critical part of the sustained existence of corporate entities and, in many cases, is a prerequisite when pursuing expansion and growth strategies. Finance or capital can be raised in a variety of ways and the election of a particular method of financing is typically a function of several considerations, including the tax efficiency of the method.

Determining with certainty how the tax authorities will treat the instrument issued is not straightforward and this is a risk to corporate taxpayers tasked with generating shareholder value and predictable shareholder returns. These difficulties were outlined in chapter 2.

This chapter recaps the purpose and objectives of the study and concludes on the findings in chapter 4 and proposes areas of future research interest.

Purpose Statement

This study aims to identify potential factors giving rise to divergent financial instrument classifications between tax and financial reporting in order to gain insight into the reasons for the potential divergence.

The research objectives of the study are:

- To determine whether there is incongruity between the tax and accounting classification of selected financial instruments.
- To identify the factors giving rise to a possible incongruent outcome.
- To evaluate the reasons for incongruity in order to gain insight into the differing objectives of taxation and corporate reporting.

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5.1.1 Evaluation of the reasons for incongruity in order to gain insight into the differing objectives of taxation and corporate reporting

The analysis of the case studies in chapter 4 identified contingent settlement provisions and arbitrary tax rules or "bright-lines" as two reasons for the existence of incongruity between the financial reporting and taxation classification of financial instruments. This provides meaningful insight into the differing objectives of the two disciplines. The objectives of financial reporting and of a taxation system were explored in chapter 2.

In essence, financial reporting (under IFRS) has the objective of providing decision-useful information to the stakeholders of an entity. When considered from this perspective, it could be argued that financial reporting seeks to indicate the claims on the resources of an entity – i.e. its liabilities or debt – whenever an obligation may rest on an entity, even if it is not probable that the debt will be repaid in the foreseeable future. Financial reporting may favour the classification of financial instruments as debt in achieving this objective. In other words, financial reporting, although placing great emphasis on the contractual terms of a financial instrument, ultimately seeks to capture the economic substance of a financial instrument and to ensure that it is reflected in the financial accounting records of an entity in a manner which reflects that substance.

A core objective of taxation is to raise revenue for the state so that government can execute on its strategies and deliver public goods and services. From a revenue raising perspective, however, it would be tax efficient to view long dated instruments that are contingent on future events as equity share capital thereby denying the taxpayer any deduction when a distribution is made on the instrument. Taxation may therefore favour the classification of financial instruments as equity in achieving this objective. Furthermore, tax law places great emphasis on financial instruments either conforming to or falling foul of certain very specific definitions and rules in order to govern their tax treatment. The view taken under the tax provisions is generally legalistic (rules-based) rather than principle based as is the case under financial reporting guidance.

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5.2 CONCLUSIONS

Incongruence exists between the financial reporting and taxation classification of financial instruments from the perspective of the issuer of those instruments.

This study has attributed this incongruence to the impact of contingent settlement provisions and the rules-based approach taken by tax authorities as opposed to the principle or substance-based approach favoured by financial reporting.

The incongruence noted suggests that, based on their differing objectives, financial reporting favours the classification of financial instruments as debt whilst taxation favours the classification of financial instruments as equity.

5.3 RECOMMENDATIONS AND FUTURE RESEARCH

Although the approaches currently followed by financial reporting and taxation are different, recent amendments have incorporated financial reporting guidance into the ITA. Future research can be conducted to determine the impact of aligning financial reporting and taxation principles on tax certainty from a taxpayer perspective.

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APPENDIX A

INFORMED CONSENT FORM

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UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA
Faculty of Economic and Management Sciences

Informed consent for participation in an academic research study

Dept. of Taxation

AN ANALYSIS OF THE FACTORS LEADING TO DIVERGENCE BETWEEN THE TAX AND FINANCIAL REPORTING CLASSIFICATION OF FINANCIAL INSTRUMENTS ISSUED BY CORPORATE TAXPAYERS

Research conducted by:

Mr. D. Van der Merwe (25216377/04349881)
Cell: 082 041 2214

Dear Respondent

You are invited to participate in an academic research study conducted by Divan van der Merwe, a Masters student from the Department of taxation at the University of Pretoria.

The purpose of the study is to understand the potentially basis for differences between the classification of financial instruments as either debt or equity instruments from a tax perspective versus an accounting perspective.

Please note the following:

- This study involves the anonymous use of data provided by you/your firm. Your name and those of the parties involved in the case studies will not appear in the research output and will be treated as strictly confidential. Neither you nor the parties involved in the case studies will be identified in person.
- Your participation in this study is very important to us. You may, however, choose not to participate and you may also stop participating at any time without any negative consequences.
- Please perform the analysis as outlined in the attached case studies as completely as possible. This should not take more than 8 hours of your time.
- The results of the study will be used for academic purposes only and may be published in an academic journal. We will provide you with a summary of our findings on request.
- Please contact my supervisor, Prof E.R. Venter at elmar.venter@up.ac.za if you have any questions or comments regarding the study.

Please sign the form to indicate that:

- You have read and understand the information provided above.
- You give your consent to participate in the study on a voluntary basis.

____________________________ ____________________

Respondent's signature **Date**

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