ANNEXURE 4

DAVIS TAX COMMITTEE: SECOND INTERIM REPORT ON BASE EROSION AND PROFIT SHIFTING (BEPS) IN SOUTH AFRICA

SUMMARY OF DTC REPORT ON ACTION 4: LIMIT BASE EROSION VIA INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS

This report is based on the OECD's report on Action 11 that seeks to limit base erosion via interest deductions and other financial payments. Due to the mobility and fungibility of money, multinational groups are able to achievable tax results by adjusting the amount of debt in a group entity. Financing a company with debt, at a commercial interest rate, which is a deductible expense, is more effective in reducing source country tax than financing with equity where a distribution of dividends is not deductible. In the 2013 BEPS Draft Report the OECD notes that the deductibility of interest can give rise to double non-taxation in both inbound and outbound investment scenarios.

Limiting BEPS due to interest deductions is a high priority for South Africa due to the potential risk of loss to the fiscus due to such avoidance strategies by multinationals. South Africa employs various provisions to curb the avoidance of tax using interest and similar instruments, including transfer pricing and thin capitalisation provisions, and various recharacterisation and provisions that limit the deductibility of interest. Such provisions are also used in other jurisdictions. The OECD however, considers that these provisions are not adequate due to the developing financial structures currently used by multinationals.

The 2015 BEPS Report On Limiting BEPS Involving Interest And Other Financial Payments[1] lists the following three scenarios as the basic avenues that pose BEPS risks, namely:

- Groups placing higher levels of third party debt in high tax countries;
- Groups using intragroup loans to generate interest deductions in excess of the group's actual third party interest expense; and
- Groups using third party or intragroup financing to fund the generation of tax exempt income.

The Report recommends a best practice approach that involves the use of the fixed ration rule (which limits an entity's net interest deductions to a fixed percentage of its profit, measured using earnings before interest, taxes, depreciation and amortisation based on tax numbers). This rule is supplemented by the group ratio rule in terms of

[1] OECD. (2015), *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project. (OECD/G20 2015 Final Report on Action 4).

which if an entity exceeds the benchmark fixed ratio, it will be allowed to deduct the net interest expense up to its group's net third party interest expense or the earnings before interest, taxes, depreciation and amortisation ratio, if the latter is higher. The Report recommends that where necessary, the special provisions could be introduced that restrict interest deductions on payments made under specific transactions or arrangements. Specific rules are suggested for the banking and insurance sectors as well as transitional measures.

Having considered the above, the DTC makes the following recommendations for South Africa:

Recommendations on the effectiveness of arm's length principle in preventing BEPS due to excessive interest deductions

The OECD recommended that the arm's length test should only apply to the pricing of the debt i.e. the interest rate. It may be preferable in the South African context to retain the approach of evaluating the extent of debt (i.e. thin capitalization) and the debt pricing (i.e. the interest rate) separately. In doing so, exchange control requirements should be borne in mind.

- The Draft Interpretation Note on Thin Capitalisation creates uncertainties with taxpayers due to the fact that it has remained a draft since its release in March 2013. This has created concern for foreign investors as reliance on a draft of this nature is problematic.

The DTC recommends that the Guidance from SARS should be changed to be in line with that of the OECD and international thinking as a matter of urgency, and be finalised to avoid uncertainty of its application. It is important that the use of thin capitalisation rules to prevent BEPS resulting from excessive interest deductions is in line with what is recommended by the OECD, as different rules between different countries could lead to double taxation. In finalising or redrafting this draft, the DTC recommends that SARS considers the following:

- Simplification of rules;
- Consistency with the OECD recommendations and international precedent on the Final Report;
- Transfer pricing rules for interest rate should take into account outcome of the GE and Chevron cases on relevance of parent credit ratings;
- Introducing ways of reducing the administrative burden for taxpayers with a low risk of BEPS through interest deductions. These could be one or all of the below:
    - Introduction of a safe harbour; and
    - Threshold based upon loan value or another measure whereby taxpayers falling below such a threshold would not have to comply with the rules.

- How to treat start-up operations where loan funding is required;
- Compliance cost for investors.

It is recommended that a “safe harbour” with a fixed ratio be introduced in section 31 or the Interpretation Note to provide non-residents that are funding local entities with guidance as to reasonable levels of debt versus equity.
It is further recommended that legislation and Interpretation Notes be released together, first in draft and then in final form.

Recommendations on exchange controls

It is recommended that the interest cap between SARB and SARS should be aligned. Interest rates allowable from a SARB perspective are potential indicators of risk from a South African transfer pricing perspective.

The DTC’s recommendation is further that a taxpayer should determine what interest rate would be acceptable from a Transfer Pricing perspective. If acceptable, then it should be allowed by SARB. Alternatively SARS should indicate what interest rates it would allow, and then those should be allowed from an exchange control perspective.

Recommendation on withholding tax on interest

Although the OECD rejected the use of withholding taxes on interest as not suitable for preventing BEPS relating to excessive interest deductions unless the rates are aligned with the corporate tax rate. Nevertheless, the withholding tax on interest became effective in South Africa with effect 1 March 2015. Although OECD countries reject withholding taxes, they are used by source countries to ensure allocation of taxing rights to the source jurisdiction. As such, despite the OECD’s rejection of withholding taxes as a measure of preventing BEPS, it is considered that the withholding tax serves an important role in the South African tax system, that being protecting the South African tax base by ensuring its ability to tax interest sourced in South Africa.

- To that end, from a treaty context, it is recommended that the treaties with zero or low interest withholding tax rates be renegotiated to afford South Africa a full taxing right to such interest. It is noted, however, that renegotiation of tax treaties is a time consuming process, and should perhaps be done in a holistic manner where the objective is to achieve more than just one objective.

Recommendation on interest deductibility

Recognising the complexities and uncertainties for potential investors as to what level of interest deductibility they would be entitled to in any particular year it is recommended that a proper analysis be made to determine whether reliance on deduction limitation rules is appropriate.

Recommendation on incurral and accrual of interest

Section 24J was originally introduced into the Income Tax Act principally to regulate the incurral and accrual of interest in respect of “instruments”. The provisos to rules relates to the definition of “yield to maturity". However as explained in the detailed report below, the wording of the provisos is wider than their intended ambit as expressed in the Explanatory Memorandum. It is recommended that:

- ➢ The rules relating to incurral and accrual of interest in section 24J be reconsidered, without widening the definition of interest, to ensure that the rules do not adversely apply to transactions where there is no tax avoidance purpose.
- ➢ The appropriate mechanism to remedy this problem is to add a requirement that, for example, there must be a purpose of avoiding tax before the provisos apply, or to include some other explicit reference to the tax avoidance mischief identified in the Explanatory Memorandum.
- ➢ The definition of interest is apposite. There should not be any amendment to the definition of interest for the purpose of interest withholding tax that could broaden the definition further than the current definition that includes the definition in para (a) and (b) of the definition of interest in section 24J(1).
- ➢ It is also not recommended that a further withholding tax on derivative payments should be imposed. This would constitute an unusual withholding tax from an international perspective and could adversely impact on foreign direct investment.

Recommendations on hybrid interest and debt instruments

Both section 8F and section 8FA of the Income Tax Act re-characterise interest as dividends in both the paying and receiving entities in certain circumstances. These provisions are effective in preventing excessive interest deductions in respect of inbound transactions, but not outbound transactions. In respect of outbound transactions these provisions mean that a South African resident, instead of receiving taxable interest, receives a tax exempt dividend.

- ➢ The re-characterisation in respect of outbound debt instruments falling within the provisions of section 8F or section 8FA of the Income Tax Act should be changed to refer to “foreign dividends”. Such foreign dividends would therefore only be exempt if they qualify for the more onerous exemption criteria set out in section 10B of the Income Tax Act.
- ➢ In addition in all circumstances these transactions should be subject to the provisions of section 8EA of the Income Tax Act. There has been much time spent on section 8EA of the Income Tax Act, but these rules can now be

circumvented by taking security over a hybrid debt instrument falling into the provisions of section 8F or section 8FA of the Income Tax Act.

These recommendations are intended to improve and enhance the South African tax system's ability to curb tax avoidance using interest and similar payments.

DTC REPORT ON ACTION 4: LIMIT BASE EROSION VIA INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS

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1 INTRODUCTION

There are essentially two ways in which a company may be financed; debt (loan capital) or equity capital.[1] The tax treatment of a company and its financers differs fundamentally depending on whether it is financed by loan or equity capital.[2] In an international context, the difference between debt and equity may be a significant concern to the tax authorities[3] since multinational companies often manipulate group company financing to minimize their global tax exposure.[4]

If capital is loaned by a parent company to its subsidiary in another jurisdiction, the subsidiary company will have to pay interest to the parent company, which in most jurisdictions is regarded as an expense incurred in earning profits, and is deductible by the payer of the interest in computing its taxable income (unless there are special rules to the contrary).[5] However, withholding tax may be payable by the payer of the interest on behalf of the recipient. If there is an applicable double tax treaty, interest paid to the parent company is usually subject to a lower withholding tax.[6] If the parent company were to subscribe for shares in its subsidiary in another jurisdiction, dividends would be distributed by the subsidiary to the parent company. In most jurisdictions the dividends would not be deductible when calculating the subsidiary's taxable income since these are distributions of profits that have already been taxed.[7]

From the above it is clear that financing a company with debt, at a commercial interest rate, which is a deductible expense, is more effective in reducing source country tax than financing with equity where a distribution of dividends is not deductible.[8] Thin capitalisation often entails cases where a company is financed with

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1 AW Oguttu "Curbing Thin Capitalisation: A Comparative Overview With Specific Reference To South Africa's Approach - Challenges Posed By The Amended Section 31 of The Income Tax Act" (2013) Vol 67 Issue No 6 *Bulletin for International Taxation* at 312; RA Sommerhalder 'Approaches to Thin Capitalisation' *Bulletin for International Fiscal Documentation* (March 1996) at 446.

2 Sommerhanlder at 82.

3 B Lawrence 'Government Restrictions on International Corporate Finance (Thin Capitalization)' *Bulletin for international Fiscal documentation (March* 1990) at 118.

4 HM Revenue & Customs "INTM542005 - The Main Thin Capitalisation Legislation: Overview". Available at http://www.hmrc.gov.uk/manuals/intmanual/intm542005.htm accessed 18 September 2015.

5 K Huxham & P Haupt *Notes on South African Income Tax* (2013) at 80.

6 United Nations Ad Hoc Group of Experts on International Cooperation in Tax Matters at 18; Sommerhalder at 82.

7 Sommerhalder at 82.

8 BJ Arnold & MJ McIntyre *International Tax Primer* (2002) at 72-73; L Olivier & M Honiball *International Tax: A South African Perspective* (2011) at 649.

more debt than it could have borrowed based on its own balance sheet and, thus, financial strength, because it is borrowing either from, or with the support of, connected persons.[9]

The deductibility of interest can give rise to double non-taxation in both inbound and outbound investment scenarios. With inbound investment, the concern is mostly with loans from a related entity in a low-tax regime. This creates interest deductions for the borrower without a corresponding tax on the interest income for the lender. For outbound investment, a company may use debt to finance the production of exempt or deferred income, claiming a deduction for interest expense while deferring or exempting the related income.[10]

Domestic tax authorities often introduce rules that place a limit on the amount of interest that can be deducted in calculating the measure of a company's profit for tax purposes. From a policy perspective, failure to tackle excessive interest payments to associated enterprises gives multinational enterprises an advantage over purely domestic businesses that are unable to gain such tax advantages.[11]

The problem of excessive use of deductible payments is not limited to loans and debt. Other forms of financial transfers can give rise to similar base erosion processes: intra-group insurance and guarantees on commercial and credit default risk and internal derivatives used in intra-bank dealings. Excessive deductions can also involve royalties and management costs at headquarters level.

The 2013 OECD BEPS report[12] notes that:

> "The deductibility of interest expenses can give rise to double non-taxation in both the inbound and outbound investment scenarios. From an inbound perspective, the concern regarding interest expense deduction is primarily with lending from a related entity that benefits from a low-tax regime, to create excessive interest deductions for the issuer without a corresponding interest income inclusion by the holder. The result is that the interest payments are deducted against the taxable profits of the operating companies while the interest income is taxed favourably or not at all at the level of the recipient, and sometimes the group as a whole may have little or no external debt. From an outbound perspective, a company may use debt to finance the production of exempt or deferred income (e.g. participation exemptions), thereby claiming a current deduction for interest expense while deferring or exempting the related income. Rules regarding the deductibility of interest expense should therefore take into account that the related interest income may not be fully taxed or that the underlying debt may be used to inappropriately reduce the earnings base of the issuer or finance deferred or exempt income. Related concerns are raised by deductible payments for other financial transactions, such as financial and performance guarantees, derivatives, and captive and other insurance arrangements, particularly in the context of transfer pricing."

9 G Richardson, D Hanlon & L Nethercott "Thin Capitalization: An Anglo-American Comparison" *The International Tax Journal Spring* 1998 Vol 24 Iss 2 at 36.

10 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 16.

11 OECD "Thin Capitalisation Legislation: A Background Paper for Country Tax Administrators" August 2012 (draft) at 7.

12 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 16-17.

The OECD notes that BEPS using interest can arise from arrangements using third party debt (for example where one entity or country bears an excessive proportion of the group's net third party interest expense) as well as intragroup debt (for example where a group uses intragroup interest expense to shift taxable income from high to low tax countries). [13]

2 INTERNATIONAL TRENDS IN PREVENTING EXCESSIVE INTEREST DEDUCTIONS

A large number of intra-group debt techniques exist for which countries have considerable restrictions even before the BEPS Action Plan. Such include:[14]

2.1 THIN CAPITALISATION PROVISIONS

One approach to curbing the financing of subsidiary companies with higher levels of debt than equity capital is the use of the arm's length principle[15] (which is applied in curbing transfer pricing[16]) to determine whether the size of the loan would have been made in an arm's length transaction,[17] whether the rate of the interest is at an arm's length rate and whether a prima facie loan can be regarded as a loan or some other kind of payment.[18] Thus, if the loan exceeds what would have been lent in an arm's length situation, then the lender must be taken to have an interest in the profitability of the enterprise and so the loan, or interest rate that exceeds the arm's length amount, must be taken to be effectively designed to procure a share in the profits.[19] A high debt to equity ratio would thus be considered as one of the factors in determining whether the loan is non-arm's length and thus treating the interest as a distribution of dividends for tax purposes.[20]

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13 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 19.

14 A Cinammon "How the BEPS Action Plan Could Affect Existing Group Structures" Tax Analyst 12 Nov 2013.

15 The arm's length principle as set out in article 9 (1) of the OECD MTC provides that when conditions are made or imposed between two associated enterprises in their commercial or financial relations which differ from those which would have been made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

16 Transfer pricing is a term that describes the process by which related entities set prices at which they transfer goods or services between each other. It entails the systematic manipulation of prices in order to reduce profits or increase profits artificially or cause losses and avoid taxes in a specific country. See Arnold & McIntyre at 53.

17 In an arm's length transaction, each party strives to get the utmost possible benefit from the transaction. See Article 9 of the OECD *Model Tax Convention on Income and on Capital* (2010 condensed version).

18 OECD Issues in International Taxation No.2 *Thin Capitalisation: Taxation of Entertainers, Artists and Sportsmen* (1987) in in para 48.

19 OECD Issues in International Taxation No.2 at 15 in para 25(i); see also OECD/G20 BEPS Project 'Limiting Base Erosion Involving Interest Deductions and Other Financial Payments' (2015 Final Report) para 12.

20 OECD Issues in International Taxation No.2 at 15 in para 25(i).

The OECD's views on thin capitalisation were first presented in its 1979 Report on "Transfer Pricing and Multinational Enterprises".[21] In 1987, the OECD issued a Report on Thin Capitalisation[22] which examined the ways in which various OECD countries dealt with thin capitalisation. In this Report the OECD noted that countries often make use of the arm's length approach or the fixed ratio approach or a combination of the two, in order to reduce the benefits attached to thin capitalisation practices.[23]

The United Kingdom for instance, relies on the arm's length approach to prevent thin capitalisation.[24] The United States' thin capitalisation rules are commonly referred to as "earnings stripping" rules.[25] These rules are designed to prevent United States corporations from deducting interest payments in respect of outstanding debts payable to related parties who are exempt from United States tax. The US also applies the arm's length principle in order to curb thin capitalisation. According to the United States' Treasury Regulations 1.482-2(a) loans between related parties must be at an arm's length interest rate.

Research conducted on the impact of thin capitalisation rules[26] that limit the tax deductibility of interest on the capital structure of the foreign affiliates, found that these rules affect multinational firm capital structure in a significant way. The research shows that restrictions on borrowing from the parent company reduce the affiliate's debt to assets ratios. This shows that rules targeting internal leverage have an indirect effect on the overall indebtedness of affiliate firms. The impact of capitalisation rules on affiliate leverage is higher if their application is automatic rather than discretionary.[27]

The OECD notes that one advantage of an arm's length approach is it recognises that entities may have different levels of interest expense depending on their circumstances. However, since each entity is considered separately after arrangements are entered into, the outcomes of applying the arm's length principle can be uncertain.[28] The OECD noted that some countries that applied this approach concerns about its effectiveness in preventing BEPS. This is particularly so in cases of groups structuring intragroup debt with equity-like features to justify interest payments that are in excess of those the group actually incurs on its third party debt.

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21 OECD "Transfer Pricing and Multinational Enterprises" (1979) paras 183-191.
22 OECD Issues in International Taxation No.2 in para 20.
23 OECD Issues in International Taxation No.2 para 25.
24 HJ Ault & BJ Arnold *Comparative Income Taxation: A Structural Analysis* 2nd edition (2003) at 413; AK Rowland "Thin Capitalization in the United Kingdom" (1995) *Bulletin for International Fiscal Documentation* at 554.
25 Ault & Arnold at 412.
26 J Blouin, H Huizinga & L Laeven, G Nicodème "Thin Capitalization Rules and Multinational Firm Capital Structure" (15 January 2014).
27 Ibid.
28 OECD/G20 2015 Final Report on Action 4 in para 12.

The OECD also notes that arm's length test does not prevent an entity from claiming a deduction for interest expense which is used to fund investments in non-taxable assets or exempt income.[29] The other concern is that internationally there are no clear guidelines for determining the parameters within which the arm's length principle is to apply in the context of thin capitalisation. Consequently, internationally countries tend not to only rely on the arm's length principle to curbing thin capitalisation but they often apply this principle alongside fixed debt/equity ratios which can be used as 'safe harbours' in setting the parameters within which this principle applies. Sometimes fixed debt/equity are applied exclusively since they are considered relatively easier for tax administrations to administer as countries can easily link the level of the interest expense to a measure of an entity's economic activity.[30]

2.2 FIXED RATIO RULES

In terms of fixed ratio rules, the interest relating to the debt above the fixed ratio is not taxed deductible. However the OECD cautions that the fixed ratios can be relatively inflexible if the same ratio is applied to entities in all sectors. The other concern is that in some countries the rates at which these ratios are set are too high to be an effective tool in addressing BEPS or too low such that they can lead to double taxation risks. A rule which limits the amount of debt in an entity still allows significant flexibility in terms of the rate of interest that an entity may pay on that debt. interest expense, which makes it relatively easy for a group to manipulate the outcome of a test by increasing the level of equity in a particular entity. Due to these disadvantages, the OECD concludes that although the fixed ratio approach can play a role within the overall tax policy to limit interest deductions, in general it is not a best a best practice approach to tackle BEPS.[31]

2.3 WITHHOLDING TAXES ON INTEREST

Some countries levy withholding taxes on interest as a means of preventing the erosion of their tax bases. A withholding tax is used as a mechanism to enable the collection of taxes from non-residents, by appointing a resident as the non-resident's agent and imposing an obligation on the resident agent to withhold a certain percentage of tax from payments made to the non-resident. If the resident agent does not comply with this duty or if he/she withholds an incorrect amount of tax, personal liability can be imposed on the resident agent.[32] Where there is a double tax treaty in place, withholding tax rates will be reduced to 10% for treaties based on article 11 of the OECD MTC. Any double taxation that arises is usually addressed in terms of article 23A of the OECD MTC by giving credit in the country where the

[29] OECD/G20 2015 Final Report on Action 4 in para 12.
[30] OECD/G20 2015 Final Report on Action 4 in para 17.
[31] OECD/G20 2015 Final Report on Action 4 in para 17.
[32] L Olivier & M Honiball *International Tax: A South African Perspective* (2011) at 362-363.

interest payment is received. The OECD notes unless the withholding tax is applied at the same rate as corporate tax, opportunities for base erosion and profit shifting would remain. In fact, in some cases withholding taxes can drive BEPS behaviour, where groups enter into structured arrangements to avoid imposition of a tax or generate additional tax benefits (such as multiple entities claiming credit with respect to tax withheld). For the above reasons, the OECD advises that countries should apply withholding taxes alongside other best practices as discussed below.[33]

2.4 DEBT/EBITDA RATIOS

A debt/EBITDA ratio is a metric measure of a company's ability to pay off its short term incurred debt by giving an investor the approximate amount of time that would be needed to pay off all debt. The metric ratio is calculated as debt divided by earnings, before factors such as interest, taxes, depreciation and amortization are taken into account. A high debt/EBITDA ratio suggests that a company may not be able to service their debt in an appropriate manner and can result in a lowered credit rating. Conversely, a low ratio can suggest that the firm may want take on more debt if needed and it often warrants a relatively high credit rating.[34] Although debt/EBITDA ratios may be useful, the fact that they do not include the effects of the company's expenditures on its finances requires that they should be used with caution when evaluating a company, as not all of the company's risk is accounted for in the ratio.[35]

2.5 GROUP RATIO TESTS

Some countries apply group ratio tests which compare the level of debt in an entity by reference to the corporate groups' overall position. These group ratio tests typically operate by reference to debt/equity ratios. However in many cases the amount of equity in an entity may at best only be an indirect measure of its level of activity and can be subject to manipulation.[36]

2.6 TARGETED ANTI-AVOIDANCE RULES

Some countries apply targeted anti-avoidance rules which disallow interest expense on specific transactions. However, as new BEPS are exploited, further targeted rules may be required and so there is a tendency over time for more rules to be

33 OECD/G20 2015 Final Report on Action 4 in para 13.

34 Investopedia Available at http://www.investopedia.com/terms/d/debt_edbitda.asp#axzz2AxUfUVka accessed 31 October 2012; see also E Novinson 'Explanation of Debt to EBITDA Ratio' eHow.com http://www.ehow.com/info_7856136_explanation-debt-ebitda-ratio.html#ixzz2AxWymT1e accessed 31 October 2012.

35 The Free Dictionary 'Debt/EBITDA ratio'. Available at http://financial-dictionary.thefreedictionary.com/Debt%2FEBITDA+ratio accessed 31 October 2012.

36 OECD/G20 2015 Final Report on Action 4 at 19.

introduced, resulting in a complex system and increased administration and compliance costs.[37]

2.7 SPECIFIC COUNTRY EXAMPLES

An example of a specific provision applied in some countries to deny excessive interest deductions is the participation exemption provision. In other countries, interest deductions are denied to the extent that the paying company benefits from the receipt of tax-free dividends and gains. The following are examples of provisions applied in some countries:

2.7.1 UNITED KINGDOM

The UK uses the worldwide debt cap which treats inbound loans as dividends. It is not a straightforward comparison of each member's debt-equity ratio to the group's total debt-equity ratio.[38] The worldwide debt cap prevents British interest deductions from exceeding the group's worldwide interest expense. It applies to purely domestic groups with intra-group debt, which are allowed to exclude the income represented by disallowed interest. The tested amount is the total intra-group interest expense in the United Kingdom, excluding British external interest expense, and the cap is the worldwide group's net external interest expense. HM Revenue & Customs must determine the subject company's debt capacity - that is, how much it would be able to borrow, as an independent company, from an outside lender. Debt capacity is then compared to the subject's actual borrowing from related companies, or under a related party guarantee, to determine whether it is thinly capitalised. Outside loans are considered when the proceeds are on-lent around the group.[39] However the debt cap still focuses on the location of the borrower. The location of an interest deduction can be arbitrary. Even for a group without outside borrowing, the interest deduction is likely to be in the parent's home country or in a high-tax country with developed capital markets. Since money is fungible, and borrowing benefits the whole group, the allowable interest deductions should be allocated in the group in a rational manner.[40]

2.7.2 UNITED STATES

In terms of the branch profits tax under section 882(c) of the US Internal Revenue Code, Treasury regulation 1.882-5 allocates interest between foreign banks and their US branches based on the fair market value of its US assets relative to its worldwide assets for purposes of determining the branch's separate US interest deduction. The

[37] OECD/G20 2015 Final Report on Action 4 at 20.
[38] Ibid.
[39] Ibid.
[40] Ibid.

regulation treats money as fungible, and the branch as having a call on its parent's assets. This regulation is formulary apportionment in all but in name. [41]

2.7.3 GERMANY

Germany applies a limitation of interest deductions which is to 30 percent of EBITDA (section 8A of the *Abgabenordnung*). This percentage is becoming the standard for Europe. However, EBITDA ratios have their shortcomings, particularly in the fat capitalisation situation, in which a multinational with no debt uses internal interest deductions to strip income from operating affiliates. [42]

3 OECD BEPS REPORT RECOMMENDATIONS

On the domestic front the 2013 OECD BEPS Report[43] recommended that:

- Countries should come up with provisions that limit base erosion via interest deductions and other financial payments.
- Countries should develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example:
    - through the use of related-party and third-party debt to achieve excessive interest deductions; or
    - to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments.

On the international front the OECD recommended that addressing this concern would require considering how the OECD transfer pricing guidelines would work with regard to:

- the pricing of related party financial transactions,
- financial and performance guarantees,
- derivatives, and
- captives and other insurance arrangements.

The OECD's work in this regard was to be co-ordinated with the work on hybrids and CFC rules.

4 SUMMARY OF OECD DISCUSSION DRAFT ON ACTION 4: INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS

On 18 December 2014 the OECD Issued a Discussion draft on Action 4 ("the Discussion Draft").[44] The Discussion Draft noted in the Introduction that "the use of

41 Ibid.

42 L Shepperd "What should the OECD do about Base Erosion?" Copenhagen precise of 2013 International Fiscal Association annual Congress" 9/9/2013.

43 OECD "Action Plan on Base Erosion and Profit Shifting" (2013) at 17.

interest, in particular related party interest is perhaps one of the most simple of the profit-shifting techniques available in international tax planning." The Discussion Draft listed the following concerns regarding BEPS using interest deductions:

- The interest deducted by a group in total may be higher than its actual third party interest expense;
- Parent companies are typically able to claim relief for their interest expense, while the return on equity holdings is taxed on a preferential basis, benefiting from a participation exemption, preferential tax rate or taxation only on distribution;
- Subsidiary entities may be heavily debt financed, bearing a disproportionate share of the group's total third party interest cost and incurring interest deductions which are used to shelter local profits from tax;
- Taking the above combined, these potentially create competitive distortions between groups operating internationally and those operating in the domestic market. This in turn has a negative impact on capital ownership neutrality, creating a tax preference for assets to be held by overseas groups rather than domestic groups;
- Another form of BEPS could be the use of interest deductions to fund income which is exempt or deferred for tax purposes, and obtaining relief for interest deductions greater than the actual net interest expense of the group;

MNE's have achieved this through various ways including:

- the use of intragroup loans to generate deductible interest expense in high tax jurisdictions and taxable interest income in low tax jurisdictions;
- development of hybrid instruments which give rise to deductible interest expense but no corresponding taxable income;
- the use of hybrid entities or dual resident entities to claim more than one tax deduction for the same interest expense; and
- the use of loans to invest in structured assets which give rise to a return that is not taxed as ordinary income.

The Discussion Draft noted that the use of a specific approach to restrict interest deductions in a single country could adversely impact the attractiveness of the country to international business and the ability of domestic groups to compete globally. It is therefore necessary for a consistent approach utilising international best practices, if concerns regarding BEPS on interest are to be addressed. A consistent approach should remove distortions, reduce the risk of unintended double taxation, remove opportunities for BEPS and, as a result, increase fairness and equality between groups.

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[44] Public discussion draft, BEPS Action 4: Interest Deductions and other financial payments, 18 December 2014 to 6 February 2015 – www.oecd.org/ctp/agressive/discussion-draft-action-4-interest-deductions.pdf

The Discussion Draft focused on options for designing statutory limitations on the deductibility of payments that truly represent interest, rather than how to set the prices for financial transactions. In general the OECD recommends that groups should be able to obtain tax relief for an amount equivalent to their actual third party interest cost.

The OECD considered the rules (discussed in paragraph 2 above) that are currently applied by countries to prevent base erosion through excessive interest deductions, and categorized these into 6 broad groups, with some countries (such as South Africa) applying more than one of these rules concurrently. These were:

- rules which limit the level of interest expense or debt in an entity with reference to a fixed ration including debt-equity ratios, interest to EBITDA ratios and interest to asset ratios;
- rules which compare the level of debt in an entity by reference to the corporate groups' overall position;
- targeted anti-avoidance rules which disallow the interest expense on specific transactions;
- arm's length tests which compare the level of interest or debt in an entity or person that would have existed had that entity being dealing entirely with third parties;
- withholding tax on interest payments, which are used to allocate taxing rights to a source jurisdiction; and
- rules which disallow a percentage of interest expense of an entity in respect of the nature of the payment or to who it is made.[45]

Of these methods, the OECD Discussion Draft rejected 3 methods as not being effective in in preventing BEPS. These are:

- arm's length tests,
- withholding taxes
- rules to disallow a percentage of interest, irrespective of the facts and circumstances.

In the Discussion Draft, many countries expressed the view that it is difficult to find the right solution to address BEPS with regards to interest payments. Countries felt that existing approaches may have had limited success in fully addressing BEPS issues involving interest deductions. There is a general view that international groups are still able to claim total interest deductions significantly in excess of the group's actual third party interest expense. It was agreed that in order for an approach to work, it will be necessary for countries to agree upon the definitions and scope of terms such as interest, groups, etc.

[45] OECD Discussion Draft on Action 4 at 12.

5 THE OECD'S 2015 FINAL REPORT ON ACTION 4

5.1 INTRODUCTION

On 5 October 2015 the OECD released an OECD/G20 Base Erosion and Profit Shifting Project: *Limiting Base Erosion Involving Interest and Other Financial Payments* – Action 4:2015 Final Report ("the Final Report"). The Final Report builds on the concerns and suggestions made in the Discussion Draft. At the outset the Final Report acknowledges that it is an empirical matter of fact that money is mobile and fungible. This factor allows multinational groups to achieve favourable tax results by adjusting the amount of debt in a group entity. "Financial instruments can also be used to make payments which are economically equivalent to interest but have a different legal form, therefore escaping restrictions on the deductibility of interest."[46] The report lists the following three scenarios as the basic avenues that pose Base Erosion and Profit Shifting (BEPS) risks, namely:

- Groups placing higher levels of third party debt in high tax countries;
- Groups using intragroup loans to generate interest deductions in excess of the group's actual third party interest expense; and
- Groups using third party or intragroup financing to fund the generation of tax exempt income.[47]

These are the risks against which Action 4 of the OECD BEPS Action Plan 2013 called for recommendations for best practice to curb BEPS using interest and payments economically equivalent to interest. The Final Report analyses several best practices and recommends an approach which directly addresses the risks outlined above. The recommended best practice includes the implementation of a fixed ratio rule and a group ratio rule which may be supplemented by targeted rules to prevent the circumvention of the former rules. The approach also allows the fixed ratio rule and the group ratio rule to be supplemented with other provisions, to reduce the impact of the rules on entities or situations which pose less BEPS risk, such as the *de minimis* rule, an exclusion for interest paid to third party lenders on loans used to fund public benefit projects and the carry forward/back of disallowed interest expense and unused interest capacity for use in future/prior years to cater for industries that incur interest before generating income.

5.2 FIXED RATIO RULE

According to the Final Report the best practice approach is based around a fixed ratio rule which limits an entity's net interest deductions to a fixed percentage of its profit, measured using earnings before interest, taxes, depreciation and amortisation (EBITDA) based on tax numbers. This is a straightforward rule to apply and ensures

46 OECD/G20 2015 Final Report on Action 4 at 11.
47 OECD/G20 2015 Final Report on Action 4 at 11.

that an entity's interest deductions are directly linked to its economic activity.[48] This approach is also favoured because it directly links the deductions to an entity's taxable income, which makes the rule reasonably robust against planning.[49]

The key advantage of a fixed ratio rule is that it is relatively simple for companies to apply and tax administrations to administer. The main disadvantage, on the other hand, is that it does not take into account the fact that groups operating in different sectors may require different amounts of leverage, and even within a sector groups may adopt different funding strategies for non-tax reasons.[50]

Although a fixed ratio rule provides a country with a level of protection against base erosion and profit shifting, it is said to be a blunt tool which does not take into account the fact that groups operating in different sectors may require different amounts of leverage, and even within a sector some groups are more highly leveraged for non-tax reasons. If a benchmark fixed ratio is set at a level appropriate to tackle BEPS, it could lead to double taxation for groups which are leveraged above this level.[51]

It is recommended that countries set their benchmark fixed ratio within the corridor of 10% to 30% or EBITDA. However, because of different legal frameworks and economic circumstances countries are encouraged to take into account a number of factors in setting benchmark fixed ratios, including the following:

- Applying a higher benchmark fixed ratio if it operates a fixed ratio rule in isolation, rather than operating it in combination with a group ratio rule;
- Applying a higher benchmark fixed ratio if it does not permit the carry forward of unused interest capacity or carry back of disallowed interest expense;
- Applying a higher benchmark fixed ratio if it applies other targeted rules that specifically address the base erosion and profit shifting risks to be dealt with under Action 4;
- Applying a higher benchmark fixed ratio if it has high interest rates compared with those of other countries;
- Applying a higher benchmark fixed ratio where, for constitutional or other legal reasons (e.g. EU law requirements), it has to apply the same treatment to different types of entities which are viewed as legally comparable, even if these entities pose different levels of risk; and
- Applying different fixed ratios depending upon the size of an entity's group.[52]

Due to the fact that the recommended benchmark ratios are set low, the Final Report recommends that countries adopt a group ratio rule to offer relief to companies in

[48] OECD/G20 2015 Final Report on Action 4 at 25.
[49] OECD/G20 2015 Final Report on Action 4 at 26.
[50] OECD/G20 2015 Final Report on Action 4 at 47.
[51] OECD/G20 2015 Final Report on Action 4 at 26.
[52] OECD/G20 2015 Final Report on Action 4 at 50.

groups that are more highly leveraged for reasons other than tax. This rule allows an entity to deduct more interest expense in certain circumstances. A group ratio rule is introduced in addition to the fixed ratio rule and or as a separate provision from the fixed ratio rule.

5.3 GROUP RATIO RULE

In terms of this rule, if an entity exceeds the benchmark fixed ratio, it will be allowed to deduct the net interest expense up to its group's net third party interest expense or the EBITDA ratio, if the latter is higher. The net interest expense that exceeds both the benchmark fixed ratio and the ratio of the group should be disallowed. In calculating the group's ratio, a country may also apply an uplift of up to 10% to the group's net third party interest expense (i.e. its third party interest expense after deducting third party interest income).[53]

Determining the amount of net interest expense deductible under a group ratio rule involves a two stage test. The first step is to determine the group's net third party interest or EBITDA ratio. The second step is to apply the group's ratio to an entity's EBITDA.

The Final Report acknowledges two scenarios where the presence of loss making entities may require the limitation of the general approach. The first is where a group which has a positive EBITDA includes the results of a loss-making entity. In this case countries may apply a general principle that places an upper limit on the interest capacity of any entity applying the group ratio rule, equal to the net third party interest expense of the entire group.[54]

The second scenario concerns groups which have negative EBITDA at a consolidated level, but which include some profitable entities. In this situation, it is not possible to calculate a meaningful net third party interest/EBITDA for the group, as the ratio will be negative. In this case, under the best practice approach an entity with positive EBITDA which is part of a loss-making group could receive interest capacity equal to the lower of the entity's actual net interest expense and the net third party interest expense of the group.[55] An alternative approach to these solutions, according to the Final Report would be to exclude loss-making entities from the calculation of a group's EBITDA. This would remove the risk that any entity would receive an excessive amount of interest capacity.

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53 OECD/G20 2015 Final Report on Action 4 at 67-68.
54 OECD/G20 2015 Final Report on Action 4 at 65.
55 *Ibid*.

5.4 ENTITIES THAT THE BEST PRACTICE APPROACH APPLIES TO

For the purposes of considering which entities these rules should apply to, the Final Report has categorised entities into three types:

a) entities which are part of a multinational group;
b) entities which are part of a domestic group; and
c) standalone entities which are not part of a group.

The OECD recommends that, as a minimum, the best practice approach in this report should apply to all entities that are part of a multinational group. Countries may also apply the best practice approach more broadly to include entities in a domestic group and/or standalone entities which are not part of a group.[56] For the purposes of applying a group ratio rule, a group includes a parent company and all entities which are fully consolidated on a line-by-line basis in the parent's consolidated financial statements.[57]

5.5 THE INSTRUMENTS TO WHICH A BEST PRACTICE APPROACH APPLIES

A best practice rule to address base erosion and profit shifting using interest expense should therefore apply to:

a) interest on all forms of debt;
b) payments economically equivalent to interest; and
c) expenses incurred in connection with the raising of finance.[58]

These should include, but not be restricted to, the following:

- payments under profit participating loans;
- imputed interest on instruments such as convertible bonds and zero coupon bonds;
- amounts under alternative financing arrangements, such as Islamic finance;
- the finance cost element of finance lease payments;
- capitalised interest included in the balance sheet value of a related asset, or the amortisation of capitalised interest;
- amounts measured by reference to a funding return under transfer pricing rules, where applicable;
- notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowings;
- certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance;
- guarantee fees with respect to financing arrangements; and

[56] OECD/G20 2015 Final Report on Action 4 at 33.
[57] OECD/G20 2015 Final Report on Action 4 at 59.
[58] OECD/G20 2015 Final Report on Action 4 at 29-30.

- arrangement fees and similar costs related to the borrowing of funds.[59]

The best practice approach does not apply to payments which are not interest, economically equivalent to interest or incurred in connection with the raising of finance, such as:

- foreign exchange gains and losses on monetary items which are not connected with the raising of finance;
- amounts under derivative instruments or hedging arrangements which are not related to borrowings, for example commodity derivatives;
- discounts on provisions not related to borrowings;
- operating lease payments;
- royalties; and
- accrued interest with respect to a defined benefit pension plan.[60]

5.6 VOLATILITY AND DOUBLE TAXATION

Where volatility in earnings, or mismatches in the timing of interest expense and EBITDA impacts an entity's ability to deduct interest expense, the group ratio rule may provide a solution by allowing the entity to deduct net interest expense up to the group's net third party interest/EBITDA ratio where this is higher. The Final Report recommends that, alternatively, these issues may be addressed to an extent by using average EBITDA over a number of years or by permitting an entity to carry disallowed interest expense and unused interest capacity for use against the fixed rule ratio or group rule ratio in earlier or later periods.

Permitting long term carry forward or carry back may be viewed as incentivising BEPS practices and the Final Report thus suggests that limits in terms of time or value may be worthy of consideration.[61]

5.7 TARGETED RULES

Targeted interest limitation rules include any provisions which apply to restrict interest deductions on payments made under specific transactions or arrangements. These may be contrasted with general interest limitation rules, such as the fixed ratio rule and group ratio rule, which impose an overall limit on an entity's interest deductions.[62]

The Final Report recommends that a fixed ratio rule (and group ratio rule where applied) should be supported by targeted rules to counteract planning undertaken by

59 OECD/G20 2015 Final Report on Action 4 at 30.
60 OECD/G20 2015 Final Report on Action 4 at 30.
61 OECD/G20 2015 Final Report on Action 4 at 67-70.
62 OECD/G20 2015 Final Report on Action 4 at 71.

groups to reduce the impact of these rules. To achieve this, it is recommended that countries also introduce targeted rules to address the following risks:

- An entity with net interest expense enters into an arrangement to reduce the net interest expense subject to the fixed ratio rule (e.g. by converting interest expense into a different form of deductible expense, or by converting other taxable income into a form which is economically equivalent to interest);
- An entity which is part of a group enters into an arrangement with a related party or third party in order to increase the level of net third party interest expense under the group ratio rule (e.g. by making a payment to a related party or to a third party under a structured arrangement, or by converting interest income into a different form); and
- A group is restructured to place an unincorporated holding entity at the top of the structure, to create two groups. This may be to prevent a fixed ratio rule applying (e.g. in a country where the rule does not apply to standalone entities) or to separate the original group into two parts for group ratio rule purposes.

Although the fixed ratio rule and group ratio rule, described in this report, provide an effective solution to tackle BEPS involving interest and payments economically equivalent to interest, a country may restrict application of the fixed ratio rule and group ratio rule to entities in multinational groups. Therefore, targeted rules may be required to address BEPS risks posed by entities which are not subject to the general interest limitation rules. Even where the fixed ratio rule and group ratio rule apply, a number of specific base erosion and profit shifting risks remain. Therefore, it is recommended that countries consider introducing rules to address those risks.[63]

In addressing the risks the Final Report recommends that the definitions of 'related parties' are clear in order to address the risks set out. In addition 'structured arrangements' need to be dealt with e.g. those incorporating a third party e.g. 'back to back' arrangements, often using non- interest payments in one leg of the structure.[64]

5.8 PROVISIONS THAT REDUCE THE IMPACT OF THE RULES ON ENTITIES

The recommended approach also allows countries to supplement the fixed ratio rule and group ratio rule with other provisions that reduce the impact of the rules on entities or situations which pose less BEPS risk. These are:[65]

- A *de minimis* threshold which carves-out entities which have a low level of net interest expense. Where a group has more than one entity in a country, it is recommended that the threshold be applied to the total net interest expense of the local group.

[63] OECD/G20 2015 Final Report on Action 4 at 72.
[64] OECD/G20 2015 Final Report on Action 4 at 74.
[65] OECD/G20 2015 Final Report on Action 4 at 12.

- An exclusion for interest paid to third party lenders on loans used to fund public-benefit projects, subject to conditions. In these circumstances, an entity may be highly leveraged but, due to the nature of the projects and the close link to the public sector, the BEPS risk is reduced.
- The carry forward of disallowed interest expense and/or unused interest capacity (where an entity's actual net interest deductions are below the maximum permitted) for use in future years. This will reduce the impact of earnings volatility on the ability of an entity to deduct interest expense. The carry forward of disallowed interest expense will also help entities which incur interest expenses on long-term investments that are expected to generate taxable income only in later years, and will allow entities with losses to claim interest deductions when they return to profit.

5.9 BANKING AND INSURANCE GROUPS

Due to the special features of the banking and insurance sectors, such as the role that interest plays in these sectors, the fact that they hold financial assets and liabilities as an integral part of their main business activities, and that they are subject to strict regulations in most countries, the Final Report considers that a different approach from the general approach should be taken when addressing BEPS using interest in these sectors.[66]

According to the Final Report, BEPS by banking and insurance groups could potentially take a number of forms. These include: regulated entities holding a regulatory capital buffer (including a debt component) above the level required to support existing business; routing regulatory capital and ordinary debt issued within a group through intermediate entities in low tax countries, placing excessive interest deductions in branches, which do not need to be separately capitalised for regulatory purposes, and in non-regulated entities; using deductible interest expense to fund assets which are tax exempt or taxed on a preferential basis; and the use of hybrid financial instruments and hybrid entities.[67]

Banks and insurance companies typically hold buffers of regulatory capital above the minimum level required which provides some opportunities for BEPS. The Final Reports states that the recommended fixed ratio rule and group ratio are unlikely to be effective in addressing these BEPS risks for a number of reasons, including and in particular that banking and insurance groups are important sources of debt funding for groups in other sectors and as such many are net lenders by a significant margin.[68]

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66 OECD/G20 2015 Final Report on Action 4 at 75.
67 OECD/G20 2015 Final Report on Action 4 at 75.
68 OECD/G20 2015 Final Report on Action 4 at 75-76.

The Final Report recommends that banks and insurance companies are not to be exempted from best practice, but a best practice approach that includes rules which are capable of addressing risks posed by different entities is to be developed. To that end, further work will be conducted, to be completed in 2016, to identify best practice rules to deal with the potential BEPS risks posed by banks and insurance companies, taking into account the particular features of these sectors. This will include work on regulated banking and insurance activities within non-financial groups (such as groups operating in the manufacturing or retail sector).[69]

5.10 IMPLEMENTATION AND TRANSITIONAL MEASURES

Countries are encouraged to give entities reasonable time to restructure existing financing arrangements before the rules come into effect. As a transitional measure, countries may decide whether to exclude pre-ruler existing loans from the best practice or not.[70]

The Final Report suggests that countries applying separate entity taxation systems, like South Africa, may apply the fixed ratio rule and group ration rule in the following three ways:

- The fixed ratio rule and group ratio rule may be applied separately to each entity based on its EBITDA;
- The country may treat entities within a tax group as a single entity for the purposes of applying the fixed ratio rule and group ratio rule; or
- The country may treat all entities in the country which are part of the same financial reporting group as a single entity for the purposes of applying the fixed ratio rule and group ratio rule.[71]

Countries may treat the entities within the consolidated tax group or which are part of the same financial reporting group as a single entity for purposes of applying the fixed ratio rule and group ratio rule.

5.11 INTERACTION WITH OTHER ACTIONS

Action 2 - hybrid mismatch rules: the application of the fixed ratio rule reduces, but does not eliminate, the BEPS risk posed by hybrid mismatch arrangements. The Final Report recommends that the rules to address hybrid mismatch arrangements should be applied by an entity before the fixed ratio rule and group ratio rule to determine an entity's total net interest expense. Once this total net interest expense figure has been determined, the fixed ratio rule and group ratio rule should be applied to establish whether the full amount may be deducted, or to what extent net interest expense should be disallowed. Further work should be done on the

69 OECD/G20 2015 Final Report on Action 4 at 76.
70 OECD/G20 2015 Final Report on Action 4 at 79.
71 OECD/G20 2015 Final Report on Action 4 at 80.

treatment of interest and payments economically equivalent to interest in a separate OECD work.[72]

<u>Action 3 – CFCs:</u> Countries may introduce the fixed ratio rule and the group ratio rule as well as the CFC rules. The Final Report demonstrates that the interaction of these two types of rules needs to be carefully crafted so as to ensure that neither the taxpayer, nor the relevant fiscus in the country where the interest is deducted and simultaneously imputed, are prejudiced or advantaged. The best practice approach should reduce the pressure on a country's CFC rules, by encouraging groups to spread net interest expense between group entities so that there is a greater link to taxable economic activity.

<u>Withholding taxes:</u> Where a country applies withholding tax to payments of interest, this should in no way be impacted by the application of the fixed ratio rule, group ratio rule or targeted rules described in this report. Withholding taxes would continue to apply.[73]

<u>Other interest limitation rules:</u> A country may also apply other general interest limitation rules, such as arm's length rules, rules to disallow a percentage of all interest expense and thin capitalisation rules. It is suggested that in most cases, these targeted and general interest limitation rules should be applied before the fixed ratio rule and group ratio rule.[74]

6 BASE EROSION VIA INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS FROM SOUTH AFRICA

Cross-border interest and similar financial flows have a long track record, in South Africa, as a BEPS risk, and are, thus of great concern to the country. The Explanatory Memorandum to the Taxation Laws Amendment Bill 2013 noted that while debt capital is an important tool for investment, debt capital can also create opportunities for base erosion. A balance is required between attracting debt capital and the protection of the tax base against base erosion. In line with international concerns the South African tax base could potentially be at risk of allowing interest deductions in excess of what is actually incurred overall by a group. This is mitigated to a large extent through the following existing measures in place in South Africa:

- **Exchange control**: The interest rate payable on loan financing obtained from a non-resident is capped and subject to pre-approval by the South African Reserve Bank ("SARB"). The SARB places a cap on the interest rate payable on these loans.

[72] OECD/G20 2015 Final Report on Action 4 at 81.
[73] OECD/G20 2015 Final Report on Action 4 at 82.
[74] *Ibid.*

- **Transfer pricing**: Section 31 and the SARS Draft Interpretation Note on Thin Capitalisation requires taxpayers to not only price the interest rate at arm's length, but also to determine whether it is thinly capitalised on an arm's length basis. Ratios applied through submission of the annual tax return are designed to alert the tax authorities to potential transfer pricing risk pertaining to interest.
- **Income tax**: Sections 8F, 8FA, 23N and 23M restrict interest deductions.
- **WHT on interest**: With effect 1 March 2015, a 15% WHT is imposed on South African sourced interest paid to non-resident persons, subject to DTA reductions.

All of the above measures should prevent excessive interest deductions provided taxpayers comply with these rules and measures. Provided these requirements are correctly applied, it is therefore unlikely that South Africa is significantly at risk of BEPS through excessive interest deductions. Of concern, is the capacity of the South African Revenue Service to audit adequately to ensure compliance with the requirements, and it is essential that such capacity be put in place and maintained.
However, the current legislative environment is complex and unclear. Having several differing sections all serving to limit interest deductions is cumbersome and needs to be addressed. The lack of clarity on the application is also a concern with no final guidance having been provided on the thin capitalization measures since the incorporation of these into the broader transfer pricing rules in 2012. Taxpayers need certainty and simplification to be compliant. From a broader regulatory point of view, it is also preferable that tax and exchange control rules applicable to inbound debts be aligned as far as possible.

The table below[75] considers each of the methods considered by the OECD that countries apply currently to prevent excessive interest deductions, their advantages and disadvantages. The ones applied in South Africa are pointed out in the table and a full discussion of how they apply follows immediately below.

OECD Rule	Advantages of rule	Disadvantages of rule	Effectiveness of the rule in Final Report	South Africa
1. **Fixed Rules to limit the level of interest expense or debt with reference to a fixed ratio.** Examples of fixed ratios include debt to equity, interest to EBITDA, interest to asset ratios	• Easy to apply • Links the level of interest expense to a measure of an entity's economic activity	• Same ratio is applied to all entities in all sectors • Becomes inflexible • Current rates applied by countries using this too high to prevent BEPS	To consider further in some respects	Sections 23M and N currently apply a fixed ratio interest deduction limitation under prescribed circumstances. In addition Debt : EBITDA over 3:1 is currently used as an indication of risk in relation to thin capitalization for

[75] Graph adopted and adapted from Technical Report submitted to the TDC by Deloitte (Billy Joubert and Team) to apply to current legislation and findings of the Final Report.

				transfer pricing purposes
2. **Rules which compare the level of debt in an entity by reference to the group's overall position** (often Debt : Equity ratios)	• Easy to apply • Provides reasonable certainty to groups in planning financing	• Equity not a good measure of level of activity • Equity levels can be subject to manipulation	To consider further in some respects	Not currently used~~.~~
3. Anti-avoidance rules which disallow interest expense on certain transactions	• Many countries have these in place and seems to be effective	• As new BEPS opportunities are exploited new targeted rules may be required • Could lead to complex rules • May be costly to administer and comply with	To consider further	South Africa has rules in place in respect of hybrids (sections 8F and FA) which reclassify income to dividends while the underlying transaction remains debt
4. **Arm's length tests** which compare the level of interest or debt in an entity with the position that would have existed had the entity been dealing entirely with third parties	• Good test as it provides an arm's length result • Recognises that entities may have different levels of interest expenses depending on the circumstances	• Time consuming • Burdensome • Expensive	Not considered to be best practice in tackling BEPS.	Section 31 and the Draft IN rely on the arm's length test
5. **WHT on Interest payments** used to allocate taxing rights to a source jurisdiction	• Mechanical tool • Easy to apply and administer	• Difficult for EU members to apply	Rejected as not suitable for preventing BEPS	Introduced with effect 1 March 2015
6. Rules which disallow a percentage of the interest expense of an entity, irrespective of the nature of the payment or who it is made to	• Easy to apply	• Not aimed at addressing BEPS	Rejected as not suitable for preventing BEPS	Section 23M disallows a percentage of interest expense paid to a recipient which is not subject to SA tax on the interest income. This disallowance is based upon a formula~~.~~ No fixed percentage disallowance in South Africa

From the above it is clear that South Africa is applying a form of the fixed rule method, whilst also applying two of the other three methods rejected by the OECD as not being effective in preventing BEPS with regards to interest payments (these are: arm's length tests and withholding taxes). The effectiveness of the methods applied in South Africa is discussed below.

6.1 THE TREATMENT OF INBOUND FINANCIAL ASSISTANCE - THIN CAPITALISATION: THE ARM'S LENGTH PRINCIPLE

One of the provisions that South Africa has applied over the years to prevent excessive deduction of interest is the use of thin capitalisation rules to prevent the funding of entities by disproportionate degree of debt to equity capital. Thin capitalisation rules were introduced in South Africa in 1995, based on a combination of an arm's length approach (in the then section 31(3) of the Income Tax Act – now repealed) and a shareholder 3:1 debt/equity safe harbour ratio that was used to determine excessive interest (based on the now scrapped SARS Practice Note 2). The previous section 31(3) gave the Commissioner the power to re-characterise debt as equity, with the result that interest incurred thereon was not deductible for income tax purposes.[76] Section 31(3) applied where a non-resident investor granted financial assistance whether directly or indirectly to a resident connected person in whom there was an interest.

The then thin capitalisation rules were however found to be narrow because they only applied to financial assistance granted by a foreign resident investor to certain residents and not to financial assistance by a foreign resident to another foreign resident, even if the latter had a South African permanent establishment. As a result, some taxpayers sought to exploit this loophole by having a foreign company utilise a wholly owned foreign subsidiary with most or all of its operations conducted in South Africa through a branch (permanent establishment). The foreign company would then capitalise the foreign subsidiary with excessive debt, thereby using the interest deductions associated with the excessive debt to offset income attributable to the South African permanent establishment.[77]

It was thus necessary to amend and broaden the rules so as to close this loophole. The legislators also reasoned that the previous thin capitalisation rules paralleled the transfer pricing rules and that they were not in line with international practice under the OECD and UN Model Tax Conventions which deal with thin capitalisation as part of the transfer pricing rules.[78] Consequently in terms of the Taxation Laws Amendment Act 24 of 2011, the thin capitalisation rules have now been merged with the transfer pricing rules (effective from years of assessment commencing on or after 1 April 2012).[79] Basically, the focus of the new provision is on cross-border transactions, operations, schemes, agreements or understandings that have been effected between, or undertaken for the benefit of, connected persons.

If the terms or conditions made or imposed by the connected persons differ from the terms and conditions that would have existed between independent persons acting

[76] Olivier & Honiball at 651.
[77] Explanatory Memorandum on the Taxation Laws Amendment Bill of 2010 in para 5.3 Part II(C).
[78] Article 9 of the OECD Model Tax Convention.
[79] Explanatory Memorandum on the Taxation Laws Amendment Bill of 2010 in para 5.3 Part II(C).

at arm's length, and the difference confers a South African tax benefit on one of the parties, the taxable income of the parties must be calculated as if the terms and conditions had been at arm's length. In terms of the current rules the arm's length principle is applied to deny deductions for interest that would not have existed had the South African entity not been able to procure the debt based on its balance sheet.

Section 31(1) defines financial assistance as including any loan, advance or debt or any security or guarantee. Thus, any borrowing (i.e. foreign financial assistance) from a foreign person to a foreign person with a South African business establishment is subject to the rules.[80] The practical effect of the provision is that the taxpayer must determine what amount it would have been able to borrow had the transaction been concluded in the open market. The taxpayer has to determine its lending capacity by taking into account terms and conditions which would have been applicable between independent parties.

Should the Commissioner be of the opinion that the financial transaction is not at arm's length, he is entitled make a primary adjustment to ensure an arm's length result. The legislation also provides for a secondary adjustment under section 31(3) on the basis that any "adjustment amount" (i.e. the difference between the tax payable calculated in accordance with the provisions of section 31(2) and otherwise) will be deemed to be a dividend paid by the South African taxpayer to the non-resident connected person on which dividends tax must be paid.

To provide some guidance as to how excessive interest will be determined, SARS published a Draft Interpretation Note on thin capitalisation which was open for public comment until the end of June 2013.[81] The Explanatory Note to the draft interpretation note states that the Draft Note provides taxpayers with guidance on the application of the arm's length basis in the context of determining whether a taxpayer is thinly capitalised under section 31 and, if so, calculating taxable income without claiming a deduction for the expenditure incurred on the excessive portion of finance. The guidance and examples provided are not an exhaustive discussion of every thin capitalisation issue that might arise. Each case will be decided on its own merits, taking into account its specific facts and circumstances. SARS explains that it is not enough for the taxpayer to demonstrate that it could have secured the loan at arm's length terms. The taxpayer must, in addition to proving that the loan or financial assistance was at arm's length, demonstrate a business need for the loan.[82]

In order to consider what is an appropriate amount of debt for thin capitalisation purposes and in applying the arm's length principle to funding arrangements, a

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80 Explanatory Memorandum on the Taxation Laws Amendment Bill of 2010 in para 5.3 Part III (B).

81 SARS Draft Interpretation Note "Determination of the Taxable Income of Certain Persons from International Transactions: Thin Capitalisation" (2013) at 3.

82 SARS Draft Interpretation Note at 3.

taxpayer should consider the transaction from both the lender's perspective and the borrower's perspective. That is, from the lender's perspective, a taxpayer should consider whether the amount borrowed *could* have been borrowed at arm's length (that is, what a lender would have been prepared to lend and therefore what a borrower could have borrowed) and from the borrower's perspective, whether the amount *would* have been borrowed at arm's length (that is, what a borrower acting in the best interests of its business would have borrowed).

In analysing a funding transaction on this basis, SARS proposes that a taxpayer perform a functional analysis to support the appropriateness of its arm's length debt assessment. SARS has indicated that, in performing such a functional analysis of the transaction, the following types of factors and information could be relevant in support of a taxpayer's funding arrangements:

- The funding structure which has been or is in the process of being put in place, including, *inter alia*, the dates of transactions, the source of the funds, reasons for obtaining the funds, the purpose of the funding, the repayment and other terms and conditions;
- The business of the taxpayer, including details of the industry in which it operates;
- The financial and business strategies of the business;
- Details of the principal cash flows and the sources for repayment of the debt;
- The taxpayer's current and projected financial position for an appropriate period of time, including the assumptions underlying the projections and cash flows;
- Appropriate financial ratios (current and projected), for example:
  - debt: EBITDA ratio;
  - interest cover ratio;
  - debt: equity ratio; and
- Other indicators of the creditworthiness of the taxpayer, including, if available, any ratings by independent ratings agencies.

SARS has provided what it considers to be indicators of risk (paragraph 7 of the draft Interpretation Note), acknowledging that the risk indicator may not constitute an arm's length position for a particular taxpayer or industry. SARS may make use of a "risk based" audit approach as a risk identifier.[83] In this regard, debt/EBITDA ratios[84] would be applied as a potential risk identifier for a particular taxpayer or industry but not as indication of what constitutes an arm's length position.[85] SARS may consider transactions in which the debt/EBITDA ratio of the South African taxpayer exceeds 3:1 to be of greater risk. There is however no guarantee that a ratio which does not exceed 3:1 may not be considered as a risk by SARS. It can therefore be inferred that transactions below the 3:1 ratio may also be investigated if they are risky to

[83] SARS Draft Interpretation Note at 7.
[84] SARS Draft Interpretation Note at 2.
[85] Idem at 11.

SARS. Unfortunately, by the time of writing of this Report the Draft Interpretation Note had not yet been finalised. Thus, taxpayers are left with little formal guidance, other than the OECD guidelines.

Recommendation on the effectiveness of arm's length principle in preventing BEPS due to excessive interest deductions

It is worth noting, as explained above, that the OECD indicated in its Discussion Draft and in the Final Report that the use of the arm's length test, although a very good test, is not to be considered further as the best method for preventing BEPS in the context of Action 4 and the quantum of debt, due to the fact that it can be time consuming, burdensome and very expensive for taxpayers to comply with. The approach recommended by the OECD is that the arm's length test should only apply to the pricing of the debt i.e. the interest rate. This makes sense as the pricing is directly reflective of the quantum of the debt and associated risk, therefore applying a two-tier test to both the quantum and the price is counter intuitive and to some degree pointless. Higher levels of debt will inevitably attract higher risk and higher rates.

Thus, it may well be considered preferable in the South African context to retain the approach of evaluating the extent of debt (i.e. thin capitalization) and the debt pricing (i.e. the interest rate) separately. It is suggested that, in considering which approach to follow, exchange control requirements be borne in mind. This could mean that the current guidance (draft) available to South African taxpayers in determining its thin capitalization position may change completely if the OECD recommendations are to be followed. The DTC recommends that the Guidance from SARS should be changed to be in line with that of the OECD and international thinking as a matter of urgency.

- The Draft Interpretation Note on Thin Capitalisation creates uncertainties with taxpayers due to the fact that it has remained a draft since its release in March 2013. This has created concern for foreign investors as reliance on a draft of this nature is problematic.
- It is important that the use of thin capitalisation rules to prevent BEPS resulting from excessive interest deductions is in line with what is recommended by the OECD, as different rules between different countries could lead to double taxation.

Other recommendations on the thin capitalisation rules

There is uncertainty as to how excessive interest is going to be determined. No definitive guidance has been provided by SARS in this regard. This uncertainty is detrimental to inbound investment. Investors are often less concerned about the actual rules than about having certainty about what they have to comply with. The

Draft Interpretation Note needs to be finalised, urgently, so that South African taxpayers have certainty on thin capitalisation rules.

In finalising or redrafting this draft, the DTC recommends that SARS considers the following:

- Simplification of rules;
- Consistency with the OECD recommendations and international precedent on the Final Report;
- Transfer pricing rules for interest rate should take into account outcome of the GE and Chevron cases on relevance of parent credit ratings;
- Introducing ways of reducing the administrative burden for taxpayers with a low risk of BEPS through interest deductions. These could be one or all of the below:
    - Introduction of a safe harbour (e.g. Debt to Equity of 2:1); and
    - Threshold based upon loan value or another measure whereby taxpayers falling below such a threshold would not have to comply with the rules (see recommendations on Actions 8-10 and 13);
- How to treat start-up operations where loan funding is required;
- Investors often feel that, due to the potential risk associated with a transfer pricing adjustments in respect of interest, they have no choice but to undertake costly debt pricing exercises – notwithstanding certain ratios being indicated in the Draft Interpretation Note as indicating lower risk to SARS (e.g. a Debt:EBITDA ratio not exceeding 3:1).

It is recommended that a “safe harbour” with a fixed ratio be introduced in section 31 or the Interpretation Note to provide non-residents that are funding local entities with guidance as to reasonable levels of debt versus equity. Investors need clarity as to how they can structure their investment without running the risk of any costly and time intensive enquiries from the revenue authorities. It should be kept in mind that ascertaining what qualifies as an arms-length debt:equity ratio is extremely difficult as the appropriate comparative information is very costly to source or justify given the uniqueness of each group’s circumstances.

It is further recommended that legislation and Interpretation Notes be released together, first in draft and then in final form. This is in order to avoid the current situation that prevails around the thin capitalisation rules. In addition, transfer pricing rules should be amended to apply to cell captive insurers as was done for CFCs. Payments by a South African company to an offshore cell captive need to be addressed as this is not caught by current transfer pricing legislation because the cell captives are not connected persons in terms of the definition of connected person in section 1 of the Income Tax Act.

6.2 EXCHANGE CONTROLS

Although not governed through the Income Tax Act, it is relevant to note the importance of exchange control in relation to interest. Approvals have to be obtained for the acceptance of foreign loans prior to the receipt of the loan funds. This approval process includes not only the approval of the loan funds, but also the allowable interest rate that is capped depending on the relationship with the lender and the currency of the loan funding.

Exchange control is a very effective mechanism with which to prevent BEPS with regards to the interest rate payable, as such payment is subject to pre-approval. It will be even more effective if there is consistency between the rates allowable from a SARB and transfer pricing perspective. As a recommendation: if an interest rate is allowable from a SARS transfer pricing perspective, it should also be allowed by SARB. The SARB and SARS acceptance or otherwise, of the interest charged on a loan should be aligned.

It is also important to note that an excessive interest deduction is also limited to an extent as a result of an interest rate that is too high due to the caps in place from an exchange control perspective. However, the cap on interest rates from an exchange control perspective is in some instances higher than those viewed by SARS in the Draft Interpretation Note on Thin Capitalisation as an indication of risk from a transfer pricing perspective. This creates uncertainty for taxpayers. Exchange control can be very effective if the cap on interest rates is in line with what would be allowable from a SARS transfer pricing perspective. If this can be achieved, the risk of BEPS through excessive interest deductions (as a result of an interest rate that is too high) should be relatively limited from a South African perspective.

<u>Recommendations</u>

It is recommended that the interest cap between SARB and SARS should be aligned. Interest rates allowable from a SARB perspective are potential indicators of risk from a South African transfer pricing perspective. Currently the interest rate is firstly approved from a SARB perspective, but that may not be acceptable from a SARS transfer pricing perspective.

The DTC's recommendation is further that a taxpayer should determine what interest rate would be acceptable from a Transfer Pricing perspective. If acceptable, then it should be allowed by SARB. Alternatively SARS should indicate what interest rates it would allow, and then those should be allowed from an exchange control perspective.

The table below[86] illustrates the current discrepancies:

Loan obtained from	SARB	SARS Draft IN on Thin Cap (indicative interest rates only)	Comment
Shareholder loan, foreign currency denominated	Prime or base rate of the country of denomination	Weighted average of the base rate of the country of denomination plus 2%	Current interest rate cap from SARB should prevent non-arm's length interest rates
Non-shareholder loan, foreign currency denominated	Prime or base rate of the country of denomination + 2%	Same as above	Same as above
Shareholder loan, ZAR denominated	SA prime	JIBAR plus 2%	SARS considers interest exceeding JIBAR plus 2% to be of higher risk. JIBAR plus 2% is higher than SA prime. A taxpayer could therefore have an interest rate approved by SARB that is not viewed as arm's length from a TP perspective. This is not helpful.
Non-shareholder loan, ZAR denominated	SA prime + 3%	JIBAR plus 2%	Same as above, except that the gap between what SARB allows and SARS views as high risk is greater

6.3 DEBT PUSHDOWN TRANSACTIONS AND PROVISIONS TO PREVENT SUCH TRANSACTIONS

The so-called "debt pushdown" transactions have been a common feature of merger and acquisition transactions in South Africa. There are several variations of these transactions. The common feature is that they result in an interest deduction and often the receipt of a tax-exempt dividend.

6.3.1 ACTIONS TAKEN BY NATIONAL TREASURY TO ADDRESS DEBT-PUSH DOWN STRUCTURES

(a) Media Statements

A Media Statement was issued on 20 February 2009 which dealt with "Funnel Finance Schemes". This Media Statement was issued as a supplement to the Media Statement issued on 20 March 2008 titled "Avoidance Closure Alert: Funnel Financing Masquerades". The Media Statement, issued in 2009, included two methods of funnel finance schemes: transactions involving "split incorporation-effective management" and transactions involving "hybrid tax entities".

86 Graph adopted from Technical Report submitted to the DTC by Deloitte (Billy Joubert and Team).

However, many transactions did not fall into either of the described methods. Often the transactions involve entities which are not incorporated in South Africa and their place of effective management may be located in a foreign tax haven treaty country.

The 2009 Media Statement provided that the SARB would identify all South African incorporated entities which have their tax residence located outside of South Africa and share the information regarding these entities with the SARS. This applied in circumstances where exchange control applications were required to be submitted to the SARB in respect of such entities. However, many transactions did not require any such applications to be submitted. Mere notification was sufficient for exchange control purposes.

Generally the remedies proposed in the Media Statement were inappropriate. To deal with the above matter, one proposal related to the re-negotiation of South Africa's double tax treaties that are based on "effective management". However, the concept of "effective management" is fundamental to South African tax law. This re-negotiation process would therefore require fundamental changes to the South African tax system.

(b) Legislative provisions dealing with debt-push down structures

It is noted at the outset, that while some of these provisions may be of application only to local entities and local transactions, they form part of an investor's considerations in due diligence for investment in South Africa.

(i) <u>Section 45 of the Income Tax Act</u>

Excessive debt transactions using debt pushdown structures can be dealt with under section 45 of the Income Tax Act, which deals with "intra-group transactions". Section 45(3A) of the Income Tax Act states that various funders of transferee companies will be deemed to have a base cost of nil in preference shares and loans advanced to such transferee companies. This would thus result in a capital gain tax imposition on the full value of the shares upon disposal thereof.

(ii) <u>Section 23N – limitations of deductibility of interest</u>

For years of assessment ending 1 April 2014, section 23K of the Income Tax Act requires that a ruling be obtained in respect of the deductibility of interest in respect of debt arising from a re-organisation transaction. From 1 April 2014, section 23N was introduced in the Income Tax Act to replace section 23K's discretionary ruling system with a codified formula which provides for a maximum deduction in the context of re-organisation transactions.

Section 23N limits the deduction of an interest expense incurred by a company on a loan or debt raised to acquire assets or shares in reorganisations and acquisition transactions. It imposes a limitation on the deductibility of interest in the case of leveraged asset acquisitions in respect of reorganisations and acquisition transactions in particular, those undertaken relying upon any of an intra-group transaction or liquidation distribution contemplated in sections 45 and 47 of the Income Tax Act respectively, as well as acquisition transactions governed in terms of section 24O of the Income Tax Act.

(iii) Section 23M of the Income Tax Act - limitations of deductibility of interest

Section 23M came into effect on 1 January 2015. It imposes a limitation on the deductibility of interest on debt owed to persons (borrower) in a controlling relationship. Essentially the section applies to interest paid to certain entities that are not subject to tax in South Africa connected to the debtor and in this regard it has been criticised for potentially being discriminatory. The rationale for introducing the legislation was because the legislators had noted that excessive interest deductions pose a recurring risk if the creditor and debtor form part of the same economic unit. The terms of the funding instrument are often irrelevant because both parties can freely change the terms to serve the overall interest of the group. As a result, the debt label for these instruments is often driven by tax and other regulatory factors; whereas, loan capital frequently represents equity capital to be repaid only once the debtor is profitable.

Of particular concern to the legislators was the fact that the methods to limit excessive interest owed to exempt persons were largely incomplete. Interest is generally deductible if arising from trade, incurred in the production of income and not of a capital nature. This deduction applies even if the creditor is wholly exempt in respect of the interest received or accrued. Notable parties eligible to receive exempt interest are pensions and foreign persons. In the case of a foreign person, interest from South African sources is generally exempt unless that foreign person has a South African permanent establishment. This exemption is roughly matched within the South African tax treaty network, which often exempts foreign residents from taxation in respect of South African sourced interest unless that interest is attributable to a South African permanent establishment. The purpose of this cross-border exemption is to attract foreign debt capital to the domestic market. Deductible interest paid to foreign (and other exempt) persons represents a risk to the fiscus because of the deduction/exemption mismatch. This mismatch leads certain parties to over-leverage because of the overall tax benefits.

Consequently, provisions were enacted to ensure that the aggregate deductions for interest that is not subject to tax in the hands of the person to whom the interest accrues be subject to a limitation if a “controlling relationship” exists between the debtor and the creditor. However, this limitation does not apply if the interest is included in the net income of a controlled foreign company ("CFC") as contemplated in section 9D in the foreign tax year commencing or ending in the year of assessment in which the interest deduction is claimed by the debtor.

Section 23M which was introduced into the Income Tax Act by the Taxation Laws Amendment Act 2013, effective from 01 January 2015 limits interest expenditure incurred on or after that date. Section 23M limits interest deductions incurred by a borrower:

- where the recipient of the interest is not subject to tax in South Africa on the interest accrual; and
- if the creditor holds a specified percentage of the share capital of the borrower.

The interest limitation rule will apply if either the debtor or creditor is in a controlling relationship. This would frequently apply to international groups which have invested in South Africa. For purposes of section 23M, a controlling relationship exists if the creditor and the debtor are connected persons, as contemplated in section 1, in relation to each other.

This interest limitation rule also applies to debt owed to persons who are not in a controlling relationship if:

- ➢ that person obtained the funding of the debt from a person with a controlling relationship in relation to the debtor; or
- ➢ the debt is guaranteed by a person with a controlling relationship with the debtor.

The deductible interest limitation is based on a formula calculation, in terms of which the aggregate deductions for interest paid or incurred (not being subject to tax in South Africa in the hands of the beneficial owner) in respect of debt owed to persons in a controlling relationship with the debtor will be limited to:

a) the total interest received or accrued to the debtor; and
b) 40% of adjusted taxable income.

With effect from 1 January 2017, section 23M would not apply to so much of interest incurred by a debtor in respect of a debt owed to a creditor if the creditor funded the debt amount with funding granted by a lending institution that is not in a controlling relationship with the debtor and the interest rate charged does not exceed the official rate of interest plus 1%.[87]

[87] Paragraph 1 of the Seventh Schedule to the Income Tax Act defines "official rate of interest" as (*a*) in the case of a debt which is denominated in the currency of the Republic, a rate of interest equal to the South African repurchase rate plus 100 basis points; or (*b*) in the case of a debt which is denominated in any other currency, a rate of interest that is the equivalent of the South African repurchase rate applicable in that currency plus 100 basis points.

Recommendations on the effectiveness of sections 23N and 23M in preventing BEPS relating to excessive interest deductions:

It should be noted, as explained above, that the OECD Discussion Draft rejected, as not suitable for preventing BEPS, rules which disallow a percentage of the interest expense of an entity, irrespective of the nature of the payment or who the payment is made to. Section 23M disallows an amount of interest determined in terms of a formula paid to a person that is not subject to tax in South Africa. Section 23M does not take account of whether or not the foreign creditor is subject to tax in their home jurisdiction on the interest they receive, but merely whether or not they are subject to South African tax. The limitation of interests deductions in this context may well be misplaced given that there may well not be any tax avoidance related to the funding advances, unless the creditor is, for example exempt from tax in their home country or subject to a lower tax rate. In light of the OECD recommendations, the legislators should re-consider the relevance of section 23M in preventing BEPS relating to excessive interest deductions.

Other concerns about section 23M

Section 23M, which sets out rules to limit interest deductions in relation to acquisition transactions and untaxed connected party debt, also creates uncertainties, especially with regard to the 40% of adjusted taxable income. The section may potentially impact on commercially driven arrangements, resulting in uncertainties, especially for start-ups and cyclical businesses (e.g. mining), and may lead to double taxation.

It is recommended that in order to bring about clarity on the details and application of section 23M of the Income Tax Act and the interaction between section 23M and section 31 of the Income Tax Act, the SARS should clarify the application of, or publish an interpretation note on, section 23M of the Income Tax Act. Furthermore, the limitation on interest deductions needs to be extended to incorporate other finance charges and payments e.g. finance lease payments and derivative payments.

It is also not entirely clear whether this provision will apply to payments of interest to foreign persons – since such persons will, subject to possible DTA relief, become subject to withholding tax on interest which came into effect from 1 January 2015. It is undesirable to have the same amount of income subjected to multiple levels of taxation.

Comments on the calculation applied to limit the interest deductibility

In the calculation set out in sections 23M(3) and 23N(4), the limitation calculation applied to limit the interest deductibility in both is similar. The upper threshold of the interest which may be deducted is calculated with reference to the repo rate at that point in time. The percentage figure generated in terms of this calculation is then multiplied by the amount of “adjusted taxable income” for that entity.

Because the calculation of a company’s “adjusted taxable income” begins with its taxable income as the key determinant of the amount of interest which is deductible, the definition of adjusted taxable income prejudices certain entities. In this regard, a number of papers providing commentary to the OECD analysis warn that, in general, the use of a percentage ratio can be arbitrary and discourage economic activity.[88] This is a general concern but we believe that this criticism is enhanced in the current legislation due to the reliance on taxable income as the key factor for calculation the limitation amount.

The result of this formulation is that borrowers who pay more tax generally will be less impacted by the limitation on the amount of interest which they can deduct in the relevant scenarios when compared with similar borrowers with lower taxable income. The rationale for linking the limitation to the tax paid appears cogent at first glance: entities paying more tax are less likely to be eroding profits or shifting their tax base. On greater scrutiny though, and as can be seen from the OECD analysis, there are a range of alternative factors that can be taken into account: these include the group’s gearing, the asset base of the borrower, the finances of the borrower, etc. These factors, while potentially arbitrary in their own rights, are more rational in our view than preventing taxpayers that do not pay a lot of tax from deducting interest expenditure without interrogating the reasons behind the amount of tax paid by the entity.

There is significant commentary in the OECD analysis to the effect that the use of a fixed ratio does not take account of different industry needs and can deter investment. For example, on page 3 of Part 1 of the commentary, included in the comments submitted by the 100 Group Taxation Committee. The submission notes “… capital intensive industries will be disproportionally impacted by the proposed recommendations compared to other industries”. We believe this is correct. South Africa is in a slow-to-no growth phase and is seeking to attract foreign investment; encourage development and projects aimed at improving the country’s infrastructure and stimulate job creation. Including overly-complex tax rules which negatively impact on how projects in capital intensive sectors are funded is counterproductive and discouraging of these sorts of initiatives. Further, limiting capital-intensive industries by regulating their funding is of concern.

Moreover, many start-up businesses pay very little tax, and require significant funding before profitability is attained. It is exactly these types of entities that are

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88 See for example the comments on page 649 of paper 2 of the comments submitted by the Irish Tax Institute.

going to be prejudiced by making tax paid the key reference point of the calculation. Where a group seeks to achieve tax efficiency through its debt model, the current rules will only lead to more complex tax planning being implemented. Funding will intentionally, and perhaps artificially, be routed through companies that have a high taxable income or alternative finance structures is merely utilised. In our view, these types of focused anti-avoidance rules rarely achieve their desired outcome; they simply add to complexity in the system as those taxpayers that need to raise finance will always do so. If a taxpayer has the means, they will ensure they plan sufficiently so that they are not affected by the rules in question. A fixed ratio rule should be considered to supplement a single entity calculation.

(iv) Section 24O of the Income Tax Act

In terms of section 24O of the Income Tax Act, where debt is issued or used by a company for the purpose of financing the acquisition by that company of equity shares in an operating company in terms of an acquisition transaction, any interest incurred by that company in terms of that debt must be deemed to have been incurred in the production of its income and expended for the purposes of trade. This provision therefore allows the deduction of interest in respect of share acquisitions. The deduction of the interest is limited, however, since the acquiring company must obtain a controlling stake (i.e. at least 70% of the equity shares) in the target company. In addition the target company must constitute an operating company as defined in section 24O(1) of the Income Tax Act. The deductibility of the interest ceases when the controlling group company ceases to be a controlling group company, an operating company ceases to be an operating company or any company in the transaction ceases to form part of the group of companies.[89]

(v) Interest withholding tax

The Taxation Laws Amendment Act 31 of 2013 amended the Income Tax Act by the insertion of Part IVB in Chapter II of Act 58 of 1962, to introduce a withholding tax on interest. Section 50B provides for the levying a final withholding tax on interest, at a rate of 15% on the amount of any interest paid by any person to or for the benefit of any foreign person to the extent that the amount is regarded as having been received or accrued from a source within the Republic in terms of section 9(2)*(b)*. The interest withholding tax, which is subject to certain exemptions set out in section 50 of the Income Tax Act, came into operation on 1 March 2015.

In the original version, the withholding tax provisions did not contain a specific definition of interest, and thus interest was understood in the ordinary meaning of the word. The definition of interest for purposes of the withholding tax on interest has been included by section 70 of the Taxation Laws Amendment Bill 2015 to include

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89 Section 23(4)(a) of the Income Tax Act.

interest as defined in para (a) and (b) of the definition of interest in section 24J. This includes in the definition of interest the following items: (a) gross amount of interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement; or (b) amount, or portion thereof payable by a borrower to the lender in terms of any lending arrangement as represents compensation for any amount to which the lender would, but for such lending arrangement, have been entitled.

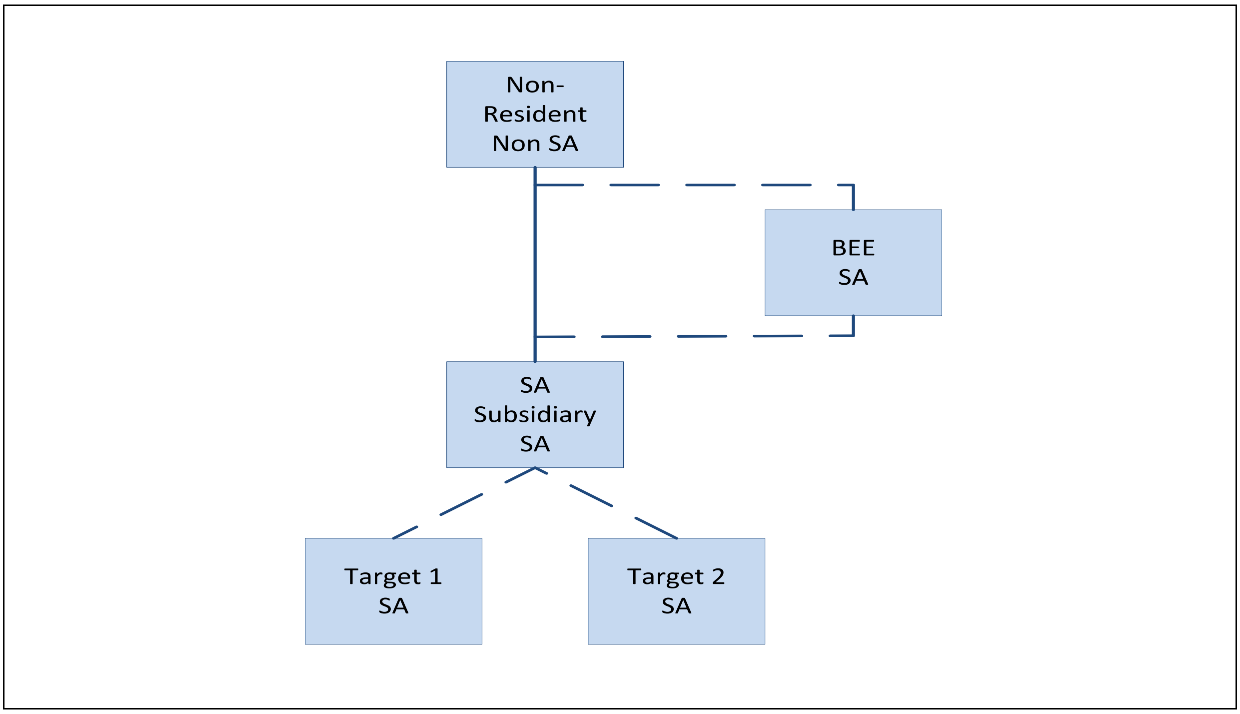
The withholding tax is reduced to zero under most South African tax treaties since most of South Africa's double tax treaties have not been re-negotiated to provide for better rates. This provides an opportunity for foreign lenders to make their loan funding from an appropriate jurisdiction which has a zero withholding tax rate in respect of interest advanced to South Africa, provided that they are able to demonstrate that the recipient has beneficial ownership thereof.

Recommendation:

It should be noted, as discussed above, that the OECD in the Discussion Draft and the Final Report specifically rejected the use of withholding taxes on interest as not suitable for preventing BEPS relating to excessive interest deductions unless the rates are aligned with the corporate tax rate. Nevertheless, the withholding tax on interest became effective in South Africa with effect 1 March 2015. Although OECD countries reject withholding taxes, they are used by source countries to ensure allocation of taxing rights to the source jurisdiction. As such, despite the OECD's rejection of withholding taxes as a measure of preventing BEPS, it is considered that the withholding tax serves an important role in the South African tax system, that being protecting the South African tax base by ensuring its ability to tax interest sourced in South Africa. To that end, from a treaty context, it is recommended that the treaties with zero or low interest withholding tax rates be renegotiated to afford South Africa a full taxing right to such interest. It is noted, however, that renegotiation of tax treaties is a time consuming process, and should perhaps be done in a holistic manner where the objective is to achieve more than just one objective.

Comments on the complexity posed by all the provisions and the challenges these pose to foreign investment

The complexities attaching to cross-border debt seems to be at odds with the steps one would intuitively suggest that a jurisdiction, which is trying to encourage foreign investment, should be taking. It is important to ensure a balance between the limiting base erosion and stimulating economic growth. The example below illustrates the complexities facing non-resident investors.



In the scenario above:

- a foreign group wishes to expand its operations by way of making acquisitions in South Africa;
- it forms a local holding company and seeks to fund that company appropriately to make a series of acquisitions in the region;
- it can choose to use debt funding and/or equity funding subject to the transfer pricing rules;
- the acquisitions which the subsidiary may make could well involve restructurings utilising the provisions of section 45 and/or section 47 of the Income Tax Act.

In such a situation, the foreign group must take the following factors into account:

- They must understand the exchange control regime and its obligations in respect of the funding provided to the local holding company;
- Any funding introduced into the company must meet the requirements of the Income Tax Act:
  - section 11(a) i.e. be in the production of income;
  - sections 8F and 8FA relating to hybrid interest and hybrid debt; and
  - section 31 of the Income Tax Act; i.e. comply with the transfer pricing rules;
- If the parent company is tax resident in a treaty country and the treaty imposes withholding tax at a rate of 0% on interest accruing to that entity, the provisions of section 23M would apply. The entity has to factor in, based on its future performance, whether it will be entitled to deduct any funding provided by its offshore shareholders;

- If any of the local funding is used for any acquisition transactions (using any of sections 45, 47 or 24O of the Income Tax Act), the provisions of section 23N may also need to be taken into account. Section 23N *and* 23M may apply where any funding received from the offshore parent are used for any acquisition transactions;
- The parent company must understand the interest withholding tax rules and if it is entitled to any treaty benefits it must make sure that all requisite declarations required by section 50E are properly and timeously submitted.
- The parent company must also consider the home country tax implications, thus whether the interest receipt would be subject to tax, qualify for a unilateral or bilateral foreign tax relief, etc.

While the above analysis may be sensible in a number of more developed jurisdictions, it poses complexities and uncertainties for parties as to what level of interest deductibility they will be entitled to in any particular year. The rules can also be overwhelming for groups which do not have sophisticated in-house tax skills or a large foreign network which has introduced them to these types of rules previously. It is therefore important that regulatory certainty is maintained for foreign investors, who have to take such matters into account when deciding where their funds are best placed. It is recommended that a proper analysis be made to determine whether reliance on deduction limitation rules is relevant or if it just amounts to overkill in the circumstances.

From the above it is clear that taxpayers may be subject to multiple layers of taxation. This can be demonstrated as follows: if a South African taxpayer has excessive interest from a transfer pricing perspective:

- o Income tax payable by the South African borrower is adjusted for the excessive interest portion; and
- o Interest income subject to non-South African tax in the hands of the recipient (albeit possibly subject to credit for South African withholding tax on interest)

This result is in line with a conventional double taxation scenario. However, under current law, the MNE is also potentially subject to two types of other tax on interest, more specifically:

- South African withholding tax on interest in the hands of the entity receiving the interest income (on the full interest expense); and
- Secondary adjustment imposed in South African on the borrower

This seems like an unduly punitive result. This result could be mitigated by amending the WHT rules to state that any withholding tax on interest paid by the South African borrower can be claimed as a credit against any tax on interest payable as a result of a secondary adjustment.

7 INTEREST: DIVIDEND SWAPS

Interest: dividend swap transactions raise similar issues to the debt pushdown arrangements. However, a difference is that interest:dividend swaps are not necessarily linked to a group re-organisation. Instead a South African resident investor invests in, say, preference shares issued by a foreign entity which, in turn, invests in debt instruments in South Africa. The interest payable on the debt is deductible for the borrower, no tax is suffered in the non-resident entity and tax exempt dividends are declared to the South African investors in respect of the redeemable preference shares. Various mechanisms have been put in place to prevent these transactions. These include the following:

7.1 SECTION 10B ROUND-TRIPPING PROVISIONS

Section 10B of the Income Tax Act contains round-tripping provisions. In particular a foreign dividend will not be exempt from tax if any amount of the foreign dividend is determined directly or indirectly with reference to an amount paid by a South African resident entity to a non-resident entity in circumstances where the South African resident entity obtains a tax deduction for the payment and the payment is not subject to tax in the hands of the non-resident entity.[90]

In addition, the provisions in section 10B require an investment in equity shares in order to qualify for the participation exemption on foreign dividends. The round-tripping provisions of section 10B have been very effective in ending many transactions previously entered into in this regard.

7.2 SECTION 8E

Section 8E can be applied to deem a dividend declared by a company on a hybrid equity instrument as interest. The aim of the provision is to turn non-taxable dividends into taxable interest.

7.3 SECTION 8EA

Section 8EA applies in respect of preference shares where investors have security over such shares and therefore do not take “equity risk”.

7.4 TAX TREATIES: DOUBLE NON-TAXATION OF INTEREST

Double non-taxation of interest and other financial payments arise in South Africa when foreign direct investment in South Africa is routed through a jurisdiction which does not tax interest/financial payments. For example, a foreign investor may invest in, say, a Luxembourg company or Mauritian company which on-invests in the South

[90] Section 10B(4) of the Income Tax Act.

African target. The South African target would obtain a deduction in respect of interest paid to the Luxembourg/Mauritian entity. In addition, due to the application of applicable DTAs, the interest may only suffer a reduced (to as little as zero) amount of withholding tax from the introduction of the withholding tax on interest in March 2015. If the investment is routed through a jurisdiction that has a double tax treaty with South Africa but the jurisdiction levies zero withholding tax on interest, no or limited tax would then be suffered in the intermediate jurisdiction. Depending on the CFC rules in the jurisdiction of the ultimate investor, the interest may then never be taxed in the hands of the investor. The policy issue arises whether this is a problem for South Africa as the source jurisdiction. If so, consideration could be given to amendment of our domestic tax law in circumstances where no or limited tax is suffered on interest payments in the recipient jurisdiction.

7.5 BASE EROSION VIA OTHER FINANCIAL PAYMENTS

Base erosion can also arise from excessive interest deductions arising from derivative financial instruments. Derivatives are financial instruments in which the rights and obligations under the instrument are derived from the value of another underlying instrument but they are not themselves the primary instruments.[91] In most countries, the income taxation of financial instruments is based on the distinction between debt and equity. But derivatives cause an outright fragmentation of the distinction between debt and equity.[92]

Amounts derived from derivatives may not fall into the definition of interest and will therefore not be subject to the interest withholding tax when introduced. An example is “manufactured interest” payments in respect of share lending agreements. Another example is amounts payable on forward exchange contracts and cross currency swap contracts where there are no initial exchanges. This economically represents interest, but does not fall into the definition of interest. Set-off mechanisms can also be used, in terms of which there is no physical payment of interest between parties which would give rise to interest withholding tax. However such amounts give rise to a tax deductible payment for the payor since the relevant amount is “actually incurred” by it, although it is not paid due to the set-off mechanism.

7.6 SECTION 24J

Section 24J was originally introduced into the Income Tax Act principally to regulate the incurral and accrual of interest in respect of “instruments”. The section prescribes *inter alia* that interest accrues on a day-to-day basis using a yield-to-maturity methodology (unless an alternative method has been used and approved), and applies to all instruments.

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91 L Oliver & M Honiball *International Tax: A South African Perspective* 5 ed (2011) at 252.

92 AW Oguttu “Challenges in Taxing Derivative Financial Instruments: International Views And South Africa’s Approach” *(2012) 24 South African Mercantile law Journal* at 390.

The provisions of section 24J of the Income Tax Act therefore require the existence of an “instrument”. An “instrument” includes any “interest bearing arrangement” or debt. Section 24J(2)(*a*) of the Income Tax Act provides that the issuer of an “instrument” is deemed to have incurred an amount of interest during a year of assessment equal to the sum of all “accrual amounts” in relation to all accrual periods falling, whether in whole or in part, within such year of assessment in respect of such instrument.

In calculating the “accrual amount” of an instrument, the “yield to maturity” is applied to the “adjusted initial amount”. The proviso to paragraph (*b*) of the definition of “adjusted initial amount” provides, in relation to the issuer of any instrument, that where such instrument forms part of a transaction, operation or scheme:

> *“any payments made by the issuer to any other person pursuant to that transaction, operation or scheme with a purpose or with the probable effect of making payment directly or indirectly to the holder or a connected person in relation to the holder, must be deducted for purposes of this paragraph; and*
>
> *in the case where any party to that transaction, operation or scheme is a connected person in relation to that issuer, any payments made by that connected person to any other person pursuant to that transaction, operation or scheme with a purpose or with the probable effect of making payment directly or indirectly to the holder or a connected person in relation to the holder, must be deducted for purposes of this paragraph”.*

The “yield to maturity” is defined as, *inter alia*, the rate of compound interest per accrual period at which the present value of all amounts payable or receivable in terms of any instrument in relation to a holder or an issuer, as the case may be, of such instrument during the term of such instrument equals the initial amount in relation to such holder or issuer of such instrument. The proviso to the definition of “yield to maturity" is similar to the proviso to paragraph (*b*) of the definition of “adjusted initial amount” set out above.

Problem statement

The above provisos were inserted into the Income Tax Act by the Revenue Laws Amendment Act, 32 of 2004. The Explanatory Memorandum issued by SARS in conjunction therewith states the following in relation to the insertion of the provisos:

> *“A number of structured finance schemes which are based on convertible loans have been identified. The schemes under investigation were entered into between members of groups of companies (large and smaller companies) and are as a general rule facilitated by financial institutions.*
>
> *Common characteristics of the structures are the use of compulsory convertible debt, the circular flow of funds through a number of related and unrelated companies, and the borrowing of an inflated amount by the party claiming interest for tax purposes. The tax benefit for the group of companies entering into the scheme is the deduction of interest on the principal amount of a loan on an accrual basis and the creation of a deferred capital gain which in essence results in the deduction of interest and capital of the actual financing needs of the borrower.*

In order to address the tax avoidance element of schemes which are based on the circular flow of funds to which more than one company in a group of companies are party it is proposed that the interest claimed by a group company be limited to the net amount borrowed in terms of the scheme by the group of companies. It will be required that payments made by the borrower in respect of a financial arrangement or scheme as well as payments made by any connected person in relation to the issuer in respect of a financial arrangement or scheme should be taken into account. A circular flow of funds would then reduce the amount of interest claimed by a group company.
The definitions of "adjusted initial amount" and "yield to maturity" in section 24J(1) are to be amended to provide that where an instrument forms part of any transaction, operation or scheme and, any payments made by the issuer or connected person must be taken into account if made with a purpose or the probable effect of making payment directly or indirectly to the holder (or a connected person to the holder)".

<u>Issue</u>

The wording of the provisos is wider than their intended ambit as expressed in the Explanatory Memorandum. Consider a hypothetical situation where Company A, Company B and Company C form part of a group of companies, Company A advances an interest-bearing loan to Company B which, in turn, advances an interest-bearing loan to Company C as part of a single arrangement. Company A is a connected person in relation to Company C. Payments are made by Company A to any other person (Company B) with both the purpose and probable effect of making payment to the holder (Company B).

In these circumstances Company C's "adjusted initial amount" is reduced by the value of the entire loan advanced to it by Company B. In addition, these amounts reduce Company C's yield to maturity. The effect of this is that Company C obtains no tax deduction for the interest it incurs on its loan from Company B, while Company B is taxed on the full amount of such interest.

<u>Recommendations:</u>

- The appropriate mechanism to remedy this problem is to add a requirement that, for example, there must be a purpose of avoiding tax before the provisos apply, or to include some other explicit reference to the tax avoidance mischief identified in the Explanatory Memorandum.
- The definition of interest is apposite. There should not be any amendment to the definition of interest for the purpose of interest withholding tax that could broaden the definition further than the current definition that includes the definition in para (a) and (b) of the definition of interest in section 24J(1).
- It is also not recommended that a further withholding tax on derivative payments should be imposed. This would constitute an unusual withholding tax from an international perspective and could adversely impact on foreign direct investment.

7.7 SECTION 8F AND SECTION 8FA

From 1 April 2014 section 8F of the Income Tax Act deems interest on a hybrid debt instrument to be a dividend *in specie* for both the company paying the interest and the person receiving the interest. As a result, no deduction is allowed of the interest paid by the issuer on the instrument. Section 8F(2) of the Income Tax Act disallows the deduction of interest incurred on a hybrid debt instrument that is considered debt in its legal form but is actually equity in economic substance.

Section 8FA of the Income Tax Act, introduced from 1 April 2014 and deems hybrid interest paid by a company to be a dividend in specie for both the company paying the interest and the person receiving the interest.

Both section 8F and section 8FA of the Income Tax Act re-characterise interest as dividends in both the paying and receiving entities in certain circumstances. These provisions are effective in preventing excessive interest deductions in respect of inbound transactions, but not outbound transactions. In respect of outbound transactions these provisions mean that a South African resident, instead of receiving taxable interest, receives a tax exempt dividend.

<u>Recommendations:</u>

- The re-characterisation in respect of outbound debt instruments falling within the provisions of section 8F or section 8FA of the Income Tax Act should be changed to refer to "foreign dividends". Such foreign dividends would therefore only be exempt if they qualify for the more onerous exemption criteria set out in section 10B of the Income Tax Act.
- In addition in all circumstances these transactions should be subject to the provisions of section 8EA of the Income Tax Act. There has been much time spent on section 8EA of the Income Tax Act, but these rules can now be circumvented by taking security over a hybrid debt instrument falling into the provisions of section 8F or section 8FA of the Income Tax Act.

7.8 THE SECTION 80A-80L GENERAL ANTI-AVOIDANCE PROVISIONS

The general anti-avoidance provisions under sections 80A to 80L of the Income Tax Act can also be applied to prevent excessive interest deductions. A question that arises is whether a "tax benefit" in terms of section 80G(1) of the Income Tax Act, exists as a consequence of the transaction, operation, scheme, agreement or understanding entered into (s 80L of the Income Tax Act).

In the context of the definition of a "tax benefit" in terms of section 1 of the Income Tax Act, and based on case law (*Hicklin v SIR*[93] and *Smith v CIR*[94]), the liability for the payment of any tax, levy or duty that a taxpayer must seek to avoid, postpone or reduce is not an accrued or existing liability, but an anticipated liability. In *Smith v CIR*,[95] it was held that to avoid liability in this sense is "to get out of the way of, escape or prevent an anticipated liability".

In *ITC 1625*,[96] Wunsh J held that the test to be applied in determining whether a transaction had the effect of avoiding tax was to ask whether "the taxpayer would have suffered tax but for the transaction." The court stated that "if the transaction in issue had not been entered into, the taxpayer would not have acquired the property, it would not have earned the income and it would not have incurred the interest expenditure" and thus the court could find "no basis on which it can successfully be argued that by incurring expenditure on interest in order to earn the income on which it has to pay tax the taxpayer avoided tax or reduced tax."

If there is a "tax benefit", the second requirement for the application of the anti-tax-avoidance provisions in terms of section 80A of the Income Tax Act is that the "sole or main purpose" of the avoidance arrangement is to obtain such tax benefit. Therefore, provided the taxpayer does not comply with this requirement, the arrangement will not constitute an impermissible tax avoidance arrangement and so the provisions would not apply.

Section 80G of the Income Tax Act provides that an avoidance arrangement is presumed to have been entered into or carried out for the sole or main purpose of obtaining a tax benefit, unless and until that party proves that, reasonably considered in light of the relevant facts and circumstances, obtaining a tax benefit was not the sole or main purpose of the avoidance arrangement. The purpose of a step in or part of an avoidance arrangement may be different from the purpose attributable to the avoidance arrangement as a whole and may itself be subject to the anti-avoidance provisions.

If a non-resident enters into a derivative arrangement instead of advancing a loan to a South African resident, this may have the effect of avoiding an anticipated tax liability in respect of interest withholding tax for the non-resident entity. A tax benefit will therefore arise for the non-resident. The non-resident then bears the onus of proving that its sole or main purpose was not to achieve the tax benefit.

[93] 1980(1) SA 481(A); 4 SATC 179.
[94] 1964 (1) SA 324(A).
[95] 1964 (1) SA 324(A).
[96] (1966) 59 SATC 383.

7.9 SUBSTANCE OVER FORM

The common law doctrine of substance over form can also be applied to interest transactions where the substance of the transaction is not the same as the form in which the transaction is presented. The recent court decisions in *Commissioner for the South African Revenue Service v NWK Ltd*[97], *Roshcon (Pty) Ltd v Anchor Auto Body Builders CC*[98] and *CSARS v Bosch*[99] demonstrated that the substance over form doctrine can be widely applied in a wide range of legal matters.

7.10 CFC – DOUBLE NON-TAXATION OF FOREIGN INTEREST

The CFC-CFC exemption contained in section 9D(9)(fA) of the Income Tax Act implies that it is possible to have a situation where a CFC (CFC 1) which qualifies for the "foreign business establishment exemption", pays interest to another CFC which does not have a foreign business establishment (CFC 2). CFC 2 may then on-declare such interest as an exempt foreign dividend back to its South African shareholder.

This type of mechanism can extract passive income (including interest) from CFC 1 into CFC 2, which, if situated in a low tax jurisdiction, can avoid tax both in the source jurisdiction of CFC 1 and in South Africa. Consider this hypothetical example:

- CFC 1 obtains a tax deduction in its jurisdiction;
- There is no allocation of an amount equal to the net income of CFC 1 to the South African residents who hold participation rights in CFC 1 due to the foreign business establishment exemption;
- The interest is not taxed or is taxed at a low rate in the jurisdiction of CFC 2;
- When CFC 2 declares a dividend back to the South African shareholder, the dividend qualifies for exemption in terms of section 10B of the Income Tax Act.

The question that arises is whether the fact that such amounts are not taxable in the source jurisdiction of CFC 1 should be an issue from a South African tax perspective. It is submitted that this should not be of concern to South Africa. Instead South Africa should concern itself with its own tax base, as the example above does not result in tax loss in South Africa.

8 GENERAL RECOMMENDATION

From the above, it is clear that many of the schemes associated with financial flows have been heavily targeted already and, as a consequence, may provide a disincentive for foreign persons to invest in South Africa. The question is whether these efforts are complete (and whether the taxes associated with cross-border

97 2011 (2) SA 67 (SCA).
98 2014 ZASCA 40.
99 2014 ZASCA 171.

financial flows have to be re-examined in light of Government's growing need for external finance).

Nevertheless, as mentioned above, the plethora of legislation dealing with the incurral of interest is creating considerable uncertainty for investors into South Africa. It is strongly recommended that the current position in relation to inbound debt be considered holistically. The following points should be considered as part of this process:

- Should taxpayers really be required to do expensive debt pricing exercises? Are safe harbours not a viable option – particularly in view of the excessive debt rules and the interest withholding tax?
- How should the excessive debt rules and the thin capitalisation rules interact with each other? For example, might it not make sense to align these rules so that the test in the excessive debt rules (40% of "adjustable taxable income") automatically apply for thin capitalisation purposes. This would avoid the need for multiple tests of the same transaction.
- There will be significant potential for economic double taxation – or even triple taxation – for groups. This would apply for example, if a transfer pricing adjustment is made in South Africa in respect of an interest payment, while the recipient is subject to South African withholding tax (possibly at a reduced rate) and income tax in their own country.
- Should thin capitalisation rules and exchange control rules applicable to inbound debt not be aligned?

The benefits of including complex provisions against BEPS, as recommended by the Final Report must always be weighed against the necessity of having legislation which is easy to interpret, accessible to taxpayers and not unnecessarily voluminous. A good tax system is one in which, *inter alia*, taxpayers have certainty regarding their obligations to the fiscus. It should also be kept in mind that in order to encourage foreign investment, there is a need for a regulatory framework which is not unnecessarily onerous or which is too complex that it will discourage investors who can easily invest their funds in less regulated environs for a similar return.[100]

At present, it appears that the tax rules regulating finance and funding of entities, and in particular, the deduction limitations rules, constitute over-regulation of this field. As a result, the balance between base protection on the one hand, and certainty for taxpayers on the other, is out of sync in favour of impractical base-protection rules. Even if some deduction limitation rules are necessary:

- the current approach based on the tax EBITDA of borrowers creates distortions and prejudices certain borrowers. This may ultimately negatively impact the economy by discouraging investment by start-ups and in certain

[100] Andrew Wellsted (Norton Rose Fulbright) Technical Report to the DTC on Action 4.

industries. A group ratio rule as canvassed in the OECD Action 4 should be considered in this regard.

- the economy desperately requires regulatory certainty and simplicity in order to stimulate growth and foreign investment. Numerous and overlapping tax rules which limit the ability to leverage undermines this goal. Only transfer pricing and interest withholding tax should be used to regulate group cross-border financing. The addition of the deduction limitation rules adds complexity which discourages foreign investment and is the benefit is disproportionate to the harm done; and
- as regards financing decisions of taxpayers in relation to a leveraged acquisition, taxpayers need to be able to freely choose which transaction they enter into and how they are funded, to the extent that such transactions do not result in BEPS. It is beyond the realms of fiscal legislation to limit taxpayer's ability to freely transact in a capitalist economy seeking to grow.

These recent provisions have focused strongly on anti-avoidance – and it is acknowledged that excessive debt has proved to be a method often used in practice for profit stripping by multi-national enterprises (MNE's). However, has this really been a big issue in South Africa (given the fact that inbound loans require exchange control approval – and the debt to equity levels of the South African borrower are taken into account).

It is suggested that, in evaluating these rules holistically, the considerations of anti-avoidance be carefully balanced against trying to make them as investor friendly as possible. This applies particularly to the compliance burden placed on MNE's.

The issuing of a final Interpretation Note on Thin Capitalisation should probably be deferred until such a holistic evaluation of all these rules has been performed. South Africa should monitor OECD recommendations on domestic rules to limit excessive interest deductions and ensure that the domestic legislation is aligned with those recommendations.

South Africa should seriously consider the costs by both local and foreign investors of complying with the required tax legislation in relation to its benefits and the impact that it has on the ease of doing business in South Africa. The Discussion Draft and the Final Report acknowledged that compliance with some of the best practice recommendations may be high. In order to reduce the compliance cost and administrative burden for entities with very low leverage and which pose a low risk of BEPS, it was suggested that a country could include a monetary threshold which sets a *de minimis* level of net interest expense below which an entity will not be required to apply the general interest limitation rule. This threshold should be set at an adequate low level to apply only to those that do not pose a risk.

It is, for instance, argued that although the thin capitalisation rules are flexible in that they apply to different industries, it is not practical for taxpayers with a low risk of BEPS to comply with the rules. Thus in the redraft of the Draft Interpretation Note, SARS could consider introducing a threshold, either at the level of the funding, or at the level of the net interest expense.

9 SUMMARY OF RECOMMENDATIONS

(i) Recommendations on the effectiveness of arm's length principle in preventing BEPS due to excessive interest deductions

The OECD recommended that the arm's length test should only apply to the pricing of the debt i.e. the interest rate. It may be preferable in the South African context to retain the approach of evaluating the extent of debt (i.e. thin capitalization) and the debt pricing (i.e. the interest rate) separately. In doing so, exchange control requirements should be borne in mind. The DTC recommends that the Guidance from SARS should be changed to be in line with that of the OECD and international thinking as a matter of urgency, and be finalised to avoid uncertainty of its application. It is important that the use of thin capitalisation rules to prevent BEPS resulting from excessive interest deductions is in line with what is recommended by the OECD, as different rules between different countries could lead to double taxation.

In finalising or redrafting this draft, the DTC recommends that SARS considers the following:

- Simplification of rules;
- Consistency with the OECD recommendations and international precedent on the Final Report;
- Transfer pricing rules for interest rate should take into account outcome of the GE and Chevron cases on relevance of parent credit ratings;
- Introducing ways of reducing the administrative burden for taxpayers with a low risk of BEPS through interest deductions. These could be one or all of the below:
    - Introduction of a safe harbour; and
    - Threshold based upon loan value or another measure whereby taxpayers falling below such a threshold would not have to comply with the rules.
- How to treat start-up operations where loan funding is required;
- Compliance cost for investors.

It is recommended that a "safe harbour" with a fixed ratio be introduced in section 31 or the Interpretation Note to provide non-residents that are funding local entities with guidance as to reasonable levels of debt versus equity.

It is further recommended that legislation and Interpretation Notes be released together, first in draft and then in final form.

(ii) Recommendations on exchange controls

It is recommended that the interest cap between SARB and SARS should be aligned. Interest rates allowable from a SARB perspective are potential indicators of risk from a South African transfer pricing perspective.

The DTC's recommendation is further that a taxpayer should determine what interest rate would be acceptable from a Transfer Pricing perspective. If acceptable, then it should be allowed by SARB. Alternatively SARS should indicate what interest rates it would allow, and then those should be allowed from an exchange control perspective.

(iii) Recommendation on withholding tax on interest

It is recommended that South Africa reconsiders the effectiveness of the withholding tax on interest to ensure that its source right to tax is protected. This would include, but is not limited to, the renegotiation of zero rate treaties.

(iv) Recommendation on interest deductibility

Recognising the complexities and uncertainties for potential investors as to what level of interest deductibility they would be entitled to in any particular year it is recommended that a proper analysis be made to determine whether reliance on deduction limitation rules is appropriate.

(v) Recommendation on incurral and accrual of interest

It is recommended that the rules relating to incurral and accrual of interest in section 24J be reconsidered, without widening the definition of interest, to ensure that the rules do not adversely apply to transactions where there is no tax avoidance purpose.

(vi) Recommendations on hybrid interest and debt instruments

The re-characterisation in respect of outbound debt instruments falling within the provisions on hybrid interest and hybrid debt instruments should be changed to apply to "foreign dividends" and these transactions be subject to the provisions dealing with third party backed shares.