INTEREST LIMITATION AND THIN CAPITALISATION RULES: AN ANALYSIS OF GLOBAL PRACTICES AND LEARNINGS FOR SOUTH AFRICA

by

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ABSTRACT

South Africa loses approximately R7 billion a year due to profit shifting by multinational corporations amounting to about 4% of the total corporate income tax receipts. It is estimated that 98% of this tax loss can be directly attributed to the profit shifting schemes of the largest 10% of multinational enterprises.

The term 'profit shifting' refers to the transferring or shifting of profits within a multinational group of companies from a firm in a higher-tax-rate country to an associated company in a lower-tax-rate country. It can be legitimate to some degree, however this practice by multinationals is increasingly becoming a challenge for tax authorities and governments worldwide. These challenges are particularly difficult for developing countries such as South Africa as the country is more reliant on corporate tax revenues compared to more economically developed countries. The risk of South Africa's tax base eroding due to profit shifting is thus vitally important to address.

It is becoming increasingly important for the South African government to protect its tax base from aggressive tax planning along with attempting to alleviate the burden on taxpayers from the administrative costs of complying with the OECD arm's length approach. Therefore, this dissertation undertook a review of South Africa's current and historic fiscal policies to address base erosion and profit shifting through excessive interest deductions. The research conducted aims to consider how various countries across the world have implemented measures to address excessive interest deductions so that South Africa may benefit from their lessons learnt.

The review has revealed the various methods that countries have applied to address the risk of excessive interest deductions. Many countries implement interest limitation rules that largely align to the OECD BEPS Action 4 recommendations on excessive interest payments. Some countries implement thin capitalisation rules based on fixed financial statement ratios to curb excessive interest. Other countries have followed a combined approach using the OECD BEPS 4 method and thin capitalisation rules. Certain countries also use other tax safe harbours such as circulating an approved arm's length interest rate for cross-border finance arrangements to encourage compliance and manage excessive interest payments. It was noted that where countries implemented rules in line with BEPS Action 4, the rules were

tailored to suit their unique economic and fiscal needs. These distinctive deviations are highlighted within this dissertation.

It was also evident that thin capitalisation safe harbour rules continued to be a key element of interest limitation rules as a means to reduce the compliance burden for low-risk entities. The research reflects that a re-introduction of thin capitalisation safe harbour rules, to address ever-increasing complexity in the relevant areas of our income tax legislation, would not be contrary to common practice in a number of countries.

Drawing on the findings from the research and analysis conducted, it is recommended that the interest limitation rules in South African should be developed further and improved upon. As an example, these developments might include the reintroduction of thin capitalisation safe harbour rules, stronger alignment of section 23M of the Act to the best practice guidelines within BEPS Action Plan 4 or the circulation of government approved arm's length interest rates for cross-border debt financing transactions between connected persons or associated enterprises.

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LIST OF ABBREVIATIONS

ATAD	Anti-Tax Avoidance Directive
ARS	Argentinian peso
ATAF	African Tax Administration Forum
ATO	Australian Tax Office
AUD	Australian dollar
BEPS	Base Erosion and Profit Shifting
CbCR	Country-by-country Reporting
CHF	Swiss Franc
CITA	Dutch Corporate Income Tax Act
CITL	Chinese Corporate Income Tax Law
D/E	Debt-to-equity ratio
DINTC	Draft Interpretation Note: Determination of the Taxable Income of Certain Persons from International Transactions: Thin Capitalisation, issued by SARS on 3 April 2013
DTC	The Davis Tax Committee
EBITDA	Earnings before Interest, Tax, Depreciation and Amortisation.
ECOWAS	Economic Community of West African States
EUR	Euro
G20	Group of 20
IMF	International Monetary Fund
IN127	Determination of the taxable income of certain persons from international transactions: intra-group loans
IN128	Definition of “Associated Enterprise”
INR	Indian Rupee
IRC	United States of America Internal Revenue Code
ITA	Indian Income Tac Act
ITAA	Australian Income Tax Act

ITC	Greek Income Tax Code
ITCL	Korean Income Tax Coordination Law
JIBAR	Johannesburg Interbank Agreed Rate
JPN	Japanese Yen
KStG	Austrian Corporate Tax Act
LIG	Argentinian Income Tax Law
MM	Miller and Modigliani
MNE	Multinational entity
ILR	Belgian new interest limitation rules
NT	South African National Treasury department
NTC	National Tax Committee
OECD	Organisation for Economic Co-operation and Development
OECD TPGs	OECD Transfer Pricing Guidelines for Multinational Enterprise and Tax Administrations, Paris 2017
OECD MTC	OECD Model Tax Convention on Income and on Capital: Condensed Version 2017, Paris 2017
PE	Permanent Establishment
PMK	Indonesian Minister of Finance Regulation
PN2	SARS Practice Note 2 issued on 14 May 1996
PN7	SARS Practice Note 7 issued on 6 August 1999
ROE	Return on equity
SAICA	South African Institute of Chartered Accountants
SARS	South African Revenue Service
Section	For convenience and unless otherwise indicated, a reference to "section" in this dissertation will refer to the relevant section of the Act
SFTA	Swiss Federal Tax Administration
STML	Japanese Special Taxation Measures law
The Act	South African Income Tax Act, 58 of 1962 (as amended)

The Commissioner	The Commissioner for SARS
TUIR	Italian Income Tax Code
UN	United Nations
USA	United States of America
USD	US Dollar
WACC	Weighted average cost of capital

CHAPTER 1 INTRODUCTION AND OVERVIEW

1.1 Background

Transfer pricing generally describes the process by which member entities within a Multinational Entity ("MNE") set the prices at which they transfer goods or services between each other. These transactions are often referred to as "controlled transactions" as the controlling relationship between firms within an MNE may influence the transaction prices which then might be set at a price at which independent willing buyers and sellers would not necessarily transact in an open market.

The transfer prices applied by MNEs directly impact the proportional profit derived by each respective member firm of the MNE in the respective country in which they are resident. If inadequate or excessive consideration is paid for the goods or services between member firms of an MNE, the profits and taxable income of those firms could be inconsistent with the economic contribution they have made toward the group profit. Therefore, transfer mispricing can be a tool for MNEs to shift profits from high tax jurisdictions to lower taxing jurisdictions.[1]

Cross-border debt financing arrangements between connected persons is a mechanism that could potentially facilitate transfer mispricing. This is because an interest expense is generally deductible for tax purposes in most tax regimes, and thus MNEs may exploit this tax shield by financing member firms with excessive debt. MNEs can therefore effectively move income that would have otherwise been taxed in a higher tax jurisdiction to a lower tax jurisdiction in an area where the member firm or parent company providing the debt financing is resident.

In 1995 South Africa introduced thin capitalisation rules with the aim of curtailing aggressive tax planning by MNEs and ultimately to protect the South African fiscus and tax base from potential erosion through profit shifting.[2] By 2011, in the wake of a global financial crisis and the necessity for the South African government to reduce its budget deficit, the thin capitalisation rules were replaced in favour of an alternative approach to increase tax revenue

[1] SARS Practice Note 7 of 1999. Republic of South Africa. p5.

[2] Oguttu, A.W. 2013. "Curbing Thin Capitalization: A Comparative Overview with Reference to South Africa's Approach – Challenges Posed by the Amended Section 31 of the Income Tax Act 1962". IBFD. p311.

through transfer pricing audits. This approach was the arm's length approach as recommended by the Organisation for Economic Co-operation and Development ("OECD").[3]

While implementing a transfer pricing regime in line with the OECD recommendations ensured South Africa kept abreast of international standards, complying with the arm's length principles was considered an onerous and costly exercise by many taxpayers and provided little to no certainty that their cross-border transactions would be accepted by the South African Revenue Service ("SARS").

In 2012, South Africa also introduced specific interest deduction limitation rules aimed at curbing aggressive tax planning and profit shifting schemes. These new rules were loosely based on the Base Erosion and Profit Shifting ("BEPS") Action Plan 4 guidelines as it limited the deductibility of interest to 30% of earnings before tax interest depreciation and amortisation ("EBITDA"). The addition of these specific interest limitation rules may have contributed to the complexity of the interest deduction legislative framework in the country. Thus, many South African lawmakers have called for simplification of legislative complexity to encourage compliance with the law by taxpayers and alleviate the burden shouldered by SARS in the administration of the tax laws.[4]

1.2 Research objective

Given the issues identified, the primary objective of this dissertation serves to explore how South Africa may better protect its tax base from profit shifting through cross-border interest payments along with providing greater certainty and administrative relief to taxpayers.

In support of the primary objective, this dissertation aims to achieve the following additional sub-objectives:

- Analysing South Africa's current and historic policy concerning thin capitalisation rules and interest limitation rules and determining whether thin capitalisation safe harbour rules could be reconsidered.

[3] *Ibid.*

[4] Evans, C et al. 2019. "Tax Simplification: An African Perspective. Pretoria:". South Africa: Pretoria University Press Law (Pulp). p295.

- Analysing the implementation of the Anti-Tax Avoidance Directive ("ATAD") interest limitation rules in a sample of European Union ("EU") countries so that South Africa may benefit from their lessons learnt in applying those rules.

- Analysing the implementation of the BEPS Action Plan 4 interest limitation rules in a sample of non-EU countries so South Africa may benefit from their lessons learnt.

- Analysing the implementation of alternative interest limitation rules in a sample of non-EU countries that have opted not to follow the BEPS Action Plan 4 guidelines so South Africa may benefit from a broader canvas of interest limitation rules.

- An alternate approach to the BEPS Action 4 guideline in addressing excessive interest deductions are debt-to-equity("D/E") based thin capitalisation rules. While South Africa previously applied a D/E safe harbour ratio of 3:1, that has since been repealed, the D/E ratio used could vary significantly. Therefore, it is a sub-objective of this dissertation to determine if the debt-to-equity based thin capitalisation safe harbour rules are grounded on sound corporate financial theory and if there is a theoretical 'ideal' D/E ratio that can be applied. The research will also consider how D/E thin capitalisation rules may be improved upon.

The split between EU and non-EU countries is discussed in further detail in section 1.3 below.

1.3 Country Selection

One means of improving South Africa's tax law is to modify tax rules that were designed for more matured and sophisticated tax systems to suit South Africa.[5] Thus reviewing how other countries have implemented interest limitation rules to combat base erosion and profit shifting could be beneficial to South Africa.

The determination as to which countries were included in the population for review was predicated on whether the country implemented the OECD Transfer Pricing Guidelines[6] (OECD TPGs") or implemented transfer pricing legislation that is largely based on the OECD TPGs and whether the country also applied special transfer pricing rules outside of the OECD TPGs' arm's

[5] *See* Evans, C et al. *Supra* n4. p313.

[6] OECD (2022). "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022". OECD Publishing, Paris. Available: https://doi.org/10.1787/0e655865-en.

length approach for financial transactions. The OECD TPGs was chosen as the benchmark as this provides a level of global interconnectedness between countries and allows for global interactions between these countries to be assessed on like terms. It further ensures an overarching, high level of comparability between South Africa and the countries reviewed.

The countries reviewed were selected using a form of stratified sampling. Stratified sampling is a way of obtaining a representative sample from a population that has been divided into specific subgroups or 'strata'. It is a method used where a population's characteristics are diverse as it ensures the characteristics of each stratum is represented in the selected sample. This method also helps with the validity of the research as it helps in reducing research bias and allows for both greater objectivity and accurate generalisations of the entire population.[7] After determining the population, using the criteria set out above, it was subdivided into the following strata:

1. Countries that applied the EU ATAD rules
2. Countries that implemented the BEPS Action 4 interest limitation rules
3. Countries that applied alternate interest limitation rules

Quota sampling was then used to select countries to review within each stratum. Quota sampling is a non-random selection of a predetermined number of samples referred to as the 'quota'.[8] This sampling method was chosen over a simple random selection to ensure greater variety within each stratum in terms of how the various countries implemented the interest limitation rules. In order to achieve this, a high-level review was performed for each country that fell within the respective strata to identify unique characteristics. This selection process highlights variances in different approaches taken by countries which is better achieved by reviewing a broad range of potential countries. The quota for each stratum in this dissertation is five countries.

An accurate and in-depth analysis of all countries within the given population would invariably lead to more accurate and reliable results. However, a balance needs to be struck between

[7] Thomas, L. 2023. "Stratified Sampling | Definition, Guide & Examples". Scribbr. Available: https://www.scribbr.com/methodology/stratified-sampling/

[8] Nikolopoulou, K. 2023. "What Is Quota Sampling? | Definition & Examples". Scribbr. Available: https://www.scribbr.com/methodology/quota-sampling/

the breadth of countries covered and the in-depth analysis of each country selected to be reviewed. In my opinion, a selection of five countries for each stratum could be considered an adequate representative sample that could strike this balance. Further, it should be reiterated that the object of this dissertation is to unpack and explore the countermeasures to excessive interest payments and the manner in which countries across the globe have reacted to these measures and not necessarily a comparability analysis between South Africa and the countries reviewed.

The EU countries that have applied the ATAD rules are as follows:

- Austria
- Belgium
- Italy
- Netherlands
- Greece

The non-EU countries that have applied BEPS Action 4are as follows:

- India
- Argentina
- United States of America
- Republic of Korea
- Japan

The countries that have applied alternate interest limitation rules are as follows:

- Indonesia
- Australia
- Canada
- Switzerland
- China

The representative sample of countries varied in terms of their economic development and levels of income. The EU countries are all classified as developed, high income countries. The non-EU countries that have followed the BEPS Action4 approach are more varied. Japan and the United States are developed, high income countries. The Republic of Korea is a developing,

high-income country whereas India and Argentina are developing lower and upper-middle income countries respectively. In the stratum where countries have applied alternate interest limitation rules; Australia, Canada and Switzerland are developed, high-income countries. China and Indonesia are both developing countries with high and lower-middle income levels respectively.[9]

Developing countries across all income levels are more economically comparable to South Africa and thus their methods to address excessing interest payments may be more relevant or better suited for our legal framework. However, there are also benefits from leveraging off developed countries. Reviewing developed legal systems can foster innovation by adopting successful practices and avoiding pitfalls from other jurisdictions. Adopting best practices from more developed countries could improve South Africa's legal framework and while also encouraging international legal harmonisation.

1.4 Limitation of scope

The definition of 'associated enterprise' that was introduced to section 31 of the Act in 2021, effective from 1 January 2023, will not be considered in this dissertation. This particular definition has been described generally as being vague and permissive. Further, neither the OECD Model Tax Convention[10] ("OECD MTC") nor the OECD TPGs provide any further guidance, or a clear definition of the terminology used in Article 9 of the OECD MTC which creates further uncertainty.[11]

The difficulty in applying the definition of 'associated enterprises' has been acknowledged by National Treasury ("NT") as evidenced in their initial postponement of the amendment to section 31 of the Act for this reason.[12] SARS has also noted that the definition is beyond the

[9] United Nations. 2023. "World Economic Situation and Prospects". p117-121. Available: https://unctad.org/system/files/official-document/wesp2023_en.pdf

[10] OECD (2017). "Model Tax Convention on Income and on Capital: Condensed Version 2017". OECD Publishing, Paris. Available: https://doi.org/10.1787/mtc_cond-2017-en

[11] Rudd, R. 2020. "Tax and Transfer Pricing: Determining the meaning of 'associated enterprises' in South African domestic law". University of Witwatersrand. 2020. p480.

[12] National Treasury. 2019. "National Treasury Explanatory Memorandum on the Taxation Laws Amendment Bill 2019". Republic of South Africa. p42.

scope of Interpretation Note ("IN") 127,[13] and have subsequently issued IN128[14] setting out their interpretation of the definition of 'associated enterprises'.

This dissertation will also not consider the tax implications of hybrid instruments or hybrid mismatches as it pertains to its implications for interest limitation rules and re-characterisation of debt to equity. Section 23M has been considered in this dissertation as it is linked to potential profit shifting schemes through excessive cross-border finance arrangements. However, the tax implications of other interest related sections of the Act such as section 23N and the interest withholding sections of 50A-50H have been scoped out of this dissertation.

1.5 Research methodology

A comparative law method will be used to review and compare the mechanisms to address excessive interest deductions on cross-border finance arrangements applied by the selected jurisdictions per section 1.3 above. The comparative law method was selected as the primary research method as the benefits of applying this method are best aligned to the research objectives.

This method is particularly useful as it involves analysing laws from different countries to identify similarities and differences which provide insights into alternative legal systems which might lead South African policymakers to make more informed decisions.[15] The comparison of thin capitalisation safe harbours and other interest limitation rules of diverse countries may help in identifying the pros and cons of various legal mechanisms. It could assist in finding an ideal middle ground that could aid in developing a more effective and efficient functioning framework for addressing excessive interest deductions

A comparative study across countries that apply similar laws and principles for particular matters such as thin capitalisation safe harbours and interest limitation rules could assist in developing South Africa's interest limitation legislation on the basis that South Africa can

[13] SARS. 2023. "Interpretation Note 127: Determination of the taxable income of certain persons from international transactions: intra-group loans".
[14] SARS. 2023. "Interpretation Note 128: Definition of "associated enterprise".
[15] "Comparative Legal Research: A Brief Overview." n.d. Afronomicslaw.org. Available: https://www.afronomicslaw.org/2020/01/24/comparative-legal-research-a-brief-overview.

leverage off the lessons learnt from the other countries by applying successful elements of their legislation and avoiding pitfalls and errors they have made.

This dissertation will not include doctrinal legal research. The research objective is not to dissect and critically analyse the letter of the law but rather how jurisdictions apply their laws to achieve a particular objective.[16]

1.6 Chapter Outline

Chapter 2 presents an overview of South Africa's tax policy concerning excessive interest. Chapter 3 offers an overview of the implementation of BEPS Action 4 in the selected EU countries through the ATAD. Chapter 4 provides an overview of the implementation of BEPS Action 4 in the selected non-EU countries. Chapter 5 illustrates knowledge gleaned from global practices that have taken a divergent approach to BEPS Action 4. Chapter 6 unpacks the relationship between corporate finance theory and ratio based thin capitalisation safe harbour rules. Chapter 7 provides the conclusions and recommendations derived from the dissertation.

[16] Kiel-Morse, M. "Research Guides: Legal Dissertation: Research and Writing Guide: Home." Law.indiana.libguides.com. Available: https://law.indiana.libguides.com/dissertationguide#:~:text=Doctrinal.

CHAPTER 2 OVERVIEW OF SOUTH AFRICA'S TAX POLICY CONCERNING EXCESSIVE INTEREST

2.1 Introduction

Thin capitalisation and interest limitation rules in South Africa developed over time to regulate the deductibility of excessive interest expenditure. They form part of South Africa's broader efforts to prevent aggressive tax planning, erosion of the tax base, fostering economic growth and encouraging foreign investment.

This chapter will unpack the history of thin capitalisation safe harbours and interest limitation rules in South Africa to explore the economic circumstances that drove their evolution over the years. Understanding the history of thin capitalisation safe harbour rules and why it was repealed, is key in ensuring that past errors are not repeated.

This chapter will consider the views on thin capitalisation safe harbour rules from a broad range of notable tax bodies both locally and internationally to shed light on whether thin capitalisation safe harbour rules are still a viable option in a modern economy and should be considered to be included in South Africa's interest limitation regime.

2.2 History of interest limitation rules in South Africa

2.2.1 Thin Capitalisation rules of section 31(3) of the Act

Thin capitalisation rules were introduced in South Africa in 1995 as a result of the findings and recommendations of the Katz Commission.[17] Prior to their introduction, the exchange control rules played a significant role in countering thin capitalisation in South Africa. The South African Reserve Bank ("SARB") would limit the interest rates on foreign inbound debt arrangements using exchange control regulations.[18] However, with the impending relaxation of exchange control rules and increasing foreign investment in South Africa, the Katz Commission took note that much of the foreign investment in South Africa was through debt

[17] National Treasury, Katz Commission. 1995. "Second Interim Report of the Commission of Inquiry into Certain Tax Structures of South Africa Thin Capitalisation Rules". Republic of South Africa. p1. Also referred to as the "Commission" or "Katz Commission".

[18] *Ibid*.

instead of equity. This observation, that foreign investors tended to favour debt financing over equity financing was considered a risk that could cause economic distortions and leave South Africa with a debt burden that might take decades for the country to correct.[19] The implementation of thin capitalisation rules was thus seen as a necessity to protect the South African fiscus from abuse by foreign investors looking to extract profits from the country through excessive debt financing arrangements.[20]

The Katz Commission recommended that the thin capitalisation rules should be a combination of the debt-to-equity ratio and the arm's length approach.[21] These recommendations were brought into law through the introduction of section 31(3) of the Income Tax ("the Act");[22] a subsection of the existing transfer pricing rules under section 31 of the Act that specifically addressed thin capitalisation. Section 31(3) not only broadened the scope of the existing transfer pricing rules, but also empowered the Commissioner of SARS ("the Commissioner") to re-characterise debt as equity, allowing the deductibility of interest on excessive debt to be prevented.[23]

The provisions of section 31(3) of the Act did not describe how excessive interest was to be determined. Instead, further guidance was provided by the Commissioner through the release of SARS Practice Note 2[24] ("PN2") in 1996 which prescribed a two-step approach to determine if debt financing was excessive. The first step involved determining if the debt-to-equity ratio of the resident taxpayer exceeded 3:1.[25] The second step was determining if the amount of interest that fell within the 3:1 guideline was based on an arm's length interest rate. PN2 defined a rand denominated loan with an interest rate not exceeding the weighted average of the South African prime rate plus two percentage points as an arm's length interest rate. Where the loan was denominated in a foreign currency, a rate not exceeding the weighted

[19] Oguttu, A.W. 2013. "Curbing Thin Capitalization: A Comparative Overview with Reference to South Africa's Approach – Challenges Posed by the Amended Section 31 of the Income Tax Act 1962". IBFD. p319.
[20] *Ibid*.
[21] *Ibid*.
[22] Income Tax Act, 58 of 1962 (as amended).
[23] Olivier, L et al. 2011. "International Tax: A South African Perspective". Siber Ink. p651.
[24] SARS. 1996. "Practice Note 2: Determination of taxable income where financial assistance has been granted by a non-resident of the republic to a resident of the republic". Government Press.
[25] *Id*., at para 4.1, p3.

average of the relevant inter-bank rate of the lending country plus two percentage points would be accepted as an arm's length interest rate.[26]

Taxpayers with financial assistance arrangements that fell within the parameters of PN2 were not required to submit additional information with their tax return to justify the arm's length nature of the financing arrangement.[27] However, the consequence for being outside these prescribed parameters would be a limitation on the deductibility of interest expense and the excess interest expenditure being deemed a dividend for tax purposes[28]

The thin capitalisation rules of section 31(3) of the Act remained unchanged until the Budget Review of 2010.[29] The Explanatory Memorandum of this review described the thin capitalisation rules as 'too narrow' as it only considered the financial assistance arrangements between foreign resident investors and South African residents. It highlighted a loophole in the legislation that was being exploited by some foreign investors. Foreign investors could avoid the thin capitalisation rules by incorporating a foreign subsidiary that would operate in South Africa as a permanent establishment ("PE") of that foreign investor.[30] In addition, this 'balance sheet' approach using debt and equity did not take a company's productivity or financial performance into account.[31] As the thin capitalisation rules did not address financial assistance arrangements between foreign investors and their PEs, these PEs could be financed with excessive amounts of debt. The outcome of the 2010 Budget Review led to section 31(3) and PN2 being repealed effective from 1 April 2012.[32]

2.2.2 South Africa' new approach to counter thin capitalisation

The global financial crisis of 2008 severely impacted the South African economy. In 2009 the economy experienced its first recession in 17 years.[33] As part of its endeavour to reduce the budget deficit following the financial crisis, SARS aimed to increase its transfer pricing audits

[26] *Id.*, at para 2.2, p3.
[27] *Id.*, at para 6.2, p6.
[28] *Id.*, at para 2.2, p3 & para 9 p7.
[29] National Treasury. 2010. "*National Budget Review 2010"*. Available: www.treasury.gov.za/documents/national%20budget/2010/review/default.aspx.
[30] National Treasury. 2010. "Explanatory Memorandum to the Taxation Laws and Amendment Bill of 2010". para 5.3, part II(C), p74–76.
[31] Mardan, M. 2013. "The effects of thin capitalisation rules where firms are financially constrained". CESifo Group.
[32] *See* National Treasury (201). *supra* n29.
[33] Steytler, N et al. 2010. "The impact of the global financial crisis on decentralized government in South Africa". CairInfo. p150.

on cross border transactions in low-tax jurisdictions and all forms of cross border intra-group funding arrangements.

In order to facilitate an increase in transfer pricing audits, SARS identified the necessity for legislation that is more effective at countering tax avoidance. This, together with the shortcomings of the existing thin capitalisation rules, led to the amendments of 2010 and 2011 that brought about the termination of section 31(3). As a result of these amendments, in the future only the arm's length principle would be used as a tool to curb thin capitalisation.

The principle behind applying the arm's length approach to counter thin capitalisation is established in the OECD Model Tax Convention ("OECD MTC") that states:

> *"Where an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or*
>
> *the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,*
>
> *and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be 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."*[34]

The OECD Committee on Fiscal Affairs further confirmed the relevance of Article 9 by stating that the Article:[35]

> *"[…] is relevant not only in determining whether the rate of the interest concerned is an arm' s length rate but also in determining whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment (depending on whether or to what extent the funds would have been contributed as a loan in the arm' s length situation)."*

[34] OECD (2017). "Model Tax Convention on Income and on Capital: Condensed Version 2017". OECD Publishing, Paris. article 9, M32. Available: https://doi.org/10.1787/mtc_cond-2017-en.

[35] *Id,* at para 48. p21.

Applying the arm's length principle to counter thin capitalisation should include considerations as to whether or not the same loan, under the same terms and conditions, would have been extended under arm's length circumstances. This means examining the particular facts and circumstances of the transaction to determine if an independent party dealing at an arm's length would have granted the loan under ordinary market conditions.[36]

On 22 March 2013 SARS released a draft interpretation note[37] setting out the guidelines for how taxpayers would be expected to support the arm's length nature of their cross border intra-group financial transactions.[38] The draft interpretation note stated that the arm's length evaluation is based on whether the borrower would have been able to obtain the loan under the same terms and conditions had the lender been an independent company and whether either party had obtained a tax benefit as a result of the transaction.[39] Although the safe harbour rules have been repealed, SARS confirmed in the draft interpretation note that a risk-based approach will be used to determine the selection for transfer pricing audits. It stated that transactions would be considered high risk if the South African company receiving the financing had a debt to earnings before interest, tax, depreciation and amortisation ("EBITDA") ratio of 3:1 or greater and an interest rate exceeding the Johannesburg Interbank Agreed Rate ("JIBAR") plus two percentage points.[40] The draft interpretation note also provided taxpayers with a list, albeit not exhaustive, of factors that should be considered when they perform their functional and comparability analysis. This draft interpretation note was unfortunately never finalised.[41]

On 17 January 2023, SARS released Interpretation Note 127 ("IN127") in response to the updated OECD Transfer Pricing Guidelines of 2022[42].[43] Similar to the draft interpretation note of 2013, the aim and purpose of IN127 is to provide taxpayers with guidance on how to apply

[36] De Hosson, F.C. et al. 1989. "Treaty Aspects of the Thin Capitalization Issues – A Review of the OECD Report Intertax". IBFD. p476

[37] SARS. 2023. "Draft interpretation note: Determination of the taxable income of certain persons from international transactions: Thin capitalisation".

[38] *Id.*, at para 1. p3.

[39] *Id.*, at para 5.2. p7.

[40] *Id.*, at para 7. p11.

[41] *See* SARS (2023). S*upra* n37.

[42] OECD (2022). OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022. OECD Publishing. Paris. Available: https://doi.org/10.1787/0e655865-en.

[43] SARS. 2023. "Interpretation Note 127: Determination of taxable income of certain persons from international transactions". Republic of South Africa.

the arm's length principle in the context of intra-group financial arrangements for years of assessment starting on or after 1 April 2012.[44] IN127 also introduced the definition of 'associated enterprises' in accordance with Article 9 of the OECD Model Tax Convention. Section 31 of the Act has thus been amended to provide that the transfer pricing provisions apply to 'connected persons' and 'associated enterprises'.[45] IN127 no longer applies the approach of using the ratio of debt to equity as a risk indicator. Instead, SARS will consider a taxpayer's debt to not be arm's length if, amongst other factors, the following factors are evident:

- the taxpayer is operating with greater levels of gearing or debt than it could sustain on its own.
- the duration of the lending period is longer than would be considered under normal or arm's length circumstances; and
- the repayment terms, interest rates or any other terms and conditions of the financial arrangement could be considered outside the normal or arm's length circumstances.[46]

The OECD recommends the arm's length approach to combat thin capitalisation as it is flexible and allows tax authorities to consider financial arrangements on a case-by-case basis. However, this approach is not without criticism and shortcomings.[47]

The application of the arm's length principle provides taxpayers with little to no certainty that their financial arrangements will be accepted by tax authorities. These uncertainties stem from the fact that the principle is based on comparing the terms and conditions of controlled transactions with terms and conditions in transactions between independent parties. For the arm's length principle to be effective, the economically relevant characteristics of the controlled and uncontrolled transactions need to be sufficiently comparable. The five factors normally considered for comparability are:

- functional analysis,
- contractual terms

[44] *Id*., at para 1. p4.
[45] *Id*., at para 4.1.4, p10.
[46] Kamoetie, D et al. 2023. "South Africa: An overview of SARS Interpretation Note 127". Bowmans. Available: https://bowmanslaw.com/insights/tax/south-africa-an-overview-of-sars-interpretation-note-127/
[47] *See* OECD (2022), *supra* n6 at para 4.3. p314.

- economic circumstances
- business strategies
- characteristics of services provided.[48]

Achieving a strong comparability can be difficult as each of these factors can be influenced by several other factors. In addition, performing these transfer pricing studies can be an onerous and costly exercise for taxpayers.[49]

There are also challenges and uncertainties in determining an acceptable arm's length interest rate which is driven by the risk associated with a company's level of debt. There are many factors and circumstances that contribute to the uncertainty over this rate. As an example, certain companies in certain industries are capable of operating independently at high levels of debt and interest.[50]

Determining the riskiness of a company can be a complex task that can be influenced by a broad range of factors such as a company's current and historic levels of debt and its ability to service the cost on that debt. Other indicators include financial performance, cash flow management and solvency and liquidity. The broad range of factors that can be considered for an arm's length interest rate provides taxpayers with little comfort that their interest rate on their loans will not be challenged by tax authorities.[51]

2.2.3 Introduction of section 23M

While the transfer pricing provisions within section 31 and the interest limitation rules within section 50A to 50H of the Act will provide some level of protection against aggressive cross-border debt financing arrangements, the fiscal authorities decided that these current methods to limit excessive interest do not address instances where the interest is owed to exempt persons and thus proposed the introduction of section 23M.[52]

Section 23M of the Act is an anti-avoidance provision that limits the deductibility of interest incurred on funding arrangements with creditors that are not subject to tax in South Africa or

[48] SARS. 1999. "Practice Note 7: Determination of taxable income of certain persons from international taxation: Transfer pricing". paras 8.1.1–8.1.6.
[49] *Ibid.*
[50] *Ibid.*
[51] *Ibid.*
[52] Kruger, D. 2015. "Interest-deduction limitation – section 23M". Siber Ink, Volume 6, (Issue 1). p13.

are subject to tax at a rate lower than the interest withholding tax rates. It was introduced in 2013[53] in response to the release of the draft BEPS Action Plans by the OECD[54] as part of a comprehensive strategy to deal with tax arbitrage between related parties.[55]

The restrictions under section 23M apply where interest paid between connected persons is not subject to South African tax in the hands of the recipient. At a high level, the amount of interest that would be allowed as a deduction in terms of section 23M, must not exceed the sum of the amount of interest received or accrued to the debtor and the amount determined by multiplying the adjusted taxable income of the debt by 30%. The term 'adjusted taxable income' is a defined term in the Act within section 23M but broadly aligns earnings before interest, tax, depreciation, and amortisation.[56]

The introduction of section 23M initially caused confusion for taxpayers as there was a degree of uncertainty as to how the provisions of section 23M would interact with the further interest limiting rules of sections 23N and 31 of the Act. Given that section 23M requires the determination of the taxpayer's taxable income, it is arguable that section 31 must be applied first before section 23M.[57] This is the view that SARS have taken, however, an alternative argument could be that if section 23M is applied first, there may be no tax benefit derived to the taxpayers and thus there would no need for section 31 to apply at all.

Since its introduction, there have been numerous shortcomings and ambiguities identified within section 23M such as a loss to the fiscus where interest is taxed in the hands of the recipient less than 15%, or the unintended narrow scope resulting from the strict definition of 'interest' as defined in section 24J of the Act.[58] As such, the provisions have been subject to amendments to improve clarity and effectiveness. The latest of these amendments came about during the 2023/2024 legislative process where proposals were made to National Treasury to include a definition of 'creditor' in section 23M, and foreign exchange gains and

[53] Section 23M of the Act was inserted through section 61(1) of the Taxation Laws and Amendment Act 31 of 2013 with an effective date of 1 January 2015.

[54] OECD (2013). "Action Plan on Base Erosion and Profit Shifting". OECD Publishing, Paris. Available: https://doi.org/10.1787/9789264202719-en.

[55] Ritchie, S. 2015. "The Interaction between the interest deductibility rules contained in the income tax act 58 of 1962". University of Pretoria. p34.

[56] Section 23M(3) of the Act

[57] *See* Ritchie, S. *supra* n55. p46

[58] Rudnicki, M. 2015. "The Modified section 23M: Interest deduction limitations". Juta and Company (Pty) Ltd, Volume 14 (Issue 1). p25.

losses be included as interest received or accrued for this purposes of section 23M, to name a few.[59]

2.3 Do thin capitalisation safe harbour rules have a place in South Africa's future?

2.3.1 Why thin capitalisation safe harbours should be reconsidered.

Currently in South Africa, many taxpayers are burdened with the onerous task of complying with a broad range of transfer pricing rules across many jurisdictions. These include tax returns, additional documentation, and transfer pricing studies in aid of minimising tax risks. These burdens are amplified for smaller companies that do not benefit from economies of scale and greater resources compared to larger MNEs.[60]

Legislative complexity can be described as the difficulty in interpretating and understanding tax legislation stemming from the structure and substantive provisions in the tax law. Effective complexity relates to the difficulty in complying with and administering the tax law.[61] Legislative complexity can further be analysed through two distinct subjects; substantive complexity and drafting complexity. Substantive complexity can be described as the 'complex technical structure of' a particular tax law. Based on this understanding of substantive legislative complexity, South Africa's international tax laws, specifically the anti-avoidance laws, can be considered complex. This complexity arises from the intricate variations of the tax treatment of international transactions and is further exacerbated by the complex terminology and structure of the respective legislation.[62]

Simplifying international tax law in South Africa would a challenging endeavour. The nature of international law is inherently more complex than domestic law as it has to be drafted and arranged in such a way to achieve multiple tax policy and fiscal objectives.[63] Further

[59] National Treasury. 2023. "Draft Response Document on the 2023 Draft Revenue Laws Amendment Bill". p55.
[60] Sweidan J. 2014. "Why SARS should consider transfer pricing safe harbours". Sabinet. p1.
[61] Evans, C. R. et al. 2019. "Tax Simplification: An African Perspective". Pretoria, South Africa: Pretoria University Press Law (Pulp.). p295.
[62] *Id* at p306.
[63] *Ibid*.

complications arise when considering that South Africa's international tax law interacts with other country's tax systems and is required to address international tax planning.[64]

Some legislative complexity can also be attributed to how international tax law is drafted and arranged. Legislation drafting difficulties or inefficiencies can be categorised into three areas: implicit drafting, 'wordy' drafting and broad or ambiguous drafting. An example of wordy drafting is section 31 of the Act, which requires more than 200 words to articulate cross-border transactions between related parties. Overly broad drafting is seen within section 8F, 8FA and the interest limitation rules under section 23M of the Act. This lack of clarity often results in unintended non-compliance by taxpayers and lack of enforcement by SARS.[65] The provisions of section 23(f) of the Act is an example of implicit drafting. The legislation disallows expenditure incurred in respect of amounts that did not constitute income. However, in my experience, SARS has allowed expenditure to be apportioned where expenditure incurred cannot directly be attributed to specific amounts.

It has thus become one of the government's main priorities to alleviate taxpayers of the administrative burden of complying with complex tax law while also trying to protect the South African tax base.[66] The use of safe harbour rules can offer South Africa a means to address some of the administrative and compliance issues. While the design and implementation of safe harbour rules may vary from country to country, the overarching benefits include:

- simplification of compliance rules and reduction in administrative costs for taxpayers,
- greater certainty for taxpayers that choose to abide by the safe harbour rules that their transactions will be accepted by SARS,
- SARS audit resources to be allocated to high risk and more complex transactions,
- reducing or avoiding litigation proceedings which can be costly to state funds, and
- boosting foreign direct investment[67]

[64] *Ibid*.
[65] *Id*. at p310.
[66] *See* Sweidan J. *supra* n60 at p3.
[67] *Ibid*.

The OECD TPGs have historically taken a negative stance on safe harbour rules, stating that the drawbacks far outweigh the benefits. Some negative considerations include:

- safe harbours may displace existing comparability methods which may be more accurate in exchange for simplicity,
- safe harbours could be arbitrary,
- unilateral safe harbours could undermine compliance in foreign jurisdictions or lead to economic double taxation. This could also shift the administrative burdens to jurisdictions that do not apply safe harbour rules,
- safe harbour rules create opportunities for aggressive tax planning and avoidance.[68]

The advantages safe harbours offer in reducing administrative and compliance costs should make it an attractive option to resolve the issues in South Africa. The negative implications can potentially be managed or mitigated by designing the safe harbours to specifically address those concerns. As an example, the new safe harbour rules should be considered as bilateral or multilateral arrangements to address the issue of double economic taxation.[69]

Determining the best approach to apply thin capitalisation safe harbours in South Africa is easier said than done as there are often conflicting views on the subject matter. A starting point in determining the best approach could involve exploring how tax bodies both locally and internationally view the usefulness of safe harbour rules. The objective of this analysis is to determine if there is an approach or method that is globally accepted as the best practice framework for safe harbour rules.

2.4 Global views on thin capitalisation safe harbours and interest limitation rules

2.4.1 International tax bodies

United Nations ("UN")

The UN Committee of Experts on International Cooperation in Tax Matters formed a new Subcommittee on Article 9 (Associated Enterprises): Transfer Pricing in 2017 ("the Subcommittee"). The mandate of this Subcommittee is to review and update the UN Practice

[68] *Id*., at p2.
[69] *Id*., at p3.

Manual on Transfer Pricing for Developing Countries based on the operation of Article 9 of the UN Model Tax Convention, and to reflect the economic realities and needs of developing countries at their relevant stages of capacity development as well as paying special attention to the experience of developing countries. The Subcommittee also considered the impact of the OECD BEPS Action Plans on developing countries.[70]

The UN Transfer manual states that determining an arm's length price can often be a costly and burdensome process for both the taxpayer and tax authority. It also states that safe harbours offer a practical alternative that provides taxpayers with a greater degree of certainty concerning their international transactions, reduction in compliance related costs and allows tax authorities to allocate greater resources to concentrate on higher risks transfer pricing audits.[71]

The UN Transfer Pricing Manual does not contain specific recommendations on safe harbours for intra-group financial arrangements. It does, however, note that certain countries have issued annual official rates of interest for intra-group loans. If these loans are applied and adhered to by taxpayers, it nullifies the taxpayer's obligation to prove the arm's length nature of the financial arrangement while also ensuring that the interest rate applied is not threatening base erosion.[72]

Determining arm's length interest rate of a debt financing transaction involves accessing the credit rating of the individual enterprise and determining the impact of implicit support for finance transactions. This process may be difficult and subject to assumptions and judgements thus making it difficult for tax authorities to verify the accuracy of an arm's length interest rate. The approach which employs issued, official interest rates, benefits both the taxpayer and tax authority by providing greater certainty and reducing the administrative burdens.[73]

[70] United Nations, Department of Economic and Social Affairs. 2021. "United Nations Practical Manual on Transfer Pricing for Developing countries". New York. piii.
[71] *Id.* at p245.
[72] *Id*. at p373.
[73] *Id*. at p374.

International Monetary Fund ("IMF")

The IMF is an organisation of 190 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world.[74]

The IMF released a working paper in February 2021 on the real effects of thin capitalisation rules ("the working paper").[75] The working paper states that while thin capitalisation rules aim to mitigate profit shifting by MNEs, they can also negatively affect the real investment in the country as a result of the increase in the cost of capital for the affected member of the MNE.[76]

There is empirical evidence to confirm that thin capitalisation rules reduce profit shifting by MNEs, however thin capitalisation rules also increases the cost of capital for affiliated MNE entities and could lead to reduced direct investments by MNEs.[77] The findings in the working paper state that the effect of thin capitalisation rules is critically dependent on the corporate income tax rate of the country in which it is introduced.[78]

Based on the empirical evidence, it was determined that thin capitalisation rules are more effective in countries with higher corporate income tax rates. In addition, the working paper determined that at an average corporate income tax rate of 27%, the introduction of thin capitalisation rules could reduce investment by MNEs by 20%.[79] Intuitively, the effectiveness of the thin capitalisation rules also increases with the degree of leverage of the affiliate MNE as well as with the strictness of the safe harbour ratio of the thin capitalisation rules.[80]

The analysis performed in the working paper does not provide a best practice approach for taxpayers or tax authorities. However, it does provide empirical, scientific evidence to support the effectiveness of thin capitalisation rules while also highlighting the negative economic implications.

[74] International Monetary Fund. "IMF Country Information". Available: https://www.imf.org/en/Countries
[75] De Moojj, R. et al. 2021. "IMF Working Paper: The Real Effects of Thin Capitalisation". International Monetary Fund.
[76] *Id*., at p2.
[77] *Id*., at p4.
[78] *Ibid.*
[79] *Id*., at p5.
[80] *Id*., at 14.

The IMF issued limited commentary concerning the earning stripping rules within BEPS Action 4. It noted that many countries already implemented interest limitation rules that aligned with the BEPS 4 recommendations. Further, the IMF noted a number of fundamental issues that the BEPS 4 recommendations did not address.[81] These issues mostly focused on how the earning stripping rule will interact with the arm's length principle. These included questions around whether the arm's length rule should apply after the earning stripping rule or be treated as a transfer pricing safe harbour. The IMF raised concerns around how interest exceeding the earning stripping rule, but less than the arm's length rule, would be treated. Would these amounts be re-characterised as dividends for tax purposes?[82]

2.4.2 African tax bodies

African Tax Administration Forum ("ATAF")

The ATAF is an international organisation that provides a platform for co-operation between African tax authorities. It serves as an African network that aims to improve tax systems throughout Africa through exchanges, knowledge dissemination, capacity development for revenue authorities and by contributing to the regional and global tax agenda. ATAF aims to contribute to the efficient and effective tax administration and tax policies of African states.[83] In 2015 ATAF established the Cross Border Taxation Technical Committee ("CBT") to represent Africa in international discussions to ensure the global tax agenda and global tax rules are fit for purpose in Africa.[84]

Before the introduction of the BEPS Action 4 Report, many African states addressed profit shifting through the use of fixed ratio thin capitalisation rules. However, these rules were not as effective as intended as MNEs that were claiming excessive interest deductions would simply inject more equity into the local entity thus making it no longer thinly capitalised.[85]

[81] Schatan, R. 2021. "Corporate Income Taxes under Pressure: Why Reform is needed and how it could be designed". International Monetary Fund. p79. Available: https://doi.org/10.5089/9781513511771.071

[82] *Ibid.*

[83] "Overview" n.d. www.ataftax.org. Available: https://www.ataftax.org/overview.

[84] "Base Erosion and Profit Shifting (BEPS" n.d. www.ataftax.org. Available: https://www.ataftax.org/base-erosion-and-profit-shifting.

[85] Breslin, S. 2021. "THIN CAP, EBITDA and the regional state of play for other interest limitations", Sabinet African Journals. p12.

While MNEs would no longer be considered to be thinly capitalised, they would still claim interest deductions that were disproportionate to their economic activity in the country.[86]

ATAF recognises that related party interest is one of the most common profit shifting techniques used in Africa and thus poses a significant risk to the tax bases of African states.[87] ATAF is involved in driving BEPS Action projects through the continent and has issued a suggested framework for how tax authorities could implement the principles of the BEPS Action 4 Report in their tax legislation.[88]

The guideline issued by ATAF included the following key elements:

- The recommended approach was a fixed ratio rule with EBITDA as a measure for determining the limit for interest deductibility.
- the EBITDA fixed ratio rule should be based on a range between 10% and 30% of taxable profit or taxable EBITDA;
- an exemption or *de minimus* rule that exempts low risk entities with a net interest expense below a certain threshold.
- There should be an allowance to carry forward previously disallowed interest for a limited number of years. The example provided by ATAG suggested a carry forward period of up to 5 years.[89]

The fixed ratio rules suggested by ATAF is a fairly straight forward method of interest limitation to apply and is directly linked to the economic activity of the companies operating in the country.[90]

The EBITDA fixed ratio rule does not however consider the varying leverage requirements of companies across different industry sectors. Companies in certain industries are naturally able to operate at higher levels of gearing compared to other industries. The EBITDA rules do not take into account loss making entities such as start-ups that may have high degrees of volatility in their earnings during their initial operating years. The EBITDA fixed ratio cannot be applied

[86] *Id* at p13.
[87] ATAF. 2021. "Suggested approach to drafting interest deductibility legislation". p1. Available: https://events.ataftax.org/index.php?page=documents&func=view&document_id=21
[88] *See* Breslin. *supra* n85 at p13.
[89] *See* ATAF. *supra* n87 at p2
[90] *Ibid*.

to banks and insurance companies as their business models are driven mostly by interest income.[91]

The ATAF recognises that there is an evolving trend in African countries to follow global tax trends in order to protect their tax bases from profit shifting. However, Africa is in a unique position in that it needs to balance profit shifting and anti-avoidance measures with the imperative to attract foreign direct investment.[92]

Economic Community of West African States ("ECOWAS")

The ECOWAS is a regional group comprising 15 West Africa states[93] established in 1975 with a mandate to promote economic integration cooperation in all fields of activity for the constituent countries. The economic activity of ECOWAS includes matters relating to industry, transport, telecommunications, energy, agriculture, natural resources, commerce, monetary and further financial issues.[94]

In September 2016 ECOWAS (in collaboration with the EU, ATAF, OECD, and the World Bank Group) released a background paper containing recommendations on matters concerning the legal and administrative framework for enforcing transfer pricing rules for ECOWAS member states.[95] This report is an output of the World Bank Group's ECOWAS Transfer Pricing project that is a component of the broader ECOWAS Investment Policy and Tax Project. The project focuses on administration, implementation, and development of transfer pricing legislation for ECOWAS member states. It recognises the need for countries to find a balance between preventing BEPS and aligning with international standards [96]

The background paper contextualises the issue of transfer pricing by stating that the loss of tax revenue as a result of transfer mispricing and BEPS is a challenge for both developed and

[91] *See* Breslin. *supra* n85 at p15

[92] *Ibid*.

[93] The 15 ECOWAS member states are: Benin, Burkina Faso, Cabo Verde, Cote d'Ivoire, The Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone, and Togo.

[94] Inaju-Challydoff, D. "Basic Information | Economic Community of West African States (ECOWAS)". Available: https://ecowas.int/basic-information/

[95] "Transfer Pricing in ECOWAS". Background Paper and Recommendations on ECOWAS Member States' Legal and Administrative Frameworks for the Enforcement of Transfer Pricing Rules." n.d. Available: https://investclimate.projects.ecowas.int/wp-content/uploads/2019/10/Transfer-Pricing-in-ECOWAS-Conference-Paper-English.pdf

[96] *Id*., at p5.

developing states. However, these issues are exacerbated for developing states due to their heavy reliance on corporate tax as a source of state revenue.[97]

The report further recognises that implementing transfer pricing rules can be a costly and time-consuming exercise for both the taxpayer and tax authorities and thus many countries have implemented transfer pricing simplification methods, such as safe harbours, to reduce this burden.[98] However, it also states that where safe harbour rules are designed or implemented incorrectly, it could lead to double taxation and loss of tax revenue.[99]

This report highlights that one of the biggest base erosion risks threatening ECOWAS states is excessive interest deductions. Internationally, countries employ a range of measures to counter excessive interest deductions by MNEs. However, ECOWAS has accepted the OECD/G20 report under the BEPS Action Plans (Action 4 of the BEPS initiative) as the international best practice approach and has recommended that its member states consider implementing rules in line with this approach.[100]

2.4.3 South African tax bodies

Davis Tax Committee ("DTC")

The DTC is a committee of nine members, chaired by Judge Dennis Davis, who were initially selected by the Minister of Finance Pravin Gordhan in 2013. The objective of the DTC is to assess South Africa's tax policy framework and its role in supporting the objectives of inclusive growth, employment, development, and fiscal sustainability. Part of the DTC's Terms of Reference is to evaluate South Africa's tax system against the international tax trends and best practices as well as recent initiatives that aim to reduce profit shifting and base erosion, measures to reduces compliance costs, and administrative burdens.[101]

In October 2015, the OECD released its final package on its Base Erosion and Profit Shifting ("BEPS") Action Plan containing 15 action plans aimed to address base erosion and profit shifting opportunities used by MNEs. OECD member states and G20 countries agreed that

[97] *Id.*, at p12.
[98] *Id.*, at p32.
[99] *Id.*, at p33.
[100] *Id.*, at p74–75.
[101] "The Davis Tax Committee". Available: https://www.taxcom.org.za/aboutus.html.

certain action plans were to be implemented as minimum standards to prevent negative spill overs and adverse implications for competitiveness as a consequence of non-implementation by certain countries. Other action plans, such as Action 4 on limiting base erosion through interest and other financial payments, was agreed to as a common approach or best practice to address BEPS concerns.[102]

In light of the release of the BEPS Action Plan by the OECD, the DTC prepared a report on the BEPS Action Plans for the Minister of Finance recommending how South Africa could incorporate the minimum standards, best practice guidelines and international standards on BEPS in our international tax framework. The report noted that any recommendation to address BEPS concerns in South Africa should not be crafted or designed from a reactionary approach to what is the current state of affairs globally, but rather the international tax policy should be designed to suit the special circumstances of the South African economy.[103]

The DTC provided specific recommendations on BEPS Action 4 through Annexure 4 of their report to the Minister of Finance. Contained within this Annexure, the DTC highlighted the importance of thin capitalisation rules in preventing BEPS through excessive interest deductions and that guidance on this matter should align with the recommendation made by the OECD. The DTC recommended that SARS consider ways of reducing the administrative burden for taxpayers with low BEPS risk with regard to interest deductions. This could be effected through the introduction of a safe harbour together with a *de minimus* loan value threshold, or similar mechanism, whereby taxpayers falling below this value would not have to comply with the rules. The DTC further recommended that a safe harbour rule with a fixed ratio be introduced in section 31 together with an interpretation note to provide non-residents funding local entities with a greater degree of certainty as to what is considered a reasonable level of debt financing.[104]

The DTC noted that the existing measures in South Africa through exchange control rules, transfer pricing rules, withholdings tax on interest and specific rules within the Act (such as section 8F, 8FA, 23N and 23M) is sufficient to prevent excessive interest deductions and thus

[102] The Davis Tax Committee. 2016. "Executive summary of second interim report on base erosion and profit shifting (BEPS): OECD BEPS project from a South African perspective: Policy perspectives and recommendations for South Africa". South Africa. p4.

[103] *Id*., at p5.

[104] *Id*., at Annexure 4., p1.

it is unlikely that South Africa is at any significant risk of BEPS through excessive interest. However, the DRC noted that a point of major concern is the capacity of SARS to adequately audit and ensure compliance with all the relevant laws that prevent excessive interest deductions.[105]

The DTC are of the opinion that the current legislative environment is complex and unclear. This complexity and uncertainty around the treatment of excessive interest is further exacerbated by multiple sections addressing the limitation of interest and needs to be addressed as a matter of urgency. Taxpayers require certainty and simplification in order to be compliant.[106]

The DTC highlighted the importance of reintroducing safe harbours in South Africa to reduce compliance costs and improve certainty for taxpayers. They also emphasised the necessity for South Africa to align its international tax policy with the recommendations of the OECD. However, they did not provide specific recommendations as to how the new safe harbour rules should be designed or implemented to achieve the intended fiscal objectives.

South African Institute of Chartered Accountants ("SAICA")

SAICA is a leading accountancy body in South Africa and is one of the prominent institutes recognised globally. It is at the forefront of developing, influencing, and leading the highest standards of ethics, education, and professional excellence.[107] The National Tax Committee ("NTC") is a committee within SAICA with a primary objective of coordinating and enhancing the national and international interest of SAICA members in the field of taxation. In order to execute this responsibility, the NTC provides commentary on behalf of SAICA on the proposed changes in tax legislation, guides, interpretations, and other related matters.[108]

SARS released a new interpretation note on section 31 concerning the determination of taxable income for certain persons on intra-group loans from international connected persons

[105] *Id*., at p27.
[106] *Ibid*.
[107] "Who We Are." n.d. Available: https://www.saica.org.za/about/overview/who-we-are.
[108] SAICA. 2023. "Member communities: National Tax Committee". Available: https://www.saica.org.za/members/member-communities/national-tax-committee-ntc.

on 11 February 2022. In response to this release, the SAICA NTC took the opportunity to review the new interpretation note and provided feedback and commentary to SARS.[109]

The SAICA NTC recommended that SARS should consider reintroducing a safe harbour rule for intra-group transactions where the quantum of the loan is below R100 million and provide a further *de minimus* threshold where the quantum of the loan is below R5 million. Only loans that exceed R100 million at the end of the financial year should be required to be supported with a detailed arm's length analysis. In support of their recommendation for the reintroduction of a safe harbour rule, the NTC referred to the DTCs recommendation that a safe harbour rule should be considered for loan transactions as well as the OECD's recommendation or warning against only using the arm's length principle to test the arm's length nature of intra-group loan transactions.[110]

The NTC also highlighted the opportunity for SARS to align the interest limitation rules under section 23M of the Act with Action 4 of the OECD BEPS programme. The recommendation was that SARS should consider using the proposed interest limitation rules and remove the need for additional transfer pricing rules. The NTC also noted that having multiple sections in the Act address the treatment of excessive interest creates undue compliance requirements for taxpayers and could potentially adversely impact South Africa's ability to attract foreign direct investment.[111]

The SAICA NTC held similar views to that of the DTC, it recommended the use of safe harbour rules for intra-group transactions and highlighted the complexity and undue compliance requirements created by multiple measures to address excessive interest. While the SAICA NTC did not provide an elaborate plan or design for the new safe harbour rules, it did recommend a quantification of intra-group loan safe harbour rules as well as a quantification of the *de minimus* rule.

[109] *Ibid.*

[110] Wiesener. C on behalf of the SAICA Transfer Pricing Subcommittee. 2022. "Comments on the draft interpretation note on section 31 – determination of the taxable income of certain person from international transactions". SAICA. p2.

[111] *Id*., at p3.

2.5 Conclusion

South Africa, in line with many other countries, has recognised the importance of combating transfer mispricing to ensure fair taxation and protection of the tax base. This chapter attempted to shed light on the evolution of thin capitalisation safe harbours and interest limitation rules in South Africa while at the same time considering whether it has a place in South Africa's future and if so, the best approach to take.

Tax bodies both locally and internationally have advocated the implementation of thin capitalisation safe harbour rules to a lesser or greater extent. The best practice approach on limiting interest deductions as proposed by the OECD BEPS Action Plan 4 has been accepted and recommended by international tax bodies such as ATAF, ECOWAS, and the EU as well as local tax bodies such as the DTC and SAICA. As South African transfer pricing legislation is largely based on the OECD Transfer Pricing Guidelines, intuitively South Africa would follow the guidance of the OECD.

However, the field of international taxation is dynamic. While the guidelines provided by the OECD BEPS Action 4 may serve as a good foundation upon which to build, South Africa would benefit further leveraging off lessons learnt from other countries on safe harbour and interest limitation rules implemented.

CHAPTER 3 OVERVIEW OF THE IMPLEMENTATION OF BEPS ACTION 4 IN THE EU

3.1 Introduction

The objective of this chapter is to explore how various European Union ("EU") member states implemented the Anti-Tax Avoidance Directive ("ATAD") framework into their existing tax systems and their motivations where they deviated or departed from the ATAD guidelines. The purpose of this research is to identify and evaluate a range of various approaches on how the OECD BEPS Action Plan 4 is practically implemented so South Africa may benefit from key lessons learnt from these EU countries. These lessons learnt may offer insights into how South Africa may reduce the complexity of its interest limitation legislation. EU countries offer a unique perspective as the ATAD rules are legally required to be implemented and thus offers a level of conformity not offered by any other organisation of countries.

The framework of the ATAD rules were identified by the EU Commission as the best mechanism to drive the introduction of the OECD BEPS Action Plans at an EU level. The ATAD rules were designed to achieve a minimum level of base protection as general anti-avoidance provisions. EU member states were thus encouraged to implement the rules to suit their particular needs and harmonise with their existing corporate tax systems.

3.2 The EU Commission's approach to BEPS Action 4

The EU is a political and economic alliance of 27 countries that grew out of a desire to strengthen economic and political cooperation throughout Europe following World War 2.[112] The European Commission ("the Commission") is an institution within the EU that aids in shaping the overall strategy of the EU, proposes new EU legislation and policies, monitors the implementation of new laws, and manages the EU budget. In addition, the Commission plays a role in supporting international development and delivering aid.[113]

[112] European Union. 2023. "Easy to Read." European-Union.europa.eu. 2023. Available: https://european-union.europa.eu/easy-read_en.

[113] European Union. n.d. "European Commission – What It Does | European Union." European-Union.europa.eu. Available: https://european-union.europa.eu/institutions-law-budget/institutions-and-bodies/search-all-eu-institutions-and-bodies/european-commission_en.

The EU Commission presented its proposal for an ATAD to the Council of the EU on 28 January 2016. The ATAD contained five legally binding, anti-abuse measures that should be applied by all EU members against aggressive tax planning. The ATAD is consistent with the OECD BEPS Action plans as the Council of the EU determined it is the preferred vehicle for implementing the OECD BEPS conclusions at an EU level.[114]

The ATAD rules are required to fit the corporate tax systems of all EU members, thus it was limited to general provisions that aimed to achieve a minimum level of protection for national tax systems and avoid creating obstacles such as double taxation. As the ATAD rules provide for a minimum standard, it is possible for member states to adopt other interest limitation rules, such as thin capitalisation rules, in addition to the rules provided by the ATAD. Individual member states were free to implement the ATAD provisions to suit their particular needs.[115]

The interest limitation rules under Article 4 of the ATAD state that exceeding borrowing costs are only deductible to the extent it is not greater than 30% of the taxpayer's earnings before interest, tax, depreciation, and amortisation ("EBITDA"). The term 'exceeding borrowing costs' is defined by the ATAD as the amount by which the borrowing costs of a taxpayer exceeds its taxable interest revenue.[116]

The ATAD contains a safe harbour provision that allows taxpayers to deduct borrowing costs without inhibition up to EUR[117] 3 million. Where an MNE has multiple associated entities within a country; the EUR 3 million will be considered for the entire local group.[118] The safe harbour rules further clarify that the interest limitation rules will not apply to standalone entities. Other exemptions include debt incurred to fund long term public benefit infrastructure projects and existing loans that pre-date the implementation of the ATAD rules.[119]

The ATAD rules provide for exceeding borrowing costs which could not be deducted in the current tax year, to be carried forward without a time limitation. Exceeding borrowing costs

[114] "The Anti-Tax Avoidance Directive." n.d. Taxation-Customs.ec.europa.eu. Available: https://taxationcustoms.ec.europa.eu/taxation-1/company-taxation/anti-tax-avoidance-directive_en
[115] European Commission. "Council Directive 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market". L 193/1.
[116] Id. at L 193/7.
[117] Euro
[118] *Id*. at L 193/8.
[119] *Ibid*.

can be carried back three years and any unused interest capacity may be carried forward for a period of five years.[120]

The ATAD rules also allow for a group ratio rule whereby a taxpayer would be allowed to deduct a higher portion of its exceeding borrowing costs under two circumstances:

1 A taxpayer would be allowed to deduct its exceeding borrowing costs in full if it is able to demonstrate that its ratio of total equity to total assets exceeds that of its group ratio by two percentage points and all assets and liabilities were valued using the same method for the taxpayer and the group:[121] OR

2 The taxpayer would be able to deduct a higher limit of its exceeding borrowing costs determined as the ratio of the groups exceeding borrowing costs to its EBITDA multiplied by the EBITDA of the taxpayer.[122]

3.3 Analysis of ATAD rules implemented by EU countries.

3.3.1 Austria

Prior to the implementation of the ATAD interest limitation rules, the Austrian Corporate Tax Act ("KStG") implemented two targeted interest limitation rules. These rules were introduced as a result of the OECD BEPS Report[123] in order to reduce tax advantages and profit shifting within groups of companies arising from different tax treatment of expenses and related revenue across different jurisdictions.[124] The first rule, contained within Article 12(1)(9) of the KStG, prohibits the deduction of interest payments if they relate directly or indirectly to the acquisition of shares from an associated corporation or a shareholder that has significant influence over the company.[125] The second rule, under Article 12(1)(10) of the KStG, prohibits the deduction of interest and licence payments made to associated corporations or

[120] *Id*. at L 193/9.
[121] *Id*. at L 193/8.
[122] Id. at L 193/8.
[123] OECD. 2015. "Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report". Paris. OECD Publishing.
[124] Geringer, S. 2022. "Critical Review of the ATAD Implementation: The Implementation of the ATAD by Austria." Intertax 50 (Issue 4), p356.
[125] *Id*. at p375.

shareholders that may exercise dominant influence and if the payments are not subject to tax or effectively taxed at a rate of 10% or lower.[126]

Despite the EU Commission adopting the ATAD in 2016, Austria only implemented the interest limitation rules of the ATAD in 2021 through the addition of Article 12a in the KStG. According to the these rules, net interest expense can only be deducted up to an amount of 30% of 'tax EBITDA'.[127] This delayed transposition of the ATAD interest limitation rules stems from the belief of both Austrian legislators and scholars that the existing interest limitation rules under Article 12(1)(9) and 12(1)(10) of the KStG were as effective as the ATAD provisions.[128] The EU Commission, however, did not agree with the position taken by Austrian legislators and subsequently initiated infringement procedures forcing Austria to adopt the ATAD rules earlier than they anticipated.[129]

This reluctance to adopt the ATAD provisions could have been anticipated as Austrian lawmakers have historically opposed the use of general interest limitation rules, similar to the ATAD rules, as it impacted the freedom of Austrian taxpayers to finance their operations with equity or debt.[130] This is particularly important as Austrian companies tend to have high degrees of debt financing as equity financing is not always readily available in Austrian capital markets.[131] Further, Austria attracts many holding companies for operations within central and eastern Europe which mainly receive exempt dividend income. Where these holding companies acquire equity investments through leveraged buyouts, the ATAD interest limitation rules will result in no interest expense deductions being allowed if these holding companies do not earn other taxable income.[132]

Given Austria's opposition to the ATAD interest limitation rules, it is not unreasonable to expect lawmakers to implement the rules in a manner that would result in minimal interference with their economy. Evidence of this minimalist approach is apparent where Article 12(a)(1) of the KStG allows for the maximum EUR 3 million *de minimus* safe harbour

[126] *Ibid*.
[127] Schuchter, Y. 2023. "Austria-Corporate Taxation-Country Guides". IBFD. p76.
[128] K. Spindler-Simader. 2018. "Implementation of the EU Anti-Tax Avoidance Directive (2016/1164) in Austria". IBFD, p286.
[129] "Press Corner." n.d. European Commission – European Commission. Available Online: https://ec.europa.eu/commission/presscorner/detail/en/INF_19_4251.
[130] *See* K. Spindler-Simader, *supra* at n128, p288.
[131] *Ibid*.
[132] *Id*. at p289.

rule. This large safe harbour provision coupled with the fact that the Austrian economy is relatively small in comparison to other EU states, may result in many corporations being excluded under this safe harbour rule and thus could be considered as covert discrimination.[133]Other indications of a minimalist approach include Austria's decision to implement Article 4(3) of the ATAD provisions that allow standalone entities to be scoped out of the interest limitation rules. To meet this exemption criteria, the standalone entity cannot be part of a consolidated group for accounting purposes, nor can it have any associated enterprises. Article 12a(1) of the KStG specifically refers to the absence of a foreign permanent establishment.[134]

Austrian legislators have also adopted the carve out for loans that are used to fund long-term inter-EU public infrastructure projects.[135] There is, however, a significant departure from the ATAD rules as the Austrian provision that provides for this exemption has specifically excluded infrastructure projects relating to nuclear power stations and climate-altering. This deviation by the Austrian government aligns strongly with their policy initiatives on green investments.[136] Austria has followed the ATAD rules by allowing disallowed borrowing costs and excess interest capacity to be carried forward indefinitely. This would ensure that the risk of unused interest be reduced to the greatest extent possible.[137]

The analysis of Austria's implementation of the ATAD rules revealed the country was opposed to the rules but was legally required to oblige as an EU member state. This stance taken indicates that the country may favour less restrictive rules that would not hamper economic growth and commerce. Austria's use of elective articles of the ATAD rules such as the *de minimus* safe harbour provision, exemptions for standalone entities and debt on public sector funding could illustrate how the country prioritises commercial freedom over BEPS risks. The use of carve outs and safe harbours could further indicate a reluctance to place onerous administrative and compliance burdens on its taxpayers.

[133] *See* Geringer, Stefanie, *supra* at n124, p358.
[134] *Ibid*.
[135] *Ibid*.
[136] *Ibid*.
[137] *Ibid*.

3.3.2 Belgium

Belgium introduced new interest limitation rules ("ILR") in line with the ATAD into national law on 31 December 2018 effective from 1 January 2019.[138] Before the introduction of the ILR, Belgian tax law did not contain general interest limitation rules based on a fixed ratio of EBITDA; instead, it applied two thin capitalisation rules.[139] The first rule is a 1:1 debt-to-equity ratio rule that applies to loans granted by resident or non-resident directors or shareholders in their companies. The second rule is a 5:1 debt-to-equity ratio rule that applies where the non-resident or resident creditor is not subject to tax in Belgium on the interest paid and on intra-group loans.[140]

The new ILR applies to all Belgian legal entities subject to corporate income tax as well as Belgian domiciled permanent establishments of non-residents subject to Belgian corporate income tax.[141] However, certain of these entities were identified as having a low risk of base erosion and profit shifting and thus the Belgian government has utilised the provisions offered by the ATAD to exclude or scope out certain entities.[142]

Companies that exclusively carry on activities that consist of executing tendered public private practice partnerships in accordance with public procurement legislation are excluded from the ILR and the thin capitalisation rules.[143] This exclusion is stricter than the ATAD guidelines as the project operation, borrowing costs, assets and profits are all required to be situated within Belgium whereas the ATAD allows the assets to be situated within the EU.[144] Thus, this deviation from the ATAD guidelines provides greater protection for the Belgian corporate tax base through its stricter rules.

Companies operating in the financial sectors are also excluded from the ILR rules but are still subject to the thin capitalisation rules. The financial sector incorporates a broad range of business that includes credit institutions, investment firms and insurance companies.[145] The rationale for excluding these companies is that they are generally financed with greater levels

[138] Article 19(4) and 55 of the Belgian Income Tax Code of 1992.
[139] Gutmann, D. 2017. "The Impact of the ATAD on Domestic Systems: A Comparative Survey". IBFD. p3.
[140] Cruysmans, G. 2023. "Belgium – Corporate Taxation, Country Tax Guides". IBFD.
[141] Article 198/1 of the Belgian Income Tax Code (ITC) of 1992
[142] Heyvaert, W.E.C. 2019. "ATAD Implementation in Belgium: An Analysis of the New Interest Limitation Rule". IBFD. p355
[143] Article 198/1, §4, 13° of the ITC 92
[144] *See* Heyvaert, W.E.C, *supra* n.142, p356–357.
[145] Article 198/1, §4, 1-12 of the ITC 92

of debt compared to other industries. Undertakings for collective investment in transferable securities and Alternative Investment Funds are also excluded from the ILR on the basis that interest payments made by these investment companies do not affect its tax base and thus would not be included in computing its ILR. These exclusions implemented by the Belgian government were not included in the ATAD guidelines.[146]

Standalone companies that meet the following criteria are scoped out of the interest limitation rules:

- do not belong to a group of companies,
- do not have any foreign business establishments, and,
- do not hold, directly or indirectly, 25% of the voting rights or capital of a company or that entitles that company to 25% of the profits of the other company.[147]

If an entity is subject to the ILR, its exceeding borrowing costs will be deductible to the extent that it does not exceed the greater of the EUR3 million *de minimus* threshold or 30% of the entities fiscal EBITDA. The term 'exceeding borrowing costs' is defined under Article 198/1, §2 of the Belgian Income Tax Code of 1992 ("ITC") as the positive difference between all interest and other costs to be specified by royal decree as being economically equal to interest expense and all other interest and financial income to be specified by royal decree.[148]

The Belgian government has elected to use the maximum *de minimus* threshold of EUR 3 million proposed by the ATAD to reduce any potential inhibitions to business and commerce. Where a domestic company is part of a local group, the *de minimus* threshold will be allocated proportionally across the Belgian entities. However, exempt entities or entities scoped out of the ILR will not be included in this allocation. There is a degree of uncertainty as to what constitutes a group of companies as ATAD has proposed that the definition be a group of companies that is consolidated for accounting purposes whereas Belgian legislation refers to the definition of 'related companies' to mean a group of companies.[149]

[146] *See* W.E.C. Heyvaert, *supra* n142. p356.
[147] *Ibid*.
[148] *Id*., at p358.
[149] *Ibid*.

The term 'fiscal EBITDA' used by Belgian legislators differs substantially from the definition of 'statutory EBITDA' as proposed by the ATAD. The ATAD refers to an entity's income subject to corporate tax whereas fiscal EBITDA refers to the aggregate of a taxpayers increase in retained and taxable earnings for the year, disallowed expenditure as well as distributed profits. Transactions between Belgian affiliate companies are also excluded from the fiscal EBITDA calculation to reduce the administrative burden for taxpayers.[150] Amongst the other optional provisions proposed by the ATAD, the Belgian government has opted to use the carry-forward rule whereby non-deductible interest may be carried forward to future tax periods indefinitely.[151]

The analysis of Belgium demonstrates how the ATAD interest limitation rules were folded into Belgian legislation to supplement the existing thin capitalisation rules. Adding the ATAD rules to existing legislation without replacing the existing rules could indicate the country's aversion to profit shifting through interest payments. This notion is consistent with the manner in which the ATAD rules were adapted into Belgian legislation.

Where Belgian legislators deviated from the ATAD rules it was intended to achieve a greater level of protection for the tax base. Belgian interest limitation rules implemented stricter requirements compared to the ATAD concerning provisions where entities were carved out and exempt from the rules, such as the standalone and public funding exemption. However, Belgian legislators have also opted to implement the maximum allowed safe harbour threshold of EUR 3 million which could be an indication that the interest limitation rules are effectively aimed at larger, higher risk entities.

3.3.3 Italy

Before the EU Commission issued the ATAD interest limitation rules, Italy were already applying similar rules for the past decade under Article 96 of the Italian Income Tax Code[152] ("TUIR").[153] In 2018 the ATAD interest limitation rules were transposed into Italian law by amending the existing provisions of Article 96 of the TUIR to align with the ATAD rules.[154] As

[150] *Ibid*.
[151] Article 194 series of the ITC 92.
[152] Income Tax Code (approved by Presidential Decree No. 917 of 22 December 1986)
[153] Silvani, C.2023. " Italy – Corporate Taxation sec.10., Country Tax Guides". IBFD.
[154] The amendment to article 96 of the ITC were effective through article 1 of the Legislative Decree No.142 of 29 November 2018

the existing interest limitation rules were already broadly aligned with the ATAD rules, the adjustments made to the legislation were minimal.[155]

Similar to the ATAD rules, the amended interest limitation rules under Article 96 of the TUIR provide that exceeding borrowing costs can be deducted up to 30% of the taxpayer's EBITDA. However, EBITDA is determined in accordance with the tax values of the taxpayer's revenue and expenditure for each tax year whereas the ATAD rules recommend the use of statutory or accounting EBITDA.[156]

Article 96 of the TUIR applies to all companies subject to corporate tax with certain exceptions. Tax transparent entities and non-business entities that are subject to corporate income tax are excluded from the interest limitation rules.[157] Italy has also elected to exclude interest on loans that are used to fund long-term EU public infrastructure projects in accordance with Article 4(4)(b) of the ATAD.[158] Financial service entities are also scoped out of the interest limitation rules. However, Italy has made an exception to this ATAD rule[159] as interest incurred by insurance, reinsurance, collective investment scheme vehicles, and asset management companies is only deductible up to 96% of the respective amount incurred.[160]

Where the exceeding borrowing costs are greater than 30% of EBITDA, Article 96 of the TUIR allows for the excess interest to be carried forward to future tax periods indefinitely. Additionally, the law allows for excess interest income exceeding borrowing costs to be carried forward indefinitely. Where exceeding borrowing costs do not exceed 30% of EBITDA, the excess interest deduction capacity may only be carried forward for a period of five years.[161] These domestic laws are aligned to the ATAD rules, however the ATAD rules do not permit the carry forward of excess interest income and do not limit the carry forward of excess interest capacity. This deviation from the ATAD rules is mitigated by the fact the rules are implemented in a manner that still aligns with the aim and purpose of the ATAD rules to achieve a minimum level of protection for national corporate tax systems.

[155] Arginelli,P. 2022." Critical review of the ATAD implementation: The Implementation of the ATAD in Italy", Intertax 50 (Issue 6 &7). p531
[156] *Id*., at p534
[157] *Ibid*.
[158] *Id*., at p535.
[159] Financial service entities are excluded under article 4(7) of the ATAD rules.
[160] *See* Arginelli, P, *supra* n.155., p535.
[161] Id., at p534.

Despite the interest limitation rules under Article 96 of the TUIR being strongly aligned to the ATAD provisions, there are certain elements of the ATAD that Italian legislators have elected not to apply. The Italian government has decided not to implement the EUR 3 million *de minimus* safe harbour threshold, they have not implemented carve out rules for standalone entities and they have not implemented the 'group rule'[162] which would otherwise allow entities to deduct interest costs in excess of 30% of their EBITDA provided it remains within rules when taking into account their financial position of the group as a whole. The rationale for not electing to implement these provisions is because the Italian government intends to use the interest limitation rules as an indirect stimulus for the capitalisation of corporate entities and not only as a fiscal tool to address base erosion and profit shifting.[163]

The review of the Italian interest limitation rules revealed that it already aligned to the guidelines of the ATAD rules and thus required minimal changes. However, a number of deviations were noted in Article 96 of the TUIR that were tighter and more restrictive than the ATAD rules which could be an indication of Italy's aversion to BEPS risk from interest payments. Italy's decision not to incorporate most of the carve out and exemptions for low-risk entities, such as the *de minimus* safe harbour provision and standalone entity exemption, could result in onerous compliance requirements for entities that are low risk to the Italian fiscus.

3.3.4 Netherlands

In the Netherlands, The Lower House of Parliament accepted the act implementing the ATAD on 15 November 2018. It was then sent to the Upper House of Parliament on 20 November 2018 and was approved on 18 December 2018. The Act was published on 28 December 2018 effective for tax years starting on or after 1 January 2019.[164] Under the new interest limitation rules of Article 15b of the Corporate Income Tax Act of 1969 ("CITA"), net interest is restricted to 20% of a taxpayer's EBITDA.[165] Dutch legislators believed the new interest limitation rules

[162] Id. at p534.
[163] Ibid.
[164] Korving, J.J.A.M. 2021. "Implementation of the ATAD: ATAD Implementation in the Netherlands". Interax 50 (Issue 11). p917.
[165] Van Duijn, H, J. 2023. "Netherlands – Corporate Taxation sec 10., Country Tax Guides IBFD.

were implemented to not only combat base erosion and profit shifting but also achieve a more equitable treatment of debt and equity with regards to corporate income tax matters.[166]

Dutch legislators have proposed that as the ATAD serves as a general interest limitation rule, it should be applied over and above any pre-existing targeted interest limitation rules. However, to avoid confusion around the many concurrent interest limitation rules, a number of specific or targeted rules were abolished.[167] Therefore, where an amount of interest has already been determined to be non-deductible under a targeted rule, it is not included in the consideration for the general interest limitation rules in accordance with Art.15b of the CITA. If an amount of interest is not deductible according to the generic interest limitation rule it may be carried forward to future periods indefinitely.[168]

Dutch legislators have opted for a more robust implementation of the ATAD rules and have therefore only included a *de minimus* threshold safe harbour amount of EUR 1 million as opposed to the ATAD and OECD recommendation of EUR 3 million.[169] The general interest limitation rules can also be applied at a fiscal unity or domestic group level instead of an individual entity level. This approach may be more favourable for individual entities that belong to a group of companies that have stronger economic performances. However, as the fiscal unity approach can only be applied to Dutch resident corporations, there is a risk this rule infringes on the freedom of establishment EU laws.[170]

The ATAD allows for certain industries, such as financial undertakings or standalone companies, to be excluded from the ambit of the interest limitation rules. The Dutch legislators have elected not to implement these exemptions as this would, in their opinion, undermine the objective of the Dutch 2017 coalition agreement to promote greater equality between debt and equity capital. The Dutch government has, however, elected to exempt twenty existing projects concerning public-private cooperations that relate to the improvement of highways, tunnels, and locks.[171]

[166] *Id*., at p920.
[167] *Ibid*.
[168] *Ibid*.
[169] *Id*. at p921.
[170] *Ibid*.
[171] *Id*.

The analysis of the how the Dutch implemented the ATAD rules indicates they have taken a cautious and conservative approach regarding the interest limitation rules. The Dutch rules use 20% of EBITDA, which is in line with the ATAD recommended range of 10-30% but would invariably result in more taxpayers being caught by the rules and thus more interest being denied as a deduction. Other indicators of their strict approach could include opting not to implement carve outs recommended by the ATAD such as financial undertakings, debt on public infrastructure projects or standalone entities.

These decisions support the notion that the Netherlands aims to broaden the scope of the interest limitation rules to ensure more taxpayers fall within the ambit of these rules. Dutch legislators have allowed some reprieve to low-risk taxpayers by implementing the *de minimus* safe harbour provision. However, the threshold was set relatively low at EUR 1 million compared to the ATAD limit of EUR 3 million. A lower *de minimus* threshold may have been implemented to account for the relatively small size of the Dutch economy.

3.3.5 Greece

Greek tax law on limiting interest deductibility underwent significant changes in the past decade. Before 1 January 2014, Greece applied thin capitalisation rules that limited interest incurred on debt from associated enterprises where the proportion of debt from associated enterprises exceeded the net assets of the enterprise by a ratio of 3:1.[172] These thin capitalisation rules were repealed, and Article 49 Greek Income Tax Code ("ITC") came into effect from 1 January 2014. Article 49 of the ITC introduced new interest limitation where net interest is deductible up to 60% of EBITDA. By 1 January 2017, the allowable fixed ratio of EBITDA was reduced to 30%. Article 49 of the ITC also provided *de minimus* safe harbour provision if the net interest incurred was less than EUR 5 million up until 31 December 2015 and EUR 3 million for the tax years thereafter.[173]

Greek legislators adopted the ATAD rules in April 2019 through Article 14 of Law 4607/2019. In order to transpose the ATAD rules into Greek law, paragraph 8 was added to Article 49 of the ITC to align the provisions of the article with the ATAD rules.[174] The amended Article 49 of

[172] Papademetriou, S. 2023. "Greece - Corporate Taxation sec. 10., Country Tax Guides". IBFD.
[173] *Ibid*.
[174] Perrou, K.2021. "Critical review of the ATAD implementation: The Implementation of the ATAD in Greece". Intetax,50 (Issue 8 & 9). p619.

the ITC adhered to the ATAD, but as the existing rules were already closely aligned to the ATAD provisions, it effectively remained unchanged. Exceeding borrowing costs are tax deductible up to 30% of the taxpayer's EBITDA and any excess disallowed interest may be carried forward indefinitely. A *de minimus* safe harbour provision applies to net interest less than EUR3 million.[175]

Greek law further incorporated most of the carve out provisions provided for in the ATAD rules such as financial undertakings and public infrastructure projects with an exception for standalone entities and the group ratio rule. However, in 2022 further amendments were made to Article 49 of the ITC to incorporate the ATAD group ratio[176] rule that allows more favourable interest limitation provisions for entities that belong to a consolidated group of companies.

The group ratio rule allowed entities that belonged to a group of consolidated companies a higher amount of deductible interest provided that the interest to be deducted fell within the ATAD group tax rules.[177] Greek legislation provides two options for determining the allowable interest deductions when applying the group rules. The first option requires the taxpayer to prove that its ratio of total equity over its total assets is greater than or equal to, or not lower than 2% of the same ratio for the consolidated group (referred to as the 'equity escape' rule).[178] The second options allow a taxpayer to deduct interest up to an amount determined with reference to the consolidated financial accounts of the group and will include a twostep process:

1 The group ratio is first determined by dividing the exceeding borrowing costs of the group concerning third parties over the EBITDA of the group; and

2 secondly, the group ratio is multiplied by the taxpayer's EBITDA and calculated in accordance with Article 49(3) of the ITC.[179]

The implementation of the 'equity escape' rule raised concerns regarding the inequitable treatment between standalone entities and entities belonging to a group of companies as it

[175] *Id*., at p620.
[176] Article 56 of Law 4916/2022 transposed article 4(5) of the ATAD into Greek tax law.
[177] *See* Perrou, K. *supra* n.174. p622.
[178] *Ibid*.
[179] *Ibid*.

conflicted with the principle of equal treatment under the Greek constitution.[180] The Greek group ratio rule also deviated from the ATAD rules concerning the use of consolidated financial statements. The ATAD rules permits consolidated financial statement to be prepared under any accounting standards whereas Article 49 of the ITC only permits the use of International Financial Reporting Standards or the Greek financial reporting system.[181]

The definition of 'borrowing costs' within the ITC is broader than that proposed by the ATAD provisions as it includes capitalised interest, guarantee fees and other related costs incurred in arranging the debt finance agreements. The Greek tax authority has also released additional guidance through Circular E. 2071/2019 and Circular E. 2004/2021 which clarify that the interest to be considered under Article 49 first needs to be assessed against the general non-deductible of certain expenditure rules in Article 23 of the ITC.[182]

The analysis of Greek interest limitation rules indicates that the country has adhered to the ATAD rules with no opposition and only minor deviations. These deviations include stricter rules concerning the preparation of consolidated financial statements used for the group ratio rule and a broader definition of 'borrowing costs' compared to the ATAD rules. The stricter financial reporting requirements could be viewed as more onerous and thus less taxpayers could be eligible for the equity escape rule. A broader definition of 'borrowing costs' could result in greater amounts of interest being denied as a deduction in a given tax year as a broader definition would result in greater net interest and thus a higher chance it could exceed the allowable thresholds.

Greek legislators have continued to apply the maximum *de minimus* safe harbour value of EUR 3 million. As the Greek economy is relatively small, a high safe harbour threshold may lead to minimal application of the interest limitation rules. It could also be indicative of the country's policy to reduce compliance burdens for smaller, low risk entities.

[180] *Ibid*.
[181] *Ibid*.
[182] *Id*., at p623.

3.4 Conclusion

The objective and purpose of this chapter was to explore how various EU member states implemented the general interest limitation rules of the ATAD provisions and their motivations where they deviated or departed from the ATAD guidelines.

Unlike the OECD TPGs, the ATAD rules are legally required to be imputed into the domestic tax legislation of the various EU member states. As the ATAD rules are general interest limitation provisions, some countries elected to keep their targeted interest rules. Some countries aimed to align as close as possible to the proposed wording of the ATAD provisions when drafting the sections of the tax law that would enact the provisions. Others recognised that having too many laws addressing interest deductions may result in further uncertainties and subsequently repealed any pre-ATAD interest limitation rules.

The ATAD rules were designed and implemented in a manner to ensure a minimum level of base protection from shifting across the EU region and not necessarily the creation of more tax revenue. Countries such as Austria and Belgium opted for a minimalist approach to not hinder commerce and freedom of capital movement, whereas countries like Netherlands, Italy and Greece have opted for a more robust and stricter application of the ATAD rules. While the implementation of the ATAD rules were mandatory for EU member states, the countries always tailored the rules to suit their economies and align with their fiscal goals. Additionally, some countries would opt not to implement rules that contradicted the laws or constitutions of their countries.

In my opinion, one of the key lessons for South Africa on how the EU countries implemented the ATAD is the use of safe harbour provisions. The use of the *de minimus* safe harbour provision was a consistent theme across the countries reviewed. Four out of the five countries implemented the *de minimus* safe harbour rule with three out of those four countries opting for the maximum allowed amount of EUR 3 million. This could be an indication for South Africa policy makers that the use of safe harbour provisions within interest limitation rules is still a viable method to reduce onerous compliance requirements for smaller, low risk entities.

South Africa may also benefit from understanding what drove certain countries to deviate from the ATAD rules for either a more relaxed or stricter approach. Countries that opted for a restrictive approach tended to focus on fiscal and commercial freedom and did not want the

interest limitation rules to inhibit business. Other countries that were more risk averse tended to apply stricter rules to protect the fiscus from BEPS risk. As a developing nation that is highly dependent on corporate tax revenue and foreign direct investment, striking a balance between these two objectives is crucially important for South Africa. Carve out provisions such as those for standalone entities and public infrastructure could benefit South Africa with few drawbacks. The group ratio or equity escape rules should, in my view, be avoided as it could result in MNEs operating in South Africa not being subject to tax due to the economic disparity between South Africa and more developed countries.

The following chapter will explore how countries outside the EU have implemented the BEPS Action Plan 4 without a standardised controlled body such as the EU Commission.

CHAPTER 4 OVERVIEW OF THE IMPLEMENTATION OF BEPS ACTION 4 IN NON-EUROPEAN UNION COUNTRIES

4.1 Introduction

Since the release of the BEPS Action Plans in 2015, many countries across the globe have moved towards implementing the best practice approach recommended by the OECD. Chapter 3 discussed how the European Union ("EU") implemented the BEPS Action Plans through the introduction of the Anti-Tax Avoidance Directive ("ATAD") requiring EU member states to implement various anti-tax avoidance rules including interest limitation rules. However, outside the EU, countries have been much slower or hesitant to implement the recommendations of BEPS Action 4.

The objective of this chapter is to explore how various countries outside of the EU have adopted the recommendations of the BEPS Action Plan 4 and to unpack their motivations where they have deviated from the best practice guidelines. The purpose of this research is to identify and evaluate a range of diverse approaches to how the OECD BEPS Action Plan 4 is practically implemented, so South Africa may benefit from key lessons learnt from other countries. These lessons may offer insights on how South Africa may simplify its interest limitation legislation.

4.2 BEPS Action 4 views outside the EU

BEPS undermines the fairness and integrity of tax systems because MNEs that operate across borders can use BEPS to gain a competitive advantage over enterprises that operate at a domestic level. Moreover, when domestic taxpayers see multinational corporations legally avoiding income tax, it undermines voluntary compliance by all taxpayers. BEPS is of particularly significance for developing countries that rely heavily on corporate income tax revenue.

In order to address the risk of BEPS, the OECD released the BEPS Action Plan containing 15 action plans aimed to address base erosion and profit shifting opportunities used by MNEs.[183] Action 4 addresses the BEPS risk related to interest deductions and other financial payments. It analyses several best practices and recommends an approach that addresses the risks directly.[184]

The best practice approach recommended by the OECD is based on a fixed ratio rule that limits an entity's net interest deductions according to a fixed percentage of its Earnings before interest tax depreciation and amortisation ("EBITDA"). This approach ensures that an entity's interest deduction is directly linked to its level of economic activity and profitability. The recommended fixed ratio to be used ranges between 10% to 30%.[185] Highly geared entities that are leveraged above these recommended levels may be subject to double taxation. To avoid double taxation, the OECD suggests tax authorities combine the fixed ratio interest limitation rule with a group interest limitation rule that allows entities to deduct interest up to the net interest/EBITDA ratio of its worldwide group.[186]

The OECD further recommends that entities which pose the lowest BEPS risk should not fall within the scope of the interest limitation rules and thus countries could apply a *de minimus* threshold based on a monetary value of net interest expense. Entities falling outside the scope of the interest limitation rules may deduct interest with no restrictions. However, where an MNE has multiple local entities, the threshold should apply in aggregate to the entire local group. This approach could also avoid MNEs fragmenting their local operations to abuse the *de minimus* threshold.[187]

The OECD recognises there may be instances where an entity's interest expense and earnings may occur in different years due to business volatility and economic cycles. This could lead to entities not being able to deduct interest expense in a particular year because the investment has not yet yielded income or the income may only occur in a later period. In order to reduce the effects of this volatility in timing, the OECD recommends that countries could permit

[183] OECD (2017). "Limiting Base Erosion Involving Interest Deductions and Other Financial Payments". Action 4. 2016 Update: Inclusive Framework on BEPS. OECD/G20 Base Erosion and Profit Shifting Project. OECD Publishing, Paris. p22. Available: http://dx.doi.org/10.1787/9789264268333-en

[184] *Ibid*.

[185] *Id*. at p13.

[186] *Id*. at p61

[187] *Id*. at p39.

entities to carry forward disallowed interest expense or unused interest capacity to later periods.[188]

This recommended approach by the OECD also addresses certain shortcomings and disadvantages of the thin capitalisation rules that are based on debt-to-equity ratios. The interest limitation rules are not influenced by the interest rates on the debt when compared to conventional thin capitalisation rules. Thin capitalisation rules could be manipulated by fluctuating the levels of debt and equity throughout the year to allow deduction of more interest compared to the interest limitation rules that only consider economic activity and not balance sheet values.[189]

Despite the advantages of the fixed ratio interest limitation rules recommended by the OECD, these rules are not effective for banking and insurance entities which indicates that other methods should be considered to address BEPS risks related to entities in these industries.[190]

4.3 Analysis of BEPS Action 4 rules implemented by non-EU countries.

4.3.1 India

Taxation in India is regulated through the Income Tax Act of 1961 ("ITA") that is revised annually by the Ministry of Finance in the yearly budget. The first round of BEPS recommendations to be implemented in the ITA were announced in 2016.[191] These amendments brought about significant changes within the Indian tax framework such as the introduction place of effective management, an equalisation levy, and Country-by-Country Reporting ("CbCR"). A year later in 2017, the finance minister of India announced additional changes to the ITA in line with the OECD recommendations. These changes included thin capitalisation rules and secondary adjustments.[192]

The thin capitalisation rules, also referred to as the 'interest barrier rule', was introduced into the ITA through the addition of section 94B. As recommended by BEPS Action 4, the interest

[188] *Id*. at p72.
[189] *Id*. at p51.
[190] *Id*. at p79
[191] Laddha, H. 2017. "Is India Ready for BEPS: Foreseeable problems and suggestions". Intertax 45 (Issue 12). p829.
[192] Ibid.

barrier rule imposed a limitation on the deductibility of interest expenses claimed by Indian taxpayers with respect to interest payments made to its foreign associated enterprises.[193]

The scope of the rules applies to deductible interest or similar financial payments in excess of INR[194] 10 million made by an Indian taxpayer to its foreign associated enterprise or an Indian permanent establishment to a non-resident associated enterprise.[195] The disallowed interest is determined as the lesser of the amount of interest paid or payable by an entity exceeding 30% of its EBITDA or the amount of interest paid or payable to its foreign associated enterprise. Disallowed interest may be carried forward for a period of eight years. Companies in the banking and insurance industries have been exempt from the interest barrier rules.[196]

The structure of the interest barrier rules largely follows the recommendations set out in the BEPS Action 4 Final Report such as the inclusion of a *de minimus* threshold, a fixed-ratio rule, the allowance of excess disallowed interest to be carried forward, and specific carve outs for banking and insurance companies. However, there are certain deviations that should also be noted. India has opted not to apply a group ratio rule or equity escape rule as recommended by the OECD. The OECD refers to 'excess net interest' which is the amount by which interest expense exceeds interest income. The Indian interest barrier rules only take into consideration interest expense and not interest income.[197] The safe harbour threshold of INR10 million, equating to approximately EUR 114 000 which is substantially smaller in comparison to the safe harbour thresholds implemented by EU member states illustrated in Chapter 2 of this dissertation. However, this conservative safe harbour threshold is to be expected given that India is a developing nation that would seek to use the interest barrier rules to not only prevent profit shifting but also generate additional tax revenue. This is in stark contrast to European countries where the *de minimus* threshold is deliberately set at the highest recommended amount to prevent the free flow of capital across the EU.

The analysis of India's interest limitation rules indicates the country has chosen a stricter and more conservative approach. While these rules are broadly aligned to the BEPS Action 4

[193] Govind, S. 2019. "Chapter 16: India". In *Implementing Key BEPS Actions: Where Do We Stand?* edited by Lang, M et al. IBFD Books.
[194] Indian rupee
[195] *See* Govind, S. *supra* n193.
[196] *Ibid*.
[197] *Ibid*.

recommendations, India have deviated from the guidelines to apply greater restrictions on affiliated debt financing transactions. These deviations include India's use of interest expense instead of 'net interest' when determining the amount of allowable interest expense. The sole use of interest expense would invariably result in more taxpayers being subject to the rules.

The *de minimus* safe harbour provision may offer some reprieve for low-risk taxpayers. However, it has been set significantly lower in comparison to EU countries which may indicate India is aiming to broaden the pool of potential transaction that could fall within the scope of the interest limitation rules. Other indicators of a more stringent interest limitation regime is the fact that India has opted not to implement the group ratio rules, standalone entity exemption or exemption for debt incurred on public infrastructure projects. Further, they have limited the extent to which excess interest may be carried forward.

4.3.2 Argentina

Before the BEPS project, Argentinian tax law contained thin capitalisation rules that were originally enacted in 1998 and later amended in 2003.[198] The thin capitalisation rules tackled excessive interest deduction by imposing a 35% withholding tax on interest payments made where the lender was not a financial institution or where the lender is a financial institution but located in a non-cooperative jurisdiction.[199] Interest on instruments other than loans that are subject to the 35% withholdings tax, such as intercompany loans, would not be deductible if debt-to-equity ratio of the borrowing company exceeded 2:1. The excess interest disallowed a deduction for tax purposes would be reclassified as hidden equity and subsequently be subject to dividends withholdings tax.[200]

After the release of the BEPS Action Plans, the Argentinian government issued Article 50 of Law 27 that introduced the new interest limitation rules in line with the BEPS Action 4 best practice approach and effectively replaced the existing thin capitalisation rule contained within Article 85 of the Income Tax Law ("LIG").[201] The scope of the new interest limitation rules applied to interest incurred on financial debt arising from transactions with related

[198] Law 25,784 (Official Gazette of 22 October 2003)

[199] Méndez, L. 2019. "Chapter 2: Argentina". In *Implementing Key BEPS Actions: Where Do We Stand?* edited by Lang, M et al. IBFD Books.

[200] *Ibid*.

[201] Art. 50. Law 27,430 (Official Gazette of 29 Dec. 2017

parties. The amount of interest allowed as a deduction would be limited to the greater of 30% of the borrowing entity's EBITDA or a fixed safe harbour amount of ARS[202] 1 million.[203]

Interest that was disallowed during a tax year may be carried back for a period of three years and carried forward for a period of five years.[204] The new interest limitation rules did not apply to banking, financial trusts or companies conducting leasing operations. A taxpayer may also be exempt from the interest limitation rules if it is able to evidence that its annual interest expenditure, in relation to financial debt as defined, compared to its taxable income is within or below the ratio determined by the economic group to which the taxpayer belongs. Additionally, interest may be deducted without any limitation if the company incurring the debt can demonstrate that the ultimate beneficiary of the interest paid the corresponding tax on that interest income received.[205]

The interest limitation rules contained within Article 85 of the LIG aligns closely with the BEPS Action 4 best practice recommendations.[206] However, there are certain areas where it has diverged from the OECD guidelines. The scope of the Argentinian interest limitation rules refers to 'interest incurred on financial debt' compared to the OECD which refers to 'excess net interest'. The OECD allows for standalone entities to be scoped out of the interest limitation rules. The Argentinian rules do not specifically scope out standalone entities but do clarify that interest paid on debt from intercompany transactions falls within the ambit of the rules regardless of whether the related party is resident or non-resident. The safe harbour threshold of ARS 1 million equates to approximately EUR 2700. This deviation from the recommended threshold of EUR 3 million is quite significant but is expected given that Argentina is a developing nation that would seek to use the interest limitation rules for generating tax revenue and preventing profit shifting schemes. Argentina has also elected not to exclude debt used to fund public infrastructure benefit programmes as recommended by the OECD.[207]

[202] Argentinian peso
[203] Meloni, E. 2023. "Argentina – Corporate Taxation, Country Tax Guides IBFD".
[204] *Ibid*.
[205] *Ibid*.
[206] *Ibid*.
[207] *I*bid.

Drawing on the review of the Argentinian interest limitation rules, it is evident the country has opted for a stricter interpretation of the BEPS Action Plan 4 recommendations. Argentina use 'interest expense' instead of 'net interest' when determining the allowable interest deduction. This approach would invariably lead to higher amounts of interest being disallowed as a deduction as 'interest expense' would, in most cases, be greater than 'net interest' thus increasing the likelihood it would exceed 30% of EBITDA.

The *de minimus* safe harbour threshold is significantly smaller in comparison to most of the EU countries that have used the maximum value of EUR 3 million. This could be an indication of the country's intention to broaden the pool of potential debt financing transactions to fall within the interest limitation rules. While it may lead to greater tax revenue, a lower threshold could be more onerous and costly for low-risk taxpayers. It is further evident that Argentina aims to further broaden the scope of the interest limitation rules by not implementing carve outs for standalone entities debt incurred on public infrastructure projects as this would decrease the number of taxpayers that could be subject to these rules. Argentina has limited the duration for which excess may be carried forward which would mostly likely result in excessive interest being permanently non-deductible and thus potentially lead to greater tax revenue for the country.

4.3.3 United States of America

The United States of America ('USA' or 'US') has been actively engaged in the BEPS Project as both a G20 and OECD member country. Over recent years, US policymakers have raised concerns around aggressive tax planning by certain taxpayers and the attendant adverse effects on the US economy.[208] The Joint Committee on Taxation have determined that the average US effective tax rate has decreased from 26% in 1998 to 10.6% in 2012 and the US loss approximately USD 111 billion in 2012 as a result of profit shifting.[209]

Existing US interest limitation rules were already broadly aligned to the best practice recommendations of the BEPS Action Plan 4 before its release in 2016. The scope of the rules applies to interest payments made by thinly capitalised US subsidiary companies to its foreign

[208] Kaye, T.A. 2019. "Chapter 37: United States". In *Implementing Key BEPS Actions: Where do we stand?* edited by Lang, M et al. IBFD Books.

[209] *Ibid*.

parent companies.[210] It applied where the US corporation had 'excess interest' and a debt-to-equity ratio greater than 3:2. Excess interest was defined as net interest expense that exceeded 50% of the corporations adjusted taxable earnings during such taxable years.[211]

In 2017, section 163(j) the Internal Revenue Code[212] ('IRC') was amended to instead disallow a deduction for net interest expense in excess of 30% of a business's adjustable taxable income to better align with the recommendations in BEPS Action 4. The rules also provide for disallowed interest to be carried forward indefinitely and an exemption from the rules for certain taxpayers, businesses, and trades. An exemption is allowed for small businesses that do not exceed the threshold of the 'gross receipts test' under section 448(c) of the IRC. The gross receipts test applies to taxpayers that do not earn an average annual gross income of USD 25 million over a 3-year period. Section 163(j)(7)(A) of the IRC also provides that the following "trade or businesses" shall not fall within the scope of the interest limitation rules:

(a) the trade or business of performing services as an employee,

(b) any electing real property trade or business,

(c) any electing farming business, or

(d) the trade or business of the furnishing or sale of:

    (i) electrical energy, water, or sewage disposal services,

    (ii) gas or steam through a local distribution system, or

    (iii) transportation of gas or steam by pipeline

In addition to the earning stripping rules, the US tax law also contains a safe harbour provision for interest on intercompany loans. At the taxpayer's discretion, a safe harbour interest rate loan may be applied on US denominated loans provided the lender is not in the business of lending funds to unrelated parties.[213]The safe harbour interest rates are linked to interest rates on federal government securities that are published monthly by the Internal Revenue Service. The tenure of the intercompany loans determines which federal government security

[210] *Ibid*.

[211] Sec. 163(j)(1)(A) 2017, Sec. 163(j)(2)(A)(2017) and Sec. 163(j)(2)(B)(2017) of the US Internal Revenue Code of 1986.

[212] Internal Revenue Code of 1986.

[213] Treaty Regulation § 1.482-2(a)(2)(iii)

interest rate will be used as the reference rate.[214] The safe harbour rate may not be less than 100% or greater than 130% of the applicable federal rate.[215]

The analysis of US interest limitation revealed that the existing laws were already closely aligned with the BEPS Action 4 guidelines. However, there are a number of elements of the BEPS Action 4 Plan that US policy makers have chosen not to implement. The US rules do not provide a *de minimus* safe harbour provision rule for the net interest incurred compared to BEPS Action 4. However, US law does provide an exemption from the interest limitation rules for small taxpayers with gross income below a certain threshold and a safe harbour for the interest rates. While these safe harbour rules may not be in line with BEPS Action 4, it ultimately achieves the same objective of ensuring smaller, low risk taxpayers are not burdened with onerous tax compliance requirements.

The US have opted for a stricter approach concerning carve outs for certain entities as they have decided not implemented a group ratio or equity escape rule, nor have they scoped out standalone entities, banking or other financial institutions and debt incurred on funding provided for public infrastructure projects. This could be an indication that the US aims to broaden the scope of the interest limitation rules.

4.3.4 Republic of Korea

Before the introduction of the BEPS Action 4 best practice guidelines, Korea had already implemented thin capitalisation rules since 1997 under Articles 14 to 16 of the Income Tax Coordination Law ("ITCL")[216] to combat excessive interest deductions. Under these thin capitalisation rules, where amounts borrowed by a Korean resident corporation from its foreign controlling shareholder exceeded its equity by a ratio of 6:1 for financial institutions, and by a ratio of 2:1 for all other corporations, interest incurred on debt in excess of the allowed ratios would not be allowed as a deduction for tax purposes.[217] Further, the excess interest expenditure would be treated as a dividend paid by the Korean corporation to its foreign parent company.[218]

[214] Treaty Regulation § 1.482-2(a)(2)(iii)(C)
[215] Treaty Regulation § 1.482-2(a)(iii)(B)
[216] Income Tax Coordination Law of 1995
[217] Yoon, J. 2023. "Korea (Rep.) – Corporate Taxation sec. 7". Country Tax Guides IBFD.
[218] Dong Kim, K. 2023. "Legal 500 Country Comparative Guides: South Korea Tax". Legalease Ltd. p6

On 19 December 2017 Article 15(2) was introduced into the ITCL effective for tax years starting 1 January 2019. The purpose of introducing this new article was to incorporate and implement the proposals from the BEPS Action 4 report.[219] These new interest limitation rules stated that if the net interest expense on debt from a foreign controlling party exceeds the allowable ratio of 30:100 of the adjusted income; the interest on the debt would not be deductible for tax purposes.[220] Unlike the thin capitalisation rules under Article 14 of the ITCL, the interest limitation rules under Article 15(2) do not apply to corporations in the financial services industry or similar business.[221]

The new interest limitation rules did not replace the thin capitalisation but was added as part of the broader interest limitation regime. Article 16 of the ITCL regulates the order of application where a transaction falls within the scope of both Article 15 and Article 14. Article 16 states that where both the thin capitalisation rules and the interest limitation rules are applicable, the provision that results in the greatest limitation of interest expense would take preference. If the amounts from both application rules result in the same amount of disallowed interested the thin capitalisation rules take priority.[222]

The review of the Korean interest limitation rules revealed the country has deviated significantly from the BEPS Action Plan 4 guidelines. The country has opted for a more comprehensive approach to addressing excessive interest payments by folding in the new interest limitation rules under BEPS 4 with its existing thin capitalisation rules. However, Korea has taken a stricter approach as the new interest limitation rules under Article 15(2) of the ITCL do not provide for a safe harbour or *de minimus* threshold, nor does it allow for the disallowed interest to be carried forward for future periods. It has also not opted to exempt interest on debt that is used to fund public infrastructure projects, standalone entities, or financial service companies. Korea declining to implement these relief provisions could indicate the country is more risk averse concerning excessive interest payments and thus

[219] Nam, T. 2017. "Chapter 23: Korea – Early Mover on BEPS, More to Come". In *Asian Voices: BEPS and Beyond* edited by Sim, S et al. IBFD Books.

[220] Article 24 (1) of the Adjustment of International Taxes Act, most recently amended by Act No. 17651 on 22 December 2020

[221] *See* Nam. T, *supra* n219.

[222] *Ibid*.

prefers a more restrictive approach where more taxpayers could potentially fall within the ambit of interest limitation rules.

4.3.5 Japan

The BEPS Action plans were accepted by the Japanese government as the best approach to prevent abusive international tax schemes. Since its inception, the Japanese government has been actively working on the BEPS project and has implemented many of the recommendations through various tax reforms. These tax reforms required substantial legislative reform in order to accommodate the BEPS provisions.[223]

Before the implementation of the BEPS 4 rules, Japan originally applied thin capitalisation rules that were introduced in 1992. These rules were contained within Article 66-5 of the Special Taxation Measures Law ("STML")[224] and restricted the deductibility of interest incurred by thinly capitalised Japanese subsidiaries on debt from its foreign related companies. It applied where the Japanese company's average level of interest-bearing debt from its related foreign company exceeded the equity capital attributable to that foreign company by a ratio of 3:1. The rule also required that the Japanese company's overall level debt-to-equity ratio exceeded a ratio of 3:1.[225]

As part of the 2012 tax reforms, additional interest limitation rules were implemented in line with the Final BEPS Action 4 Report. These rules were broader than the thin capitalisation rules because the definition of 'interest' included amounts that are economically equivalent to interest such as discount, guarantee, and redemption costs. Under these new interest limitation rules, a Japanese company would not be permitted to deduct from its income a portion of net interest paid to its associated companies if that amount exceeded 50% of the company's adjusted income amount. Excess interest disallowed as a deduction in a tax year may be carried for a period of seven years[226] and excess interest payments less than JPY[227] 1 million[228] is exempt from the interest limitation rules. The new interest limitation rules were

[223] Hamada, A. 2019. "Chapter 19: Japan". In *Implementing Key BEPS Actions: Where Do We Stand?* edited by Lang, M et al. IBFD Books.
[224] Special Taxation Measures Law, Law 26 of 1957.
[225] Uzawa, K. 2023. "Japan – Corporate Taxation sec. 10.". Country Tax Guides IBFD.
[226] Article 66-5-3, para 4.1 of the STML.
[227] Japanese yen
[228] *Supra* at n226. article 66-5-2 of the STML.

designed to complement the pre-existing thin capitalisation rules. The law states that where a transaction falls into the ambit of both provisions, the greater of the two adjustments will apply.[229]

The review of Japanese interest limitation rules demonstrated that Japan had adopted the framework of the BEPS Action 4 guidelines, but also substantially deviated from the implementation guidelines. The Japanese interest limitation rules are aligned to BEPS Action 4 to the extent that it is based on a fixed ratio of an entity's EBITDA. The deviations noted in the Japanese rules tend to result in more onerous and restrictive application of the rules. These include the *de minimus* threshold of JPY 1 million that is significantly smaller compared to the maximum allowed safe harbour of EUR 3 million. JPY 1 million approximately equates to EUR 6500 and thus offers little reprieve to small, low risk taxpayers.

Japanese law only allows the excess interest to be carried forward for seven years whereas the BEPS 4 recommendations do not limit the extent to which the disallowed interest may be carried forward. This could result in circumstances where interest is permanently non-deductible if it is rolled over longer than seven years which may be beneficial for tax revenue but detrimental to the taxpayer. Japan has also chosen not to carve out banking or other financial service companies as well as debt on public infrastructure projects which broadens the scope of potential transactions which fall in the ambit of the interest limitation rules. Japan's fixed ratio of 50% of EBITDA is greater than the recommended 30% of BEPS Action 4 which could be either an indication that the government does not wish the interest limitation rules to be too inhibiting on economic activity or an indication that Japanese companies tend to have higher levels of debt and interest expense and thus a higher fixed ratio is required.

4.4 Conclusion

The objective of this chapter was to explore how various countries outside of the EU have implemented the interest limitation rules of the BEPS Action 4 and their motivations for their deviations or departures from the BEPS Action 4 guidelines.

[229] *Id.*, at art. 66-5(4) (10); art. 39-13(11) (31) Enforcement Order of the Special Tax Measures Law; art. 66-5-2(7) Special Tax Measures Law; and art. 39-13-21(17), (22) Enforcement Order of the Special Tax Measures Law.

Unlike the ATAD rules discussed in Chapter 3 of this dissertation, the BEPS Action Plan 4 guidelines were not legally required to be implemented by any OECD member, observer, or associated states. Based on the research conducted, the countries reviewed were generally aligned to the fundamental principles of BEPS Action Plan 4 but also deviated or elected not to apply some of its recommendations and guidelines.

Four out of the five countries reviewed implemented a fixed ratio rule based on 30% of EBITDA or adjusted tax income as recommended by BEPS Action 4. Japan was an exception to the norm and applied a more lenient ratio of 50% of EBITDA. Three out of the five countries followed the BEPS Action 4 guidelines to use 'net interest' in determining the allowable interest deduction. India and Argentina both deviated from the BEPS 4 guidelines to instead use 'interest expense'. This approach would be more onerous for taxpayers as it could result in higher amounts of interest being disallowed as a deduction as it is not being offset by interest income. As India and Argentina are both developing countries, it could be expected they apply a stricter interpretation of the guidelines to possibly generate additional tax revenue or take further steps to protect the fiscus excessive interest deductions.

Four out of the five countries deviated to a greater or lesser extent concerning the BEPS Action 4 recommendation to allow excess interest to be carried forward indefinitely. Both Korea and Japan do not allow excess interest to be carried forward while India and Argentina allow excess interest to be carried forward eight and five years respectively. These countries have chosen to implement more constrictive rules because it may lead to circumstances where a portion of interest is permanently non-deductible.

All the countries reviewed opted not to implement carve out rules for standalone entities or debt on public infrastructure projects. Further, only Argentina and India implemented exemptions for financial industry entities and only Argentina have implemented the group ratio or equity escape rules. This is in an indication that most of the countries reviewed have preferred to allow the interest limitation rules a much broader scope to ensure more potentially aggressive financing transactions are caught by the rules. Only three out of the five countries reviewed implemented a *de minimus* safe harbour threshold and all three set the threshold substantially lower compared to the EUR 3 million recommendation under BEPS 4. These deviations could signal that the guidelines have been tailored to address the specific

excess interest payment risks of each country or the country aims to broaden the scope of the rules thus ensuring only the least risky taxpayers are excluded from the rules.

The review of how countries outside the EU approached the OECD BEPs Action Plan 4 recommendations highlighted a few key lessons from which South Africa may stand to benefit. The use of a *de minimus* safe harbour provision seems to be consistent outside the EU as well, with the majority of the countries reviewed implementing a *de minimus* safe harbour provision. The consistency of safe harbour rules still in existence could support the reintroduction of such rules in South Africa.

The majority of countries reviewed have chosen to limit the extent to which disallowed interest may be carried forward. Limiting the carrying forward of disallowed interest could generate additional tax revenue while having no limit could increase foreign direct investment as foreign investors could be assured their interest would always be carried forward. South Africa should strike a balance between these two approaches by potentially allowing interest to be carried forward on the condition that the entities continue to carry on a 'trade' in South Africa. If trading were to cease, the excess disallowed interest would be lost.

The use of carve out and exemptions were not popular amongst countries reviewed. I believe South Africa should follow suit to ensure the interest limitation rules have as broad a scope as possible. However, I believe carve out provisions for debt incurred on public infrastructure projects should be implemented in South Africa. As a developing nation, the benefit of additional foreign investment in public infrastructure may outweigh the loss of tax revenue from these projects.

CHAPTER 5 OVERVIEW OF NON-EU COUNTRIES THAT HAVE NOT IMPLEMENTED BEPS ACTION 4

5.1 Introduction

The recommendations under BEPS Action Plan 4 have been considered by the OECD as the best practice approach to address base erosion and profit shifting through excessive interest payments. As discussed in previous chapters, there are countries that share this view. However, there are also certain countries that having considered the BEPS Action 4 approach, decided instead on an alternative strategy.

The objective of this chapter is to explore these alternative approaches used to address excessive interest deduction payments and understand why the selected countries have chosen not to follow the BEPS Action 4 recommendations. The purpose of this research is to identify and evaluate these alternate approaches and the manner in which they are implemented so that South Africa may leverage off their lessons learnt. The key lessons learnt may be applied by South Africa to reduce legislative complexity and simplify the interest limitation regime.

5.2 Overview of countries that have not followed the OECD BEPS Action 4 guidelines

5.2.1 Indonesia

The Indonesian government has accepted that BEPS pose a significant risk to government tax revenue and tax sovereignty as it could adversely impact the government's ability to finance public goods and service delivery.[230] In 2016, research performed by the Fiscal Policy Agency determined that corporate tax base erosion was empirically significant between 1990-2015 and was driven by tax rate differences across jurisdictions, particularly tax haven countries. It was further confirmed in 2016 that the Indonesian government lost approximately EUR 33.5 billion between 2004-2013 as a result of corporate income tax base erosion.[231]Countering

[230] Rosdina, H. 2019. "Country Note: Review of Implementation of the Inclusive Framework on Base Erosion and Profit Shifting in Indonesia". Intertax 47 (Issue 6 & 7). p635.

[231] Prasetyo, B. 2016. "2.000 Perusahaan Modal Asing Tidak Bayar Pajak". Antara News.

BEPS practices has thus been a primary focus of the Indonesian government when implementing ongoing tax reforms.

The release of the Final BEPS Action Report attracted the attention of Indonesian policymakers and other tax stakeholders but was not accepted as an exhaustive list of recommendations to end BEPS entirely. Instead, it was considered a useful tool to identify areas that are vulnerable to BEPS and a guide to address those vulnerable areas. Concerns were also raised over the considerable effort that would be required by the Indonesian tax authority to practically implement the BEPS Action Plans to improve domestic tax rules.[232]

In September 2015 the Indonesian government issued the Minister of Finance Regulation ("PMK") 169/PMK.010/2015 formally introducing the thin capitalisation rules that would be effective from the beginning of 2016. These rules stated that interest incurred on excessive debt would not be deductible for tax purposes. A domestic Indonesian company would be considered to have excess debt if it had an average debt-to-equity ratio of 4:1 during the respective tax year. The definition of 'interest costs' for the purpose of the thin capitalisation rules is broad and includes, in addition to the interest incurred on the loan, discount and premium costs, arrangement costs, guarantee fees and foreign exchange differences.[233] All forms of debt, whether with an affiliated company or not, falls within the scope of the thin capitalisation rules.[234]

The debt-to-equity ratio is determined as the monthly average to avoid the risk of companies manipulating the financial information at year end to circumvent the thin capitalisation rules. The rules also provide that where an Indonesian company has an equity balance less than zero, interest is not deductible in its entirety. This is based on the premise that in an open market environment, no company would be willing to lend funds to another company with such low credit worthiness. Certain industries such as banking, financial institutions, insurance, and infrastructure industries are exempt from the thin capitalisation rules. [235]

[232] Bawono, B. 2019. "Chapter 17: Indonesia". In "Implementing Key BEPS Actions: Where Do We Stand?", edited by Lang, M et al. IBFD Books.
[233] Article 1(2) of the 169/PMK.010/2015.
[234] Article 1(3) of the 169/PMK.010/2015.
[235] *See* Bawono, B. *supra* at n232. p4.

The analysis performed on the Indonesian interest limitation rules revealed that the country opted to use debt-to-equity based thin capitalisation rules instead of the fixed ratio of the EBITDA approach recommended by the BEPS Action Plan 4. The Indonesian government justified this deviation as a debt-to-equity ratio may be more efficient in terms of an automatic application of the rules in light of the capacity constraints of the Indonesian tax authority. While the BEPS 4 recommended approach is directly linked to the economic activity in the respective country, the debt-to-equity approach is more favourable as it allows companies to deduct greater amounts of interest during periods of financial difficulty or an economic crisis. The debt-to-equity ratio has been set deliberately high at 4:1 to allow businesses greater flexibility when attempting to expand their operations. Indonesian financial service companies are scoped out of the thin capitalisation rules.[236] This might be because banks and similar institutions require significantly higher levels of gearing as part of their operations and thus a debt-to-equity approach would be inhibiting to their industry.

5.2.2 Australia

Australia has been an OECD member since 1971 and has actively participated in the development of the BEPS Action Plans. In May 2015, the Australian government announced it would implement some of the BEPS recommendations such as the CbCR Reporting, treaty abuse and anti-hybrids but not the interest limitation rules of Action Plan 4.[237]

Prior to the BEPS Project, Australia had already implemented general anti-avoidance provisions as well as a number of specific anti-avoidance provisions covering transfer pricing, controlled foreign companies and thin capitalisation.[238]Thin capitalisation rules were initially introduced in Australia as part of their long-term project on reforming the rules concerning the taxation of financial arrangements. The first design of thin capitalisation rules allowed leveraging in Australia up to a debt-to-equity ratio of 3:1 for non-banking entities.[239] The aim of these rules was to limit the amount that could be allocated to Australian entities that are

[236] *Ibid*., at p5

[237] Konza, M. 2017. “Chapter 7: BEPS Challenges in Asia and Australia’s Response”. In *Asian Voices: BEPS and Beyond* edited by Sim, S et al. IBFD Books.

[238] Taylor, C. 2019. “Chapter 3: Australia”. In *Implementing Key BEPS Actions: Where Do We Stand?* edited by Lang, M et al. IBFD Books.

[239] Cooper, G.S. 2017. "Implementing BEPS, or Maybe Not - The Australian Experience One Year on”. New Zealand Law Review no. 2. p160.

foreign-controlled and to non-residents with Australian investments as well as Australian companies with offshore investments. Interest incurred on debt that exceeded the prescribed ratio of 3:1 was permanently denied as deduction for tax purposes.[240]

In 2013 the Australian government decided to tighten the thin capitalisation rules in response to rising BEPS concerns. The new rules, effective 1 July 2014, were contained within Division 820 of the Income Tax Act ("ITAA")[241] and apply a debt-to-equity ratio of 3:2 to all debt of an entity and not just debt with foreign affiliated parties. A debt-to-equity ratio of 15:1 is applicable to all financial entities. If an entity had levels of debt exceeding the allowable ratios, it would still be permitted to demonstrate to the Australian Tax Office ("ATO") that the amount of debt is at an arm's length.[242]

The new laws introduced now permitted certain exemptions and exclusions. Taxpayers may be exempt from the thin capitalisation rules by satisfying the worldwide gearing test that provides that a company's maximum allowable debt may be 120% of the worldwide debt-to-equity ratio of the group. Taxpayers with an annual debt deduction that does not exceed AUD[243] 2 million are exempt from the thin capitalisation rules.[244] The thin capitalisation rule applies to all types of entities such as companies, trusts, partnerships, and individuals.[245] However, special purpose entities are exempt.[246]

The review of Australian interest limitation rules revealed that the country has chosen not to implement the BEPS Action 4 recommendation but rather develop its existing debt-to-equity thin capitalisation rules. While the thin capitalisation rules were tightened in 2013, Australia also implemented additional measures aimed at rendering these rules less onerous for small, low-risk entities. These relief measures included a *de minimus* safe harbour threshold and a group ratio rule akin to the BEPS 4 recommendations. Australia have justified their decision to not align with the recommendations under BEPS Action 4 by stating that their revised, tightened thin capitalisation rules are sufficient.[247]

[240] Toryanik, T. 2023. "Australia - Corporate Taxation, Country Tax Guides". IBFD.
[241] Income Tax Act 1997 (as amended)
[242] Tax Ruling 2019/D2 and Practical Compliance Guideline 2019/D3.
[243] Australian dollar
[244] Section 820-835 of the ITAA.
[245] Subdivision 820-FA and 820-FB of the ITAA
[246] Section 820-35 of the ITAA.
[247] Treasurer Media Release Morrison, 2015.

5.2.3 Canada

Canada is one of the 20 founding members of the OECD and has been an active participant and supporter of the BEPS project. It was a net importer of capital until the mid-1990s and a popular investment destination for the United States of America. Therefore, Canada has always adopted treaty rules in order to preserve source taxation and protect its domestic tax base.[248]

Canada was among the first countries in the world to introduce some form of thin capitalisation rules in 1972 for inbound investments.[249] These rules initially only applied to resident corporations but has since been broadened to apply to resident trusts and partnerships.[250] The rules apply where a non-resident lender, either alone or together with other non-arm's length persons, owns at least 25% of the shares or voting rights in a Canadian resident corporation or at least 25% of the market value of the beneficial interest in a trust.[251] Where these circumstances apply, the effect of the thin capitalisation rules is to disallow the deduction of interest expense on "outstanding debt to specified non-residents" to the extent that the debt exceeds the "equity amount" by ratio of 1.5:1.[252] Where an amount of interest was denied as a deduction for tax purposes, it would be reclassified and treated as a dividend for withholdings tax purposes.

While the Canadian thin capitalisation rules aim to curb aggressive tax planning, it is deficient in several respects.[253] These rules apply to back-to-back loans, but do not apply to arm's length loans that have been guaranteed by specified non-residents. The rules only take into account debt from specified non-residents and equity contributed by specified non-residents instead of the sum total of the debt and equity of the relevant Canadian corporation which may be a better measure for thin capitalisation. Another significant weakness of the Canadian thin capitalisation rules is the inflexibility of the fixed ratio that is applied despite evidence that debt-to-equity ratios vary significantly across industries and even across companies within

[248] Duff, D.G. 2019. "Chapter 7: Canada". In *Implementing Key BEPS Actions: Where Do We Stand?* edited by Lang, M et al. IBFD Books

[249] Canada Department of Finance. 1997. "Report of the Technical Committee on Business Taxation". paragraph 6.2.6. Available: www.fin.gc.ca/pub/pdfs/tsrep_e.pdf.

[250] Section 18(4)-(8) of the Income Tax Act (Canada) ("ITA")

[251] Definitions of "specified shareholder" and "specified beneficiary", section 18(5) of the ITA.

[252] Definitions of "outstanding debt to specified non-residents" and "equity amount" within section 18(4)-(5) of the ITA.

[253] Duff, D.G 2018. "Interest deductibility and international taxation in Canada After BEPS Action 4". Conference Report. Canadian Tax Foundation. p15.

those industries. An alternative to the single fixed ratio could be a fixed ratio for each industry.[254]

Despite Canada's position as a founding OECD member and active involvement in the development of the BEPS Project, it has not implemented interest limitation rules in line with the best practice approach set out in BEPS Action 4. The Canadian government has taken the view that more robust interest limitation rules under BEPS Action 4 may adversely impact Canada's international competitiveness in an environment where other countries either do not apply such interest limitation rules or apply less constrictive rules. Thus, the debt-to-equity provisions are sufficient to protect Canada from excessive interest payments while also ensuring freedom of capital movement in Canada.

5.2.4 Switzerland

Aggressive tax planning or base erosion and profit shifting was not a popular topic for public debate before the initiation of the OECD BEPS Project. Issues such as the abolition of banking secrecy has seen the most media attention and has been debated both privately and publicly for a number of years. Amongst tax practitioners and academics, however, base erosion and profit shifting has been discussed and debated at length in private forums.[255]

Switzerland is one of the 20 founding members of the OECD and has been an active participant in the BEPS Project, however it is unclear to what extent the BEPS Project has influenced Swiss tax policy. It has led to a few legislative proposals such as the implementation of CbCR Reporting recommended under BEPS Action 13, but it is uncertain if the BEPS Project impacted public opinion on aggressive tax schemes and base erosion. It is thus expected that the discussion concerning the implementation of the BEPS Action Plan 4 recommendations has been limited as the Swiss parliament has not considered the introduction of general interest limitation rules under BEPS Action Plan 4.[256]

Instead of following the BEPS Action 4 guidelines, Switzerland has continued to implement their thin capitalisation rules to restrict interest deductibility in financing transactions with

[254] *Id*., p5.
[255] Hongler, P. 2019. "Chapter 34: Switzerland". In Implementing Key BEPS Actions: Where Do We Stand? edited by Lang, M et al. IBFD Books.
[256] *Ibid*.

related parties. The Swiss concept of thin capitalisation rules is based on three fundamental rules. They aim to prevent the abuse of the financing freedom, equal treatment of profitable entities and the limitation of base erosion and profit shifting through interest deductions and cross-border transactions.[257]

The thin capitalisation rules were brought into law through the release of Circular Letter 6 in 1997. According to Circular Letter 6/1997, the maximum allowable debt for 'finance companies' is set at 6/7 of the total assets of the company according to its market value.[258] The total debt of any other company may not exceed the aggregate value of the following assets of the company at the end of the financial year:

- 100% of cash
- 85% of receivables on goods and services
- 85% of other receivables
- 85% of inventory
- 85% of other current assets
- 90% of Swiss and foreign bonds issued in Swiss francs
- 80% of foreign bonds issued in foreign currencies
- 60% of quoted shares, Swiss and foreign
- 50% of other shares/investments in limited liability companies
- 70% of participations
- 85% of loans
- 50% of machinery and equipment
- 70% of operating real estate, holiday homes, villas, condos, and land for construction
- 80% of other immovable property
- 0% of expenses of incorporation, increase in capital and organisation
- 70% of other intangibles.[259]

[257] Böhi, P. 2019. "Interest deductibility and the implementation of BEPS Action 4". International Fiscal Association, London Congress, Volume 104. p678.

[258] Circular Letter 6 of 1997, p2.

[259] *Ibid.*

Interest that is determined to be excessive will be disallowed as a deduction for tax purposes and treated as dividends paid.[260]

In addition to the safe harbour ratios provided above, the Swiss Federal Tax Administration ("SFTA") issues annual circular letters prescribing the required minimum or admitted maximum interest rates. These interest rates reflect the prevailing Swiss franc interest rates as observed in the Swiss capital markets.

Circular 203 of 7 February 2023 sets out the minimum interest rate for loans denominated in CHF.[261] Loans granted to shareholders or other related parties is set at 1.5% if it has been financed through equity (retained profits). With regard to loans financed through debt (pass through of loan), the interest is set at the external interest incurred plus 0.5% on amounts up to CHF 10 million and 0.25% on amounts exceeding CHF 10 million, but at a minimum of at least 0.25% in total.

Circular Letter 204 of 7 February 2023 sets out the minimum interest rates regarding loans denominated in foreign currencies, financed through equity, and granted in foreign currencies. The interest on these loans should at least reflect the safe harbour interest rate for loans denominated in CHF. Further, it should reflect the interest rates provided for the respective currency. As an example, with regards to loans issued in EUR, the minimum interest rate is 3% for 2023 and loans issued in USD, the minimum interest rate is 3.75% for 2023.

It should be noted these interest rates are merely guidelines and act as safe harbours. Therefore, it is possible for companies to apply other interest rates provided the rates they apply can be justified and supported as an arm's length rate.

The research conducted on the Swiss interest limitation rules have indicated that the Swiss government has preferred to implement thin capitalisation using a debt-to-asset ratio instead of the fixed ratio of EBITDA as recommended by BEPS Action 4. Given that topics such as banking secrecy has been a leading discussion point as opposed to excessive debt financing and interest payments, it could be expected that Switzerland has opted to continue with their

[260] Article 65 of the Federal Direct Tax Law.
[261] Swiss Franc

thin capitalisation rules as a more restrictive and onerous approach that recommended by BEPS 4, could inhibit the flow of capital and commercial activity for the country.

The use of interest rate safe harbours further illustrates Switzerland's intention to not encumber its taxpayers and potential foreign investors with onerous compliance requirements. The use of interest safe harbours such as these also provides resident taxpayers and foreign investors alike with greater certainty concerning their financing transactions.

Switzerland's framework for the thin capitalisation rules is far more comprehensive compared to previous countries researched within this chapter. Other countries only used the debt-to-equity ratio whereas Switzerland has opted for the debt-to-assets ratio and has further specified percentages of asset classes which the total debt may not exceed. While this approach may be more onerous in comparison to the debt-to-equity approach and may result in greater amounts of interest being disallowed as a deduction, it could also allow the thin capitalisation rules to be tailored in a more deliberate and accurate manner. Different percentage threshold for asset classes can be applied to companies in certain industries depending on how prone those companies or that industry is to excessive debt financing.

5.2.5 China

In the 1980s, China began to implement its market-orient reform and opened China to foreign investors. As a result, China has seen an influx of foreign direct investment and foreign investors that have set up permanent establishments in China. In order to minimise their tax burden in China many of the foreign investors shifted their Chinese-sourced profits to other low-tax or tax-free jurisdictions either through transfer mispricing schemes or thin capitalisation arrangements. These aggressive tax planning and tax avoidance schemes inevitably became a significant concern of the Chinese tax administration.[262]

Despite not being an OECD member country, China has been a key partner of the OECD since 2007 and has been an active participant in developing the BEPS Project. However, China has chosen not to implement interest limitation rules in line with the OECD BEPS Action Plan 4 recommendations and has instead chosen to adopt thin capitalisation. The thin capitalisation

[262] Zhu, Y. 2019. "Chapter 9: China". In *Implementing Key BEPS Actions: Where Do We Stand?* edited by Lang, M et al. IBFD Books.

rules are contained within Article 46 of the Corporate Income Tax Law of 2007 ("CITL")[263] and is based on the fixed debt-to-equity ratio.[264] According to Article 46 of the CITL, where the ratio of the loan capital received from affiliated parties to the equity capital received from the affiliated parties exceeds a stipulated standard ratio, the enterprise may not deduct interest expense incurred on the excess loan capital received.

The term "loan capital received from affiliated parties" is defined as any type of debt financing that is received directly or indirectly from a related party. It specifically includes the following types of debt financing arrangements:

- Financing provided by a related party through an external 3rd party,
- Financing provided by a 3rd party that has been guaranteed by a related party; or
- Any other financing provided indirectly by a related party that is debt in substance.

The term "equity capital from affiliated parties" is defined as any type of non-repaid finance that an enterprise receives from a related party and is not required to pay interest or any other economically equivalent interest amount and where investors in that enterprise have ownership of the net assets of that enterprise.[265]

The applicable debt-to-equity ratios are published by the Ministry of Finance and State Administration of Tax Circular.[266] A 5:1 ratio is applied to financial service enterprises and a 2:1 ratio is applied to non-financial enterprises. Enterprises that can provide documentary evidence that the loan transaction is conducted at arm's length, or the effective tax rate of the borrowing enterprise is not higher than that of the lenders rate in China will be exempt from the thin capitalisation rules. Non-deductible interest may not be carried forward to be used in future periods. Instead, it is recharacterised as dividends and subject to income tax.[267]

The analysis conducted on the Chinese interest limitation regime has revealed the country preferred to implement thin capitalisation rules based on the debt-to-equity instead of the fixed ratio on EBITDA as recommended under BEPS Action 4. The thin capitalisation could be

[263] Corporate Income Tax Law, promulgated on 16 March 2007 effective as of 1 January 2008.
[264] Avi-Yonah, R. 2018. "China and BEPS". Laws 7, no. 1. p10.
[265] *Supra* at n258. p6.
[266] Art. 1 Circular of the Ministry of Finance and the State Administration of Taxation on Issues relevant to the Tax Policies regarding the Criteria of Deductible Interest Expense of an Enterprise,
[267] (Shiqi) Ma, S.2023. "China (Peoples Republic) – Corporate Taxation sec.10., Country Tax Guides". IBFD.

viewed by the Chinese tax authority as easier to administer and less onerous compared to the BEPS 4 approach and seems to be functioning quite well in China.[268] It is further evident that China does not intend to align its interest limitation rules with BEPS Action 4 but rather retain and improve on its existing thin capitalisation rules which could include implementing certain elements from the BEPS Action Plan 4 recommendations.[269]

5.3 Conclusion

The purpose of this chapter was to explore and compare the alternative measures taken by countries who have chosen not to implement the OECD BEPS Action 4 best practice guidelines. Drawing on the research conducted for the five countries selected for review, it has become evident that thin capitalisation rules based on the debt-to-equity ratio is the most common alternative method used by countries to address excessive debt financing and interest payments.

All the countries reviewed implemented thin capitalisation rules with four out of the five countries using the debt-to-equity ratio as the indicator of excessive debt financing. Switzerland was the only country that chose instead to use the debt-to-asset ratio for its thin capitalisation rules. The allowable or 'safe harbour' ratios varied between more lenient ratios of 4:1 and stricter ratios of 3:2. Countries that opted for higher ratios tended to focus on commercial stimulation, international competitiveness, and freedom of capital movement while countries with lower ratios tended to focus on curbing excessive interest deductions and profit shifting.

The thin capitalisation rules were considered by some countries as easier to administer than the interest limitation rules under BEPS 4. However, BEPS 4 provides for certain companies to be carved out or exempt from the rules which could lead to less onerous administration for tax authorities. These carve outs under BEPS 4 for standalone entities, financial undertakings or public infrastructure projects have not been considered by most of the countries reviewed. Only one out of the five countries carves out banking and insurance companies. The other countries do, however, provide higher allowable fixed ratios for financial entities as these

[268] *See* Avi-Yonah, R. *supra* n265 at p11.
[269] *Supra* at n258. p6.

companies naturally require higher levels of debt for its operations. Allowable fixed ratios for banks and similar financial entities varied from 15:1 to 5:1.

None of the countries implemented carve rules for interest incurred on debt used to fund public infrastructure projects or exemptions for standalone entities. However, most countries only scoped in interest incurred on foreign in-bound debt from affiliated or associated enterprises which ultimately has the same effect as carving out standalone entities. Compared to the BEPS 4 recommendations that allows excessive interest to be carried forward, none of the countries reviewed provided for excessive interest to be carried forward. Instead, excess interest would be recharacterised as dividends which could then be subject to further taxes such as dividends withholding taxes. Further, only one out of the five countries implemented a *de minimus* safe harbour threshold as part of their thin capitalisation rules. However, Switzerland did provide a safe harbour concerning the allowable interest rates for both domestic and foreign source debt funding.

The research conducted for this chapter revealed a few key lessons from which South Africa may benefit. The continued use of thin capitalisation rules based on the debt-to-equity ratio may be an indication that it should be reconsidered as part of South Africa's interest limitation rules. However, a more comprehensive approach should be considered instead of a straight debt-to-equity rule. South Africa should consider implementing tailored fixed ratios for industries that operate at higher levels of debt such as banking, insurance, and real estate investment trusts. Stricter ratios could also be applied to industries that are at higher risk of receiving excessive foreign debt financing. Specific ratios could be more burdensome for SARS to administer but it also could foster greater compliance by taxpayers if there were provisions that are suited to their industry.

While thin capitalisation rules could be easier to administer, the lack of supporting, alleviating components such as carve outs, exemptions, carry forwards and *de minimus* safe harbour provisions that come with BEPS 4 could be seen as unnecessarily punitive and a step backwards for taxpayers. Therefore, I believe South Africa should likewise consider combining some elements of BEPS Action 4 such as a *de minimus* safe harbour provision, carve outs for debt incurred for public infrastructure and allowing disallowed interest to be carried forward. Implementing certain elements in conjunction with the thin capitalisation rules could be more

effective in ensuring the South African tax base is protected while also ensuring our tax regime is not viewed as too restrictive which negatively impacts our ability to attract foreign direct investment.

CHAPTER 6 THE RELATIONSHIP BETWEEN THIN CAPITALISATION RULES AND CORPORATE FINANCE THEORY ON FINANCIAL DISTRESS

6.1 Introduction

The research performed in Chapter 5 of this dissertation indicated that some countries have chosen not to follow the recommendations under BEPS Action 4 and instead implemented thin capitalisation rules based on the debt-to-equity ("D/E") ratio. The D/E ratio is an important financial ratio in corporate finance as it measures the degree to which a company is financing its business operations through debt instead of its own capital and reserves.

While most countries have based their thin capitalisation rules on the D/E ratio, the range of these ratios applied by the countries reviewed have varied significantly and thus could be considered arbitrary. Therefore, in light of this observation, the objective of this chapter is to determine if there is an optimal D/E ratio, grounded in corporate finance theory that when exceeded, a company would be considered undercapitalised. It will also consider if the D/E based thin capitalisation rules can be improved upon. As South Africa has previously applied a thin capitalisation safe harbour rule that has since been repealed, the purpose of this research is to ensure the potential reintroduction of D/E based thin capitalisation rules is designed in a more comprehensive and deliberate manner and implemented more effectively than its predecessor.

This objective will be realised by reviewing contemporary corporate finance theory on capital structure and financial ratio analysis.

6.2 Corporate finance theory on capital structure

Corporate finance is a business function that oversees and manages the capital structure, accounting, and investment decisions and how the company is funded. A core objective of the corporate finance function is maximising shareholder value through strategic long-term and short-term financial planning and through the execution of business strategies.[270]

[270] Hayes, A. 2019. "Corporate Finance." Investopedia. Available: https://www.investopedia.com/terms/c/corporatefinance.asp.

A key discipline of corporate finance, as noted above, is the management of a corporation's capital structure. Capital structure refers to the combination of debt and equity financing a corporation uses to fund its overall operations. Both equity and debt financing come at a cost to the corporation whether it is the implicit return on equity ("ROE") for equity financing or interest rates charged on debt financing. It is the objective of the corporate finance function to minimise the weighted-average cost of capital ("WACC") of a corporation by determining its optimal capital structure. The lower the WACC the greater the present value of future cash flows discounted at the WACC rate, and therefore the greater the return on investment for the corporation.[271]

Debt and equity finance both have advantages and disadvantages. Debt financing usually has a lower rate of return compared to equity as the repayment of the interest and capital is a contractual obligation thus reducing the risk for the debt holder. Interest payments likewise provide corporations with a tax shield as it is generally treated as a deductible expense for tax purposes. A downside of debt, however, is the cash outflows of debt related repayments. Equity has a higher rate of return compared to debt holders as they take on greater risk by virtue of the fact that their return on investment is not guaranteed and dependent on the performance of the company. Equity has no obligatory cash outflows as dividends are only paid at the discretion of the directors. Dividend payments are not deductible for tax purposes and thus there is no tax shield.

6.2.1 Modigliani-Miller theories

Miller and Modigliani ("MM") were scholars of finance and economics who studied the impacts of capital structure on a company's value. The first MM theory explains how a firm's value is influenced by its capital structure. Initially the theory states that the market value of a firm is determined by its earning power and the risk of its underlying assets and is not influenced or dependent on its capital structure. Therefore, as the capital structure does not influence the value of a business, the value of a levered and unlevered firm would be equal, assuming all else is equal. However, this first proposition by MM is based on the following assumptions:

[271] *Ibid.*

- No taxes
- No transaction costs
- Equivalence in borrowing costs for both investors and companies
- Symmetric market information.

The first proposition also assumes that debt and equity holders split operational earnings equally.[272]

Proposition 2, while still ignoring the impact of taxes, assumes that the cost of equity is a linear function of a company's debt-to-equity ratio. Proposition 2 now assumes that debt holders have a preferential right to income over equity holders but in return for the greater risk assumed, equity holders receive a greater portion of the profits.[273]

Under proposition 2, a company's cost of equity has a linear relationship to its debt-to-equity ratio because as the company's debt levels increase, the company is considered riskier thus increasing the required rate of return on equity. This increase required rate of return offsets the increased equity returns as equity investors receive greater and greater shares of the profits. When the MM theory relaxes the assumption of no taxes but continues to not consider the impact of financial distress, the value of the firm increases as it takes on more debt and reaches maximum value once it is 100% debt financed.[274]

6.2.2 Static Trade-off Theory

The static trade-off theory is a theory on capital structures outside of the MM Theory that considers a balance between financial distress costs and the tax shield benefit related to debt financing. The static trade-off theory proposes the idea that there exists an optimal capital structure that is a combination of debt and equity. While separate from the MM theory, the static trade-off theory starts off with the capital structure irrelevance theory of MM but removes the assumption of no financial distress costs related to debt financing.[275]

[272] Chen, J. 2022. "Modigliani-Miller Theorem (M&M)." Investopedia. Available: https://www.investopedia.com/terms/m/modigliani-millertheorem.asp.
[273] *Ibid*.
[274] *Ibid*.
[275] Static Trade-off Theory". Breaking Down Finance. Available: https://breakingdownfinance.com/finance-topics/finance-basics/static-trade-off-theory/.

Under these parameters, the theory continues by stating that while a firm may increase its value by taking on more debt, it will reach a point where the WACC is at its lowest and the firm has reached its maximum value. If it continues to take on more debt, the value of the tax shield provided by the interest on the debt will be outweighed by the increasing cost of financial distress. Thus, the optimal capital structure of a firm is a point where the marginal benefit of the tax shield equals the marginal cost of financial distress.[276]

6.2.3 Thin capitalisation rules and capital structure

Applying the MM theory and static trade-off theories to the concept of thin capitalisation, it can be argued that if a company has obtained debt financing beyond its theoretical optimal capital structure point, it can be considered to be thinly capitalised. In theory this would be the most equitable and reasonable debt-to-equity ratio on which the thin capitalisation rules should be set.

However, determining any firm's optimal capital structure, and thus their ideal debt to equity ratio for thin capitalisation purposes, is not straight forward due to the fluidity of corporate finance. It may also be influenced by a number of factors some of which are unique to the business while others are circumstantial as a result of the industry or country in which the company operates.[277]

Companies and certain industries with stronger and consistent cash flows will be able to operate comfortably at higher levels of debt financing as they have greater ability to meet the interest obligations on the debt. Naturally, cash flows are derived through sales or the provision of services and thus companies that have regular and stable revenue allows for a greater degree of leverage. Industries that are prone to cyclical and inconsistent sales periods would not be able to weather consistent high levels of leverage.[278]

The prevailing market conditions also impacts the make-up of a company's capital structure. During recessionary periods and economic downturn, investor confidence is low which could lead to them opting to choose the lower risk debt instruments such as debentures and

[276] *Ibid*.

[277] Hayes, A. 2022. "Optimal Capital Structure definition: Meaning, Factors and limitations". Investopedia. Available: https://www.investopedia.com/terms/o/optimal-capitalstructure.asp#:~:text=An%20optimal%20capital%20structure%20is,lowest%20cost%20mix%20of%20financing.

[278] *Ibid*.

preference shares with guaranteed returns and regular cash flows. During economic upturn and growth, investors would be willing to take on additional risk and invest in equity instruments.[279]

Legal and regulatory requirements such as those imposed on banks and insurance impacts the capital structure of those firms. Banks would naturally have higher debt to equity ratios as it is their business model, generally speaking, to lend money they have received as deposits from their clients.[280]

I believe corporate finance theory purports the idea of an optimal capital structure and therefore an optimal level of debt financing, beyond which it can be viewed that a company is thinly capitalised. However, for the purposes of thin capitalisation and interest limitation rules, a blanket debt-to-equity ratio can create opportunities for tax planning and profit shifting as the debt-to-equity ratio effectively creates a threshold for how much profit can effectively be shifted offshore before revenue authorities consider it excessive. It can also be unnecessarily punitive against industries that naturally operate at high levels of gearing such as banks and other similar financial institutions.

6.3 Conclusion

Drawing on the research conducted, it can be considered unreasonable and impractical for any revenue authority to determine the optimal D/E ratio on a case-by-case basis for each company to determine if that particular company is in fact undercapitalised. A more practical approach would be to determine a range of optimal D/E ratios for a particular sector or industry. A fundamental element of financial ratio analysis is using multiple ratios comparatively over time to determine the financial health of a company. Therefore, the use of an additional financial ratio to supplement the D/E ratio could prove to be effective. As an additional consideration, thin capitalisation rules could use a rolling 3-year average of the financial ratios. A multiple year approach could be useful in identifying trends such as which sectors or industries are consistently increasing foreign affiliated debt funding.

[279] *Ibid*.
[280] *Ibid*.

CHAPTER 7 CONCLUSION AND RECOMMENDATIONS

7.1 An in-depth analysis of interest limitation and safe harbour rules in South Africa

This dissertation undertook to review and explore how South Africa may better protect its tax base from profit shifting through excessive interest payments while also providing a greater degree of certainty and administrative relief to taxpayers. The interest limitation rules of various countries were reviewed so that South Africa may benefit from the lessons learnt of a broad range of countries. The countries reviewed were categorised in the following groups:

- European Union ("EU") member state countries that have implemented Anti-Tax Avoidance Directive ("ATAD") rules.
- Non-EU countries that have adopted OECD BEPS Action 4 rules.
- Non-EU countries that have not adopted OECD BEPS Action 4 rules but have implemented other measures to counter excessive interest payments.

Further, this dissertation provided an overview of South Africa's historic and current policy concerning interest limitation and thin capitalisation safe harbour rules. It unpacked the views on thin capitalisation safe harbour rules from recognised tax bodies locally to determine if the reintroduction of thin capitalisation rules may benefit South Africa's interest limitation regime. It also considered whether thin capitalisation rules based on fixed financial ratios are grounded in sound corporate financial theory.

Drawing on the research conducted, the key findings are documented below.

7.1.1 EU member states and the ATAD interest limitation rules

The design of the ATAD interest limitation rules were premised on the OECD BEPS Action 4 best practice guidelines. It was legally required by EU member states to ensure a minimum level of base protection and consistency for tax treatment of interest deductions amongst EU member states.

A key finding from the research performed on the ATAD rules is the use of a *de minimus* safe harbour provision that exempts taxpayers from the interest limitation rules if they did not incur net interest expense above a certain threshold, usually set between EUR 1 million to EUR

3 million. The results were indicative that some countries still apply safe harbour provisions as a means to carve out low risk or immaterial transactions. This could allow tax authorities to allocate more resources to high-risk taxpayers and cross-border financing transaction while also ensuring smaller taxpayers are not inhibited by the interest limitation rules.

The research further indicated that some countries opted for tighter regulations over interest payment deductions and thus deviated from the ATAD rules to ensure the implementation of the rules are stricter. Other countries deviated from the ATAD rules to ensure the application of the interest limitation rules are less onerous and opted for a minimalist approach where only the minimum ATAD provisions were implemented. These results demonstrate that fiscal objectives should be the driving force behind interest limitation policies and that guidelines such as the ATAD or BEPS Action 4 guidelines need to be tailored to the specific circumstances of the country.

7.1.2 Non-EU states that have implemented BEPS Action 4 Rules

The OECD BEPS Action 4 recommendations did not carry the legal backing or uniformity of the ATAD provisions. Thus, it was reasonable to expect greater deviation from the guidelines as each country was at liberty to interpret the provisions of the BEPS Action 4 recommendations.

A key finding from the research conducted was the approach the countries have taken concerning the *de minimus* safe harbour provisions. Compared to the EU where all the countries elected to implement the optional *de minimum* safe harbour provision, only 60% of the countries reviewed outside the EU have opted to do so. Further, the countries that have set a *de minimus* safe harbour provision have set the threshold that is only a small fraction of the BEPS recommendations. On average the safe harbour threshold set by the non-EU countries is only 3% of the average recommended threshold of the BEPS Action 4. A much lower threshold could suggest the country aims to broaden its interest limitation rules as more potential taxpayers would not fall within the ambit of the rules with the safe harbour threshold set so low.

The research further indicates that non-EU countries tend to apply a stricter interpretation of BEPS 4 as most countries have chosen not to implement many of the carve out and exemption provisions and have thus opted for a much broader application of the interest limitation rules.

7.1.3 Non-EU countries that have implemented alternative interest limitation rules

Countries that have chosen not to implement interest limitation rules in line with BEPS Action 4 have instead decided to use thin capitalisation rules based on a fixed ratio on 'balance sheet' figures. The most common ratio being the debt-to-equity ratio. While this approach is not ground-breaking for South Africa, there are lessons to be learnt from reviewing these countries. Most countries consider this approach easier to administer than the BEPS 4 approach. Some countries have applied higher fixed ratios for banking, insurance and other similar financial companies that naturally require higher levels of debt. Debt-to-equity ratios vary between 4:1 and 3:2 for non-financial companies, whilst debt-to-equity ratios for financial companies vary between 15:1 and 5:1. A more deliberate approach such as this may be beneficial in South Africa where certain high-risk industries could also have lower debt-to-equity ratios.

7.1.4 Corporate Finance and thin capitalisation rules

The research conducted on corporate finance and the interaction with thin capitalisation safe harbours indicates that there is an ideal debt-to-equity ratio and if a company exceeds this ratio to a significant extent, it could be considered as having excessive debt finance. While it may be theoretically the best approach to determine the ideal debt-to-equity ratio for each company on a case-by-case basis to determine whether it is thinly capitalised, this would be impractical for SARS to administer.

7.2 Recommendations

Set on the research conducted, the following recommendations are made:

1 Thin capitalisation safe harbour rules based on 'balance sheet' figures should be reintroduced as part of the interest limitation regime in South Africa as it could be an effective means to simplify our legislation. Sectors or industries that are at high risk of being excessively financed with foreign affiliated debt should have a lower D/E safe harbour ratio to mitigate the risk of profit shifting. Other industries or sectors should similarly have unique thin capitalisation safe harbour ratios based on the average level of gearing for the industry. The new thin capitalisation rules should consider using additional financial ratios such as the 'interest cover' ratio to supplement the D/E ratio. Further, the

thin capitalisation rules should consider using the 3-year rolling average values of a company's financial position. Using a 3-year period could avoid manipulation of financial results by taxpayers looking to escape the rules.

2 While it was only seen in the USA and Switzerland, I believe the use of government prescribed arm's length interest rates could encourage or foster compliance with the South African transfer pricing rules and lighten the administrative burden for SARS. This would have to be considered together with the thin capitalisation safe harbour as the amount of debt financing could still be considered excessive. Thus, if a transaction falls within the acceptable thin capitalisation safe harbour ratio and has elected to use a prescribed interest rate, it should not be subject to querying or audits from SARS.

3 Section 23M of the Act is based on the BEPS Action 4 recommendations as it limits interest to 30% of 'adjusted taxable income'. However, I believe there are certain elements of BEPS Action 4 that have not been incorporated into section 23M that could suit South Africa. Section 23M could be more aligned by implementing additional elements of the BEPS 4 recommendations. These include exempting debt incurred on public infrastructure projects as the indirect benefit of improvements to infrastructure could offset the loss of potential tax revenue. Excess interest capacity should be allowed to be carried forward in addition to disallowed interest.

4 A *de minimus* safe harbour provision should be implemented. Further research could be undertaken to determine the amount of the threshold. Currently, Section 31 considers cross-border transactions with connected persons exceeding R100 million to be materially significant. BEPS Action 4 recommends a ceiling of EUR 3 million for the safe harbour threshold which equates to roughly R60 million. However, I would recommend a more conservate range of R20–R40 million.

5 I would recommend a restructuring of the interest limitation rules in South Africa. As section 23M of the Act is based on the BEPS Action 4 recommendations, it should serve as the general interest limitation rule that is applied first. The *de minimus* safe harbour threshold should be applied at this stage of the interest limitation rules. The remaining interest that has been allowed as a deduction after section 23M would then be subject to the targeted rule of Section 31 which includes the conventional arm's length approach and the new thin capitalisation safe harbour approach. If a taxpayer is still considered to

have excessive interest and debt according to the thin capitalisation safe harbour rules, they should be allowed to determine if the debt and interest are at an arm's length. This is a high-level overview of the proposed structure; it does not consider the interaction with the withholding tax rules and double tax agreement.

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