



**A qualitative analysis of the international conformity of the
proposed amendments to section 23M of the Income Tax
Act No. 58 of 1962**

By:

Allistair Gallant

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Supervisor: Adjunct Associate Professor Deborah Tickle

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“Not my will, but HIS”

Abstract

Base erosion and profit shifting (BEPS) is the practice whereby multinational entities use tax planning mechanisms to exploit gaps in tax legislation to avoid a potential tax liability. In order to address this risk in South Africa, the Government previously introduced, amongst other things, section 23M of the Income Tax Act, No. 58 of 1962 (the Act) (an interest deductibility limitation section). However, in 2021, the Government proposed certain amendments to the interest limitation rules found in section 23M.

The research question that this dissertation thus seeks to address is: will the proposed restriction on deductibility of interest on connected party debt, which is proposed for South Africa to be at 30% of adjusted earnings, align with international best practice?

This dissertation thus, firstly considers the international conformity of the proposed amendments to section 23M of the Act. To establish such conformity, the benchmarks against which the South African amendments are measured are the BEPS project, as produced by the Organisation for Economic Co-operation and Development (OECD), guidance provided by the African Tax Administration Forum (ATAF) and research performed by the International Monetary Fund (IMF).

This dissertation then examines the current section 23M of the Act and the reason for its introduction and design. While the section assists with certain situations which may result in excessive interest deductions, the following items create some contention, namely; the section is only applicable to connected party debt and not third party debt, concept of 'subject to tax', and the section provides no clarity regarding the time limitation of the carry forward of unused interest capacity.

This dissertation also considers the guidance provided by the abovementioned international bodies. The overarching outcomes of the work performed by these bodies are that a limit of some sort is to be placed on interest deductions in order to circumvent excessive interest deductions and, in turn, protect the fiscus.

As indicated, the specific aim of this dissertation is to consider whether a 30% of earnings limit in South Africa will align with the guidance provided by the mentioned international bodies. Based on the research conducted, this dissertation finds that, from an overall perspective, the newly promulgated interest limitation rules in section 23M of the Act does conform to the guidance provided by these international bodies, especially the OECD and ATAF.

List of abbreviations

ACE	Allowance for corporate equity
ATAF	African Tax Administration Forum
BEPS	Base Erosion and Profit Shifting
CbCR	Country-by-Country Reporting
CFC	Controlled Foreign Company
DTC	Davis Tax Committee
EBIT	Earnings Before Interest and Tax
EBITDA	Earnings Before Interest, Taxes, Depreciation, and Amortization
IFRS	International Financial Reporting Standard
IMF	International Monetary Fund
OECD	Organisation for Economic Co-operation and Development
SARS	The South African Revenue Services
TARC	Tax Administration Research Centre
TCR	Thin Capitalisation Rules
The Act	The Income Tax Act No. 58 of 1962
TLAA	Taxation Laws Amendment Act
TLAB	Taxation Laws Amendment Bill

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1. Chapter One: Introduction

1.1 Background

The South African Revenue Service (SARS) was established as an organ of the state within public administration but as an institution outside public service. SARS' main objective is the efficient and effective collection of revenue.¹ While SARS has this as its objective, case law principles guide the practice that taxpayers may arrange their affairs in the most cost saving manner with the main purpose of pursuing the needs of the business, without falling foul of the tax avoidance provisions.²

Multinational companies sometimes avoid tax by arranging their affairs, disguised as pursuing business needs, to create favourable tax positions. One of these favourable tax positions is largely drawn by the location of the debt in multinational groups. These multinationals generally make use of intragroup loans in situations where higher levels of debt are placed in high taxing jurisdictions. This usually results in a reduction of a country's tax base referred to as Base Erosion and Profit Shifting (BEPS) by the Organisation for Economic Co-operation and Development (OECD). In short, this ability to arrange their affairs to best tax advantage allows multinationals to use profit shifting techniques, which in turn pose a risk to a country's tax base.³

The OECD has categorised BEPS risks in relation to interest deductibility into three basic scenarios "(i) groups placing higher levels of existing third party debt in high taxing countries and connected party debt in low taxing countries (as indicated above), (ii) groups using intragroup loans to generate interest deductions in excess of the group's actual third-party interest expense and (iii) groups using third party or intragroup financing to fund the generation of tax-exempt income".⁴

From a South African perspective, residents are taxed on their worldwide income, while non-residents are taxed on amounts sourced within the Republic. The Income Tax Act (No. 58 of 1962 – all references to sections hereinafter refer to sections of the Income Tax Act No. 58 of

¹ The South African Revenue Services Act No. 34 of 1997 – section 2 and 3

² *Commission for Inland Revenue vs Conhage (Pty) Ltd* 61 SATC 391 1999

³ African Tax Administration Forum. 'Suggested approach to Drafting Interest Deductibility Legislation'. Page 1.

⁴ Organisation for Economic Co-operation and Development. OECD/G20 Base Erosion and Profit Shifting Project Limiting Base Erosion Involving Interest Deductions and Other Financial Payments. Action 4: 2016 Update Page 13.

1962, unless otherwise stated) (the Act) provides that interest⁵ is deductible in terms of section 24J(2) provided that a trade is carried on and the interest is incurred in the production of the income. Where interest is received or accrued from a source within South Africa,⁶ such interest will be regarded as gross income,⁷ subject to tax in the hands of a non-resident.

There is however an exemption in section 10(1)(h)⁸, in terms of which such interest is not subject to tax in favour of the non-resident (provided the exclusions to the section are not met). Further, the Withholding Tax on Interest (WTI) rules in sections 50A to 50H were introduced in South Africa with effect from 1 March 2015. The WTI is levied at a rate of 15%. In terms of section 50B the WTI is applicable to interest⁹ payments made to a non-resident on or after 1 March 2015 which are derived from a source within South Africa. In section 50D, the Act lists certain instances where there is an exemption from WTI. Section 50E provides that the domestic rate of 15% may be subject to the application of a relevant Double Tax Agreement (DTA), which may provide a lower WTI rate. Importantly the section 10(1)(h) exemption is a domestic exemption from gross income, whereas the DTA relief is with reference to the WTI provisions.

⁵ Interest is defined in section 24J(1) of the Income Tax Act No. 58 of 1962 as “includes the gross amount of any interest or similar finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement; amount (or portion thereof) payable by a borrower to the lender in terms of any lending arrangement as represents compensation for any amount to which the lender would, but for such lending arrangement, have been entitled; and absolute value of the difference between all amounts receivable and payable by a person in terms of a sale and leaseback arrangement as contemplated in section 23G throughout the full term of such arrangement, to which such person is a party, irrespective of whether such amount is calculated with reference to a fixed rate of interest or a variable rate of interest; or payable or receivable as a lump sum or in unequal instalments during the term of the financial arrangement”.

⁶ The source rules are contained in section 9 of the Act. “In terms of section 9(2)(b) interest is deemed to be from a South African source where an amount constitutes interest as defined in section 24J, where such interest, is attributable to an amount incurred by a person that is a resident, unless the interest is attributable to a permanent establishment which is situated outside the Republic; or is received or accrues in respect of the utilisation or application in the Republic by any person of any funds or credit obtained in terms of any form of interest-bearing arrangement”.

⁷ In terms of section 1 of the Act “gross income is defined as in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within the Republic in proviso ii of the definition”. This interest is specifically included in gross income under paragraph (n) of the gross income definition, stating, that an amount will included specifically where “any amount which in terms of any other provision of this Act is specifically required to be included in the taxpayer’s income and that amount must for the purposes of this paragraph be deemed to have been received by or to have accrued to the taxpayer.”

⁸ In terms of section 10(1)(h) of the Act, “there shall be exempt from normal tax any amount of the interest which is received by or accrues to any person that is not a resident, unless that person is a natural person who was physically present in the Republic for a period exceeding 183 days in aggregate during the twelve-month period preceding the date on which the interest is received by or accrues to that person; or the debt from which the interest arises is effectively connected to a permanent establishment of that person in the Republic”.

⁹ In terms of section 50A “interest means interest as contemplated in paragraph (a) or (b) of the definition of “interest” in section 24J (1)”.

Prior to the introduction of section 24J, the general deduction formula, in section 11(a),¹⁰ read with section 23(g)¹¹ provided the requirements for interest deductibility. These provided minimal protection against profit shifting techniques where excessive interest payments were regarded as deductible and resulted in the erosion of, here, the South African tax base.¹²

Section 24J was introduced in order to regulate the timing of interest deductions but did not cater for the amount of interest to be deducted. In order to prevent BEPS strategies, section 23M (a specific anti-avoidance provision in addition to the transfer pricing rules found in section 31 of the Act and the exchange control rules in the Currency and Exchanges Act. 9 of 1933) was introduced by the Taxation Laws Amendment Act No.31 of 2013 (the TLAA). Section 23M provides a limitation on the amount of interest which a debtor may deduct in respect of debts owed to persons not 'subject to tax'. The section sets the interest deduction limitation for the debtor with the use of a formula. The section will, however, only apply in the event that its other requirements are met. Section 23M specifically limits the interest deduction in respect of debts owed to persons where that interest is not 'subject to tax', which may refer to both domestic and international entities. A similar interest limitation exists specifically in the domestic context ie section 23N. Section 23N applies to limit the interest deduction that may be claimed when a company incurs interest on debt arising from an 'acquisition' or 'reorganisation' transaction. Section 23N also sets out a formula to determine how much interest may deducted in a year. A detailed analysis around this section is however beyond the scope of this dissertation.

In the 2021 Budget speech the South African Minister for Finance proposed amendments to the interest limitation rules (although these amendments may not necessarily be made specifically to section 23M) in order to further curb BEPS strategies. The proposed amendments (which will be discussed in detail in the chapters that follow) are designed to

¹⁰ In terms of section 11(a) of the Act, "for the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature".

¹¹ In terms of section 23(g), "no deductions shall in any case be made in respect of any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade".

¹² African Tax Administration Forum op cit note 3 at 1.

require an “adjustment to the fixed-ratio limitation for net interest expense to 30 per cent of earnings; and to restrict only connected-party interest rather than total interest”.¹³

While section 23M has been introduced with a specific purpose, there is still a need for a more effective methodology for limiting interest in the appropriate circumstances. This is regardless of the other limitations provided by the transfer pricing and exchange control rules. As mentioned, multinationals have a right to arrange their affairs favourably whilst complying with the taxing rules related interest whether this leads to excessive deductions or not. The need for a more robust and effective interest limitation methodology has thus become increasingly important in order to establish certainty within legalisation and for providing additional protection to the South African base.

1.2 Research Question and Objective

The research question this dissertation seeks to answer is:

Will the restriction on deductibility of interest on connected party debt, which is proposed for South Africa to be at 30% of earnings, align with international best practice?

This research question gives rise to the following sub-questions which need to be answered in order to reach a conclusion on the main research question:

- a) *Will the 30% proposed interest limitation potentially achieve the objective of curbing BEPS?*
- b) *Will the proposed 30% limitation be more effective than the current formula as provided in section 23M?*

The following will be addressed in order to assist in answering the sub-questions and, in turn, provide an answer to the main research question:

1. What are the existing interest limitation rules in South Africa?
2. What guidance is provided by international bodies such as OECD, through its BEPS Action 4 initiative and the IMF? What guidance is provided specifically for Africa by ATAF?

¹³ National Treasury ‘Budget Review 2021 – Revenue trends and tax proposals Chapter 4’ <http://www.treasury.gov.za/documents/National%20Budget/2021/review/Chapter%204.pdf>, accessed on 15 February 2021. Page 47

1.3 Research Methodology

This dissertation adopts an interpretative approach to analyse section 23M and how the proposed amendments to the interest limitation rules align with international norms. This involves an analysis of peer-reviewed journal articles, literature, legislation and explanatory memoranda. The enquiry includes the review of local and international journal articles and will use the guidance provided by the OECD, in particular, the BEPS Action Plan 4, the ATAF's 'Suggested Approach' and studies performed by the IMF as a yardstick to measure against section 23M and the proposal by the Government in the 2021 Budget Review to expand the scope of the current interest limitation rules.

1.4 Limitations of Scope

In responding to the research question and objective, this dissertation will only include an analysis of section 23M and a brief discussion of section 23N (the specific anti-avoidance provisions). This dissertation will not consider the general deduction formula in section 11(a) read with section 23(g) nor will this dissertation investigate sections 23(f), 24J or 31. This dissertation will thus only consider the position where the interest would otherwise be deductible under the general rules. In other words, this dissertation is specifically addressing the specified interest limitation rules.

The dissertation has considered the proposed changes set out in the Taxation Laws Amendment Bill 2021 (TLAB). The legislation was promulgated shortly before completion of this dissertation and thus, although mentioned briefly, the dissertation does not consider the Taxation Laws Amendment Act (TLAA).

Furthermore, this dissertation will not address exchange control legislation and its implications.

1.5 Structure of Dissertation

This dissertation consists of five chapters. This first chapter details the background to the dissertation, the purpose of the dissertation including the research problem and the research methodology undertaken. This chapter also details any limitations of scope within the study.

The second chapter focuses on local legislation and the existing interest limitation rules. The chapter will introduce the history behind the need for section 23M in the context of deductibility of interest. The discussion on the introduction of section 23M will include the background of the section and the reason for its design. This chapter will also introduce the proposed

amendments to the interest limitation rules provided in the 2021 Budget Speech. Further, this chapter will include a brief discussion around section 23N and its interplay with section 23M.

The third chapter will introduce guidance provided by the OECD, more specifically around its BEPS Action 4, as well as introduce the guidance provided by ATAF and the IMF. This chapter aims to explain the guidance provided by the international bodies to provide a yardstick to measure against local legislation. This chapter will consider what these international bodies consider as appropriate when drafting and implementing rules on limiting interest deductions.

The fourth chapter will examine the proposed amendments as compared to international best practise set out in chapter three and consider the appropriateness of the amendments. This chapter will consider the level of the proposed restriction on interest deductibility and how wide this restriction should be applied. This chapter will use the findings in chapter three to assist in drawing the necessary conclusions.

The fifth chapter will summarise the conclusions reached within this dissertation.

2. Chapter Two: The existing interest limitation rules in South Africa

2.1 Introduction

This chapter introduces the existing local interest limitation rules and the purpose for their current design. The chapter will also provide a discussion around the proposal by government to change the current interest limitation rules.

2.2 Section 23M

In order to fund capital expansion, companies have a choice between debt and equity funding. Where equity funding is selected it usually represents an interest in ownership. A payment with respect to equity (usually a dividend) is generally not regarded as a deductible expense as it “represents an after-tax return on a capital investment”.¹⁴ ¹⁵ The dividend received may be fully or partially exempt from income tax depending on the circumstance (given the application of sections 10(1)(k), 10B, 64F and 64FA).

Alternatively, debt funding may be selected. Globally, revenue authorities have acknowledged the fact that debt funding in a group context may result in tax avoidance, specifically where a creditor is exempt from tax or where a creditor is subject to tax a significantly lower rate of tax than the debtor.¹⁶ This results in a significant mismatch between the tax treatment of the interest expense deduction on the part of the debtor and the tax treatment of the interest income inclusion on the part of the creditor. While this may occur in a domestic context,¹⁷ policy makers in South Africa are also concerned where such a mismatch occurs in a cross-border context. This concern arises where the foreign group lender entity (the creditor) is in a “tax haven” such that the interest receipt is not subject to tax in the foreign jurisdiction (or subject to minimal tax) and the local subsidiary (the debtor) is allowed an interest expense deduction.¹⁸ These situations create potential

¹⁴ Peter Barnes ‘Limiting Interest Deductions’ Papers on Selected Topics in Protecting the Tax Base of Developing Countries September 2014
https://www.un.org/esa/ffd/wpcontent/uploads/2014/09/20140923_Paper_LimitingInterestDeductions.pdf, accessed on 10 April 2021

¹⁵ *Port Elizabeth Electric Tramway Company Ltd v Commissioner for Inland Revenue* 8 SATC 13 1935 at page 16

¹⁶ National Treasury ‘Reviewing the Tax Treatment of Excessive Debt Financing, Interest Deductions and Other Financial Payments 2020’
<http://www.treasury.gov.za/public%20comments/Reviewing%20the%20Tax%20Treatment%20of%20Excessive%20Debt%20Financing,%20Interest%20Deductions%20and%20Other%20Financial%20Payments.pdf>, accessed on 15 February 2021

¹⁷For example, where the local recipient is specifically exempt from tax or the nature of the interest receipt is recharacterized as something else that bears a lighter tax burden.

¹⁸ Des Kruger ‘Interest- Deduction Limitation’ (2015) 6 1 *Business Tax & Company Law Quarterly* at 12

BEPS opportunities. South Africa is one of the many countries tightening its arsenal in an aim to combat this issue.

In South Africa interest is generally considered as tax deductible provided that it is incurred in the production of (taxable) income from trading operations. “In the case of a foreign person, interest from South African sources is generally exempt¹⁹ unless that foreign person has a South African permanent establishment”.²⁰ The exemption provided in section 10(1)(h) is generally aligned to the exemptions provided in the DTA which South Africa has with various other countries.²¹ The reason foreign investors are afforded this exemption is to attract foreign debt investment into the South African market.

The availability and use of foreign debt is one of the characteristics of a healthy business environment and a lack thereof may counter economic growth.²² While foreign debt remains attractive to the domestic market, the interest paid on these foreign loans may “erode” the tax base, when any party within a group context “over-leverages because of the overall tax benefits”.²³ Deductible interest paid to foreign (and other exempt) persons represents a risk to the fiscus because, potentially, “these are the situations where a borrower gets tax deduction for the interest expense while the lender is exempt from tax or is taxed at a lower rate in respect of the interest income.”²⁴

In order to combat these deduction/exemption mismatch situations, historically a 3:1 debt equity limit on cross-border debt, which operated in tandem with the transfer pricing rules, was introduced.²⁵ Later, a 15 per cent WTI that will generally apply to cross-border interest

¹⁹ Section 10(1)(h) of the Act

²⁰ National Treasury ‘Explanatory Memorandum on the Taxation Laws Amendment Bill 2013’ <https://www.sars.gov.za/wp-content/uploads/Legal/ExplMemo/LAPD-LPrep-EM-2013-02-Explanatory-Memorandum-Taxation-Laws-Amendment-Bill-2013.pdf>, accessed on 10 April 2021.

²¹ Ibid.

²² Barnes op cit note 14 at 5

²³ National Treasury op cit note 20 at 37

²⁴ Ruan Jooste ‘Tax Proposals Target Interest Deductions 2013’ <https://www.thesait.org.za/news/131469/Tax-Proposals-Target-Interest-Deductions.htm>, accessed on 12 April 2021.

²⁵ The South African Revenue Services 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’ issued on 14 May 1996 and addendum issued on 17 May 2002. This Practice Note has however been withdrawn on 5 August 2019 with effect from years of assessment commencing on or after 1 April 2021 (<https://www.sars.gov.za/legal-counsel/legal-advisory/practice-notes/>)

was also introduced.²⁶ National Treasury indicated that these methods, which are used to “limit excessive interest owed to exempt persons are largely incomplete”.²⁷ The 2013 Explanatory Memorandum stated the following:

“The 3:1 debt equity rule had to be changed in favour of a more facts and circumstances approach so as to satisfy international transfer pricing standards. The 3:1 debt limit also allowed for debt levels that are far too great with the prior rule arguably encouraging debt limits to the 3:1 level. As for cross-border interest withholding, the proposed charge is frequently reduced to zero under most South African tax treaties”²⁸

To elaborate, National treasury realised the formally introduced anti-avoidance methods were not enough in order to prevent base erosion. In a group context (domestic payments to a foreign recipient), the local entity will be entitled to an interest expense deduction while the receiving entity may not be taxed on the interest income received. A 15% WTI is levied on the interest income sourced locally, however this WTI may be reduced by a DTA (provided certain requirements are met). Given this risk of tax leakage, policy makers were motivated to introduce a further anti-avoidance measure to combat excessive interest deductions. Section 23M was therefore introduced to limit the aggregate deduction for interest that is not subject to tax in the hands of the person to whom the interest accrues if a ‘controlling relationship’ exists between the debtor and the creditor.

2.3 Excessive interest limitation in terms of section 23M

Section 23M came into force on 1 January 2015, with the main aim of limiting the amount of interest that may be deducted by a debtor where that interest is payable to persons “not subject to tax”.

The section is aimed at limiting the amount of interest that may be deducted by a resident debtor, provided the creditor and debtor are in a “controlling” relationship²⁹ or the creditor obtained the funding from a person that is in a “controlling” relationship with the debtor, and the amount of interest is not subject to tax in the hands of the person to which the

²⁶ National Treasury op cit note 20 at 37

²⁷ Ibid.

²⁸ Ibid.

²⁹ The term “controlling relationship” is discussed in detail below.

interest accrues, nor included in the net income of a Controlled Foreign Company (CFC) as provided for in section 9D. Section 23M(3) provides a limit to the amount deducted. Section 23M will, however, not be triggered if the interest is disallowed under section 23N.³⁰

Section 23M makes use of a formula in order to limit the interest when the specific requirements are met. “The limitation is calculated on the aggregate of the amount of interest received by or accrued to the debtor; and a percentage of the adjusted taxable income of the debtor to be determined in accordance with a formula which links deductible interest to the average repo rate for the year”.³¹ “To the extent that the interest paid exceeds the limitation (as per the formula), the excess can be carried forward for a period up to five years, in Jooste’s view”.³² Importantly, while section 23M uses a formula limitation, the Act also contains transfer pricing rules in section 31, in terms of which an interest deduction is only permitted where it satisfies the arm’s length principle (a detailed discussion of these rules are not within the scope of this dissertation). The transfer pricing rules are to be applied first “to determine the correct pricing of the debt owed”, after which section 23M is applied to further limit the interest in the defined circumstances and any amount of disallowed interest is carried forward to the subsequent tax year. Furthermore, the fact that the OECD’s Action Plan 4, ATAF’s Suggested Approach, IMF commentary and section 23M are considered necessary, implies that the transfer pricing rules are not considered adequate to combat BEPS on interest and hence the suggested provisions (which is discussed in further detail in chapters three and four) provide an additional backstop.

The detailed requirements that must apply in order for section 23M to apply, as mentioned above, that are discussed in detail below can be summarised as follows:

- The debtor must be a South African resident
- The transaction must be in relation to a debt
- A controlling relationship must exist between the debtor and the creditor
- The interest must not be subject to South African tax in the hands of the creditor

³⁰ Kruger op cit note 18 at 13

³¹ ENS Africa Tax ‘Thin capitalisation and section 23M 2015’ https://www.saica.co.za/integritax/2015/2395._Thin_capitalisation_and_section_23M.htm, accessed on 6 September 2021

³² Jooste op cite note 24

2.3.1 The debtor must be a South African resident

A debtor is defined as a “person that is a resident or any other person who is not a resident that has a permanent establishment in South Africa in respect of any debt claim that is effectively connected with the permanent establishment”.³³ In the context of section 23M, understanding this concept is paramount as it is the resident/PE debtor that will claim the deduction for the interest paid to the creditor. In the event that the creditor is a foreign entity, the foreign creditor will likely only be taxed in the foreign jurisdiction and not also in South Africa owing to either the local exemptions or the DTA provisions (the DTA provisions may reduce the rate at which tax is withheld on the interest paid to as little as nil).

2.3.2 The transaction must be in relation to a debt

The essence of section 23M is based on a relationship between a debtor and a creditor. However, to form this relationship, there must be a ‘debt’ between the two parties. The ordinary dictionary meaning of the word ‘debt’ is “something, especially money, that is owed to someone else”.³⁴ Without the debt, there cannot be a relationship between the debtor and the creditor and section 23M will not be applicable. It is therefore clear that the section requires a debtor/creditor relationship which exists given an obligation on the one party to repay a debt to the other.³⁵ Further, the debt does not have to be due and payable, such debt need only be acknowledged by the liable party, in order to form the debtor/creditor relationship.³⁶

2.3.3 A controlling relationship must exist between the debtor and the creditor

Section 23M will only be triggered if a controlling relationship exists between a debtor and a creditor.³⁷ The section will also be triggered where there is no controlling relationship between the debtor and the creditor but the debt advanced by the creditor was

³³ Section 23M(1) of the Act

³⁴ Cambridge Online Dictionary <https://dictionary.cambridge.org/dictionary/english/debt>, accessed on 20 April 2021.

³⁵ Kruger op cit note 18 at 15

³⁶ Ibid.

³⁷ ENS Africa Tax ‘Interest deductibility in South Africa’ https://www.ensafrica.com/uploads/newsarticles/0_ensafrica%20interest%20deductibility%20in%20south%20africa.pdf, accessed on 18 April 2021.

obtained from a person in a controlling relationship with the debtor.³⁸ Where there is no such controlling relationship the section cannot be applied. It is thus evident that the controlling relationship doesn't necessarily have to be direct, but an indirect controlling relationship will also trigger the section.

A controlling relationship is defined³⁹ as a relationship where one person directly or indirectly holds at least 50% of the equity shares in the company or at least 50% of the voting rights in the company. Section 23M will thus only combat risk where a non-SA tax paying creditor owns at least 50% of the shares in a local debtor and disregards the BEPS risk where there is 48% shareholding, for example. The controlling relationship definition previously referred⁴⁰ to "...a relationship between a company and a connected person in relation to that company". Based on both the former and the latter definition of controlling relationship, it is clear that one of the parties in the debt arrangement has to be a company.

The former definition of "controlling relationship" applied to the debt arrangement only if one of the parties was a company, "as the relationship had to be between a company and any connected person⁴¹ in relation to that company".⁴² The connected person definition contains a wide list of items that may constitute a connected person, one of which includes "...company holding at least 20% of the equity shares or voting rights in the other company and no holder of shares holds the majority voting rights in the company".⁴³ The more recent definition (the definition currently reflected in the Act) of controlling relationship makes reference to direct or indirect shareholding of at least 50%.⁴⁴ The change in the 'controlling relationship' definition is due to the fact that the connected person test was considered too low of a benchmark for the companies to

³⁸ Section 23(M)(2)(b) of the Act

³⁹ Section 23(M)(1) of the Act

⁴⁰ Prior to the amendment in 2014 Tax Laws Amendments Bill.

⁴¹ Section 1 of the Act

⁴² Kruger op cit note 18 at 15

⁴³ Section 1(d)(v) of the Act of connected person definition

⁴⁴ Kruger op cit note 18 at 16

be seen as part of the same group of companies.⁴⁵ The connected person test enabled a connection between the debtor and creditor when no majority shareholding existed and created the situation where the limitation could be applied but the creditor had no control over the debtor.⁴⁶ It also seems unlikely, in any event, that a 20% shareholder would be able to extract excessive profits from a low tax jurisdiction by means of interest charges, which would be to the detriment of other shareholders. The controlling relationship definition was therefore amended to introduce the “concept of control through the 50% shareholding requirement”.⁴⁷ This means that the creditor must exercise a level of control over the debtor and it is often this level of control that prompts BEPS, which section 23M aims to avoid.

2.3.4 The interest must not be “subject to tax” in the hands of the creditor

The final requirement of the section is that the interest on the debt must not be subject to tax in South Africa, “either directly or as a result of the application of the South African CFC rules”.⁴⁸ The interest paid to the foreign entity will generally be exempt from income tax in terms of section 10(1)(h) of the Act (unless the non-resident has a PE in South Africa). This interest payment may, however, be subject to interest withholding tax in terms section 50A to 50H of the Act. While the South African law may require the withholding tax to be applicable, a DTA between South Africa and foreign jurisdiction may, however, reduce it to nil. This creates the situation where interest paid to the foreign creditor (i.e. money leaving South Africa) is not levied with any South African tax.

The concept of ‘tax’⁴⁹ is defined in section 1 of the Act as “means tax or a penalty imposed in terms of this Act”.⁵⁰ It is clear from this definition that ‘tax’ includes both

⁴⁵ National Treasury ‘Explanatory Memorandum on the Taxation Laws Amendment Bill 2014 [B13-2014]’ <https://www.sars.gov.za/wp-content/uploads/Legal/ExplMemo/LAPD-LPrep-EM-2014-02-Explanatory-Memorandum-on-the-TLA-Bill-13-of-2014.pdf>, accessed on 3 May 2021.

⁴⁶ Ibid.

⁴⁷ Ibid.

⁴⁸ Global Legal Insights ‘Corporate Tax 2014’ <https://www.bowmanslaw.com/wpcontent/uploads/2014/07/Global-Legal-Insights-Corporate.pdf>, accessed on 1 April 2021

⁴⁹ ‘Tax’ in the context of ‘not subject to tax’ as provided for in section 23M(2) of the Act.

⁵⁰ Section 1 of the Act

income tax and withholding tax on interest.⁵¹ Therefore, in the context of the phrase ‘not subject to tax’, the question arises whether the phrase includes *all* amounts within the taxation net regardless of exemptions or only those amounts where tax is actually levied.⁵² In order to clarify the meaning behind the phrase ‘not subject to tax’, the phrase should be investigated. This phrase is, however, not defined in the Act nor is there any South African jurisprudence defining the phrase.⁵³ The meaning of this phrase was considered in a United Kingdom Tax court case of *Paul Weiser v The Commissioners for Her Majesty’s Revenue & Customs*.⁵⁴

The facts of the case were that Mr Weiser (the Appellant) was an Israeli citizen and resident for tax purposes in Israel. He relied on Article XI of the UK/Israel DTA, which provided that he was exempt from tax in the UK on his UK pension income. This claim was rejected by the UK tax authority (HMRC). Mr Weiser alleged that he fell within Article XI because, given his Israeli tax residence, he will be ‘subject to tax’ in Israel regardless of the fact that Israel exempts the UK pension fund income from the tax charge.⁵⁵ The judgment laid down by the court provided that ‘subject to tax’ means:

“...the individual must be within the charge to Israel tax in respect of his UK pension income, that is to say that the income in question must be included in the computation of the individual’s taxable income with the result that tax will ordinarily be payable in respect of that income, subject to any deductions for allowances and reliefs etc. As Mr Weiser’s UK pensions are exempt from Israel tax, they are not “subject to Israel tax” during the exempt period with the result that double taxation relief under Art XI is not available”.⁵⁶

Therefore, based on the above judgement, it would appear that where sections 50A to 50H are applicable to interest paid to a foreign entity, section 23M will not apply.⁵⁷

⁵¹ Kyle Mandy ‘The limitation of deductions for untaxed interest’ (2014) *Tax Talk* at 45

⁵² *Ibid.*

⁵³ Kruger *op cit* note 18 at 17

⁵⁴ *Paul Weiser v The Commissioners for Her Majesty’s Revenue & Customs* [2012] UKFTT 501 TC02178

⁵⁵ *Ibid.*

⁵⁶ *Supra* note 54 at 5

⁵⁷ Kruger *op cit* note 18 at 18

In the event that the exemption provisions of a DTA are applied to the WTI, reducing it to zero, such interest cannot be regarded as 'subject to tax' and therefore the interest limitation provided for in section 23M will apply.⁵⁸

In summary, where sections 50A to 50H apply and the tax is not reduced to nil by a DTA, the exclusion in section 23M(2)(i)(aa) applies to exclude the section's application as the interest will be subject to tax. Thus, in this case, the debtor (the South African entity) will not be subject to the section 23M interest limitation. Further, where an amount is exempt from South African tax in the hands of the recipient, either by virtue of tax legislation or a DTA, it is not regarded as 'subject to tax' and therefore the above exclusion will not apply. On the contrary, where interest is fully offset by deductible amounts such that no actual tax liability arises in the creditor's hands (e.g. where there is a PE which, for example, has included the interest in its income but generates a tax loss), such interest is still regarded as being 'subject to tax' in South Africa and section 23M will not apply.

2.4 The deduction formula

In the event that the above requirements (points 2.3.1 to 2.3.4) are met, the interest expense deduction claimed by the debtor (i.e. the South African debtor which is under the control of the creditor) will be limited by the formula provided by section 23M(3). This subsection provides that the interest deduction may not exceed the sum of interest received by or accrued to the debtor and a percentage ('A' in the below formula) of adjusted taxable income. This is reduced by interest incurred on other non-section 23M debts.⁵⁹

The formula provided for in section 23M(3)(b) is as follows:

$$A = B \times C/D$$

Where:

A represents the percentage to be applied;

B represents 40;

C represents the average repo rate plus 400 basis points; and

D represents 10,

⁵⁸ Ibid.

⁵⁹ Phillip Haupt 'Notes on South African Income Tax' 34 ed (2015) 141.

but not exceeding 60 per cent of adjusted taxable income of the debtor.

'Adjusted taxable income' is defined⁶⁰ as taxable income (before applying the provisions of section 23M of the Act):

- reduced by
 - an amount of interest received or accrued;
 - any net income of a controlled foreign company ('CFC') that is required to be included in the income of the resident holding participation rights in the CFC; and
 - any amount recovered or recouped in respect of a capital allowance;
- increased by
 - any amount of interest incurred;
 - any deduction allowed in respect of a capital asset; and
 - any assessed loss or balance of assessed loss allowed to be set off against the taxpayer's income under section 20 of the Act".

The concept of adjusted taxable income is designed to be a tax concept akin to the accounting concept of Earnings Before Interest, Taxation, Depreciation and Amortisation (EBITDA).⁶¹ When section 23M was first drafted in 2013, the interest expense deduction was limited to 40% of adjusted taxable income of the debtor. However, where the average repo rate⁶² exceeded 10% in a year of assessment, the above 40% was replaced with a formula provided in subsection 5 of the then section 23M. This created a situation where the market conditions (ie the movement of the repo rate) was not fully considered as the formula was only triggered where the repo rate exceeded 10%. In order to align the interest deduction limitation closely to the "cost of debt financing in the market",⁶³ section 23M was amended from a "fixed cap of 40 percent, to a flexible formula linked to the South African Reserve Bank ("SARB")

⁶⁰ Section 23M(1) of the Act

⁶¹ Kruger op cit note 18 at 18

⁶² Repo rate as defined in section 23M(1) means the interest rate at which the South African Reserve Bank enters into a repurchase agreement contemplated in section 10 (1) (j) of the South African Reserve Bank Act.

⁶³ National Treasury op cit note 45 at 21.

interest rate”.⁶⁴ The flexible formula is as provided in section 23M(3)(b). Further, the rationale for the “additional 400 basis points (in part ‘C’ of the formula) serves as a risk premium to account for volatility in the South African rand”.⁶⁵ This is demonstrated by an example:

“Assuming the reserve bank rate is 6 percent, the limit will be 40 percent: $(40 \times (6 \text{ percent} + 4 \text{ percent}))/10$; if the rate falls to 3 percent, the limit would be 28 percent: $(40 \times (3 \text{ percent} + 4 \text{ percent}))/10$ ”⁶⁶

The 60% limit on adjusted taxable income” in the above formula is in order to safeguard the fiscus as well as tax base in periods where high interest rates are prevalent.⁶⁷ After applying the above formula, where any excess remains, such an amount will not be deductible in the tax year but will be carried forward to the subsequent year and is deemed to be interest incurred in such subsequent tax year.⁶⁸ The section does not provide for a limitation on this carry forward.

2.5 Interplay between section 23M and section 23N

Corporate restructuring transactions (reorganization and acquisition transactions) form a vital part of the corporate and economic landscape in South Africa. Section 23N was originally introduced in April 2014 to limit the interest deduction that is claimed on debt arising from reorganization and acquisition transactions as defined.^{69 70} When section 23M was introduced, there was some confusion around the interaction between section 23M and section 23N.⁷¹ The confusion was largely around the fact that both sections could

⁶⁴ Alexandra Readhead ‘Preventing Base Erosion: South Africa’s Interest Limitation Rules’ Natural Resource Governance Institute at 3

⁶⁵ Ibid.

⁶⁶ Ibid.

⁶⁷ National Treasury op cit note 45 at 21

⁶⁸ Kruger op cit note 18 at 19

⁶⁹ Haupt op cit note 59 at 586

⁷⁰ Acquisition transaction in terms of section 23N means “any transaction in terms of which an acquiring company acquires an equity share in an acquired company that is a company as contemplated in paragraph (a) or (b) of the definition of “acquisition transaction” in section 24O (1); and as a result of which that company, as at the end of the day of that transaction, becomes a controlling group company in relation to that acquired company. Reorganisation transaction in terms of section 23N an intra-group transaction as defined in section 45 (1) to which section 45 applies; or a liquidation distribution as defined in section 47 (1) to which section 47 applies”.

⁷¹ Kruger op cit note 18 at 20

apply to the same interest arising from the debt.⁷² The effect of section 23N is to provide the borrower with only partial relief on the interest incurred in a reorganization and acquisition transaction. “Such interest incurred is limited to a percentage of ‘adjusted taxable income’”.⁷³

In order to clear out the confusion, section 23M was amended in 2014. The 2014 Explanatory Memorandum on the TLAB provided that where an amount of interest is to be taken into account in terms of section 23M and in terms of section 23N, that amount of interest shall only be taken into account in terms section 23M after section 23N has been applied.⁷⁴ Therefore, it is clear that where both sections are applicable section 23N must first be applied and the section 23M formula is to be applied to the interest that remains after the limitation set out in section 23N has already been applied.⁷⁵

2.6 Proposed amendments to the interest limitation rules

The South African Government acknowledges the fact that when businesses require capital, from a tax perspective, it is more favorable to make this capital acquisition using debt rather than equity.

In the 2021 Budget Speech the Minister of Finance mentioned that the current policies will be reviewed. The purpose of the review is to introduce a redesigned interest limitation policy that is guided by “certainty, base protection and simplicity”.⁷⁶ With an aim to ensure that the South African tax base is protected and taxpayers are provided with certainty, this will stimulate economic growth with foreign investment and should limit tax avoidance.⁷⁷

In February 2020 National Treasury had released a Discussion Document titled ‘*Reviewing the Tax Treatment of Excessive Debt Financing, Interest Deductions and Other Financial Payments*’ in which this policy redesign is discussed. This paper provides that in

⁷² Ibid.

⁷³ Pieter van de Zwan ‘*SILKE South African Income Tax*’ Vol 1(2017) 547

⁷⁴ Section 23M(5) of the Act.

⁷⁵ Ibid.

⁷⁶ Ibid.

⁷⁷ Ibid.

order to achieve the policy redesign outcome, the following was proposed (the detail around these items will be discussed in chapter four):

- “The scope of the current interest limitation rules must be expanded to apply to total (external and connected) net interest expense and equivalent payments.
- The new interest limitation rules apply to all entities operating in South Africa that form part of a foreign or South African multinational group.
- The economic activity be proxied by earnings, which will be based on “tax EBITDA”, meaning the sum of: taxable income; net interest expense; and deductions in respect of capital assets (depreciation and amortization).
- The introduction of a 30% fixed ratio. The discussion paper asserts that at a ratio of 30 per cent the majority of taxpayers (roughly 75 per cent) with positive “tax EBITDA” will be able to deduct all of their net interest expense in the year of incurral.
- The new rules will replace section 23M, while section 23N will remain in place.”⁷⁸

2.7 Conclusion

The South African Government, together with many other countries, acknowledges the need for certainty related to its interest limitation rules. However, the deduction of interest is acknowledged as potentially being to the detriment of the fiscus and the South African tax base, hence the proposed amendments in point 2.5 above. While this chapter discussed one method (section 23M) introduced by the Government with the aim of protecting the tax base, there is a need to move towards greater certainty and effectiveness, while aligning with international norms and still catering for the needs of taxpayers and the fiscus alike.

The third chapter will discuss the BEPS redress strategies provided by the OECD, the IMF and ATAF available to both developed and developing countries.

⁷⁸ National Treasury op cit note 16 at 45 to 47

3. Chapter Three: Guidance provided by international organisations on interest limitation rules

3.1 Introduction

This chapter contextualises the guidance provided by the OCED, ATAF and IMF around potential BEPS circumvention. This chapter lists the guidance provided by these international organisations against which local legislation will be measured. The chapter will also detail why the above international organisations are used in this dissertation as international best practice standards.

3.2 Defining the international best practice standards

Policy makers worldwide understand the dilemma where taxpayers prefer financing investments using debt rather than equity. It is this dilemma that sees many countries implementing laws in an attempt to prevent the misuse of debt and the corresponding interest implications which may potentially lead to BEPS. Apart from the country specific rules, other international organizations have performed studies in order to provide a more globally recognized and unified approach to tackling BEPS which countries may want to apply.

These international organizations (explored in this dissertation) are OECD, ATAF and IMF and will each be used as a best practice standard against which to compare local legislation. These organizations are used as benchmark for the following reasons:

The OECD

In 2015 the OECD released its final package related to the BEPS project which consists of 15 Action Plans and details how these Action Plans can combat BEPS and assist tax authorities with the application of their law. The implementation of the BEPS package proposes methods that will enable countries to improve their tax systems and redress BEPS risks.⁷⁹ The BEPS package may also require introducing requirements that curb multinationals from accessing low taxing jurisdictions and introducing strategies to curtail country specific anti-avoidance rules and finally the BEPS package may require an improvement to transparency and access to information.⁸⁰

⁷⁹ Davis Tax Committee: Executive Summary of Second Interim Report on BEPS: OECD BEPS Project from a South African Perspective. https://www.taxcom.org.za/docs/New_Folder3/1%20BEPS%20Final%20Report%20%20Executive%20Summary.pdf, accessed on 16 December 2021. Page 5

⁸⁰ Ibid.

The BEPS package is aimed at providing recommendations which South Africa may apply in order to improve its international tax policies and combat potential BEPS risks. While the BEPS Action Plans are most applicable to a more developed economy and OECD member countries, these recommendations may be applied by South Africa owing to its part developed and part developing economy.^{81 82} Given that these Action Plans are primarily drafted for more developed economies, its implementation may come with a few challenges, which South African policy makers may need to consider. However, these advanced BEPS recommendations may provide South Africa with comfort around its establishment of its BEPS redress rules and may encourage more foreign direct investments.

The ATAF

The ATAF is an international organization established in 2009 serving as an African network which aims to improve tax systems in Africa, increase accountability of the State to its citizens, enhance domestic resource mobilization and thereby foster inclusive economic growth.⁸³ There are approximately 40 countries which are ATAF members of which South Africa is one. ATAF, together with Tax Administration Research Centre (TARC) provides tax administrators in Africa (developing and underdeveloped nations) with guidance on challenges with the development of local legislation. They are committed towards sharing expertise for African countries, “assisting with enhancing local tax systems and maximizing domestic resources”.⁸⁴

ATAF has also developed a set of rules aimed at addressing excessive interest deductions resulting in BEPS. This was developed to assist ATAF members with the development and implementation of BEPS redress strategies and provide a more robust fiscus protection system. Given that South Africa is an ATAF member, which is working in the best interests of African nations, to simply adopt the OECD position without taking the ATAF’s research and approach into account could be detrimental to South Africa, as a developing African country.

⁸¹ Ibid.

⁸² The reference part developed and part developing economy is referenced from the DTC report which states that South Africa has a large group of domestic multinational entities however South Africa still relies on foreign investment for access to technology and capital.

⁸³ The African Tax Administration Forum: <https://www.ataftax.org/overview>, accessed on 16 December 2021.

⁸⁴ Ibid.

The IMF

The IMF aims to promote “international financial stability and monetary cooperation. It also facilitates international trade, promotes employment and sustainable economic growth, and helps to reduce global poverty. The IMF is governed by and accountable to its 190 member countries of which South Africa is one”.⁸⁵

The IMF acknowledges that developing nations are faced with many challenges when attempting to establish efficient and effective tax systems and policies.⁸⁶ Given the lack of effective tax policies, these nations are often susceptible to BEPS and potentially other tax evasion practices. Often where certain robust policies are introduced by developing nations, there is a lack of skill set on the part of revenue authorities with their implementation and such implementation may not always be considered in full.⁸⁷

With all the challenges faced by developed nations, the IMF assists its member countries with the development of certain tax policies and often performs studies (including studies around BEPS circumvention) to support its advice. While the IMF acknowledges that most developed nations have better tax systems, it assists with the development of tax policies that may be implemented by all countries.⁸⁸ The IMF merely performs certain empirical studies and draws conclusions, which countries may or may not use to their favour. The South African policy makers may thus draw on the work performed by the IMF to assist with their BEPS circumvention policies.

3.3 The OECD BEPS Project: The need for Action Plan 4

“The use of third party and related party interest is perhaps one of the simplest forms of the profit-shifting techniques available in international tax planning”.⁸⁹ The OECD has acknowledged that this profit shifting technique (ie BEPS) is a “harmful tax practice which diminishes global welfare and undermines taxpayer confidence in the integrity of tax

⁸⁵ The International Monetary Fund: <https://www.imf.org/en/About/Factsheets/IMF-at-a-Glance>, accessed on 16 December 2021.

⁸⁶ Vito Tanzi, Howell Zee ‘Tax Policy for Developing Countries’ (2001) *Economic Issues No.27*

⁸⁷ Ibid.

⁸⁸ Ibid.

⁸⁹ The Organisation for the Economic Co-operation and Development. 2016 op cit note 4 at 19.

systems”.⁹⁰ BEPS relates to situations where the interaction of different tax rules creates non-taxation of income or a significantly low amount of tax by shifting profits away from the jurisdictions where the activities creating those profits take place.⁹¹ Non-taxation or a reduced tax liability is not necessarily the cause of concern, however this becomes a concern when “it is associated with practices that artificially segregate taxable income from the activities that generate it”.⁹² The concerns, therefore, for policy makers are the loopholes that arise from the interaction of different tax systems and “in some cases because of the application of bilateral tax treaties, income from cross-border activities may go untaxed anywhere, or be only unduly lowly taxed”.⁹³

In order to address the harmful tax practices, the OECD has developed a set of 15 Action Plans in July 2013. The mandate of these Action Plans is to “address tax avoidance, ensuring that profits are taxed where economic activities generating the profits are performed and where value is created”⁹⁴ in other words these Action Plans were introduced to combat BEPS. One of the Action Plans developed by the OECD is Action 4 of the BEPS Action Plans, which deals specifically with “limiting base erosion via interest deductions and other financial payments”.⁹⁵ While these Action Plans aim to address “different aspects of base erosion and profit shifting using interest”,⁹⁶ the purpose of this dissertation is to specifically review the guidance provided by Action 4 of the BEPS Action Plan (“Action Plan 4”). The guidance provided by Action Plan 4, is a prescribed set of rules

⁹⁰ The Organisation for the Economic Co-operation and Development. 1998. Harmful Tax Competition: An Emerging Global Issue. https://read.oecd-ilibrary.org/taxation/harmful-tax-competition_9789264162945-en#page1, accessed on 3 October 2021. Page 9. These harmful tax practices constitute a situation where “ the first country is a tax haven and, as such, generally imposes no or only nominal tax on that income; (ii) the first country collects significant revenues from tax imposed on income at the individual or corporate level but its tax system has preferential features that allow the relevant income to be subject to low or no taxation; (iii) the first country collects significant revenues from tax imposed on income at the individual or corporate level but the effective tax rate that is generally applicable at that level in that country is lower than that levied in the second country.”

⁹¹ The Organisation for the Economic Co-operation and Development. 2013. Action Plan on Base Erosion and Profit Shifting. <https://www.oecd.org/ctp/BEPSActionPlan.pdf>, accessed on 3 October 2021. Page 10

⁹² Ibid.

⁹³ Ibid.

⁹⁴ The Organisation for the Economic Co-operation and Development. <https://www.oecd.org/tax/beps/beps-actions/>, accessed on 3 October 2021.

⁹⁵ The Organisation for the Economic Co-operation and Development. 2014. The BEPS Project and Developing Countries: from Consultation to Participation, <https://www.oecd.org/ctp/strategy-deepening-developing-country-engagement.pdf>, accessed on 3 October 2021. Page 1.

⁹⁶ The Organisation for the Economic Co-operation and Development op cit not 4 at 22

to ensure global cohesion, however countries are entitled to apply stricter rules for the purpose of addressing BEPS or to achieve any other tax policy objectives they may have.

Action Plan 4 provides recommendations that aim to “limit base erosion using interest expense to achieve excessive interest deductions or to finance the production of exempt or deferred income and other financial payments that are economically equivalent to interest payments”.⁹⁷ This Action Plan will also produce “transfer pricing guidance in relation to financial arrangements between connected parties”.⁹⁸ The proposal by Action Plan 4 is to “encourage groups to adopt funding structures whereby: (i) the net interest expense of an entity is linked to the overall net interest expense of the group; and (ii) the distribution of a group’s net interest expense should be linked to income-producing activities”.⁹⁹

The recommendations made in Action Plan 4 constitute a strategy that will redress excessive deductible payments where interest is not subject to tax in certain investment scenarios. One issue concerning interest deductibility is where funding is received from a related entity benefiting from a low tax jurisdiction. This could create excessive interest deductions for the domestic entity without an income inclusion for the other entity. The interest expense is offset against other taxable profits and the income receipt is taxed favourably or not at all on the receiving end. Another issue concerning the deductibility of interest is that an entity may use the related party debt funding as a mechanism to produce exempt or deferred income. This results in an interest expense deduction for the related debt funding while the corresponding income leg is exempt or deferred.¹⁰⁰

3.4 Recommended approach suggested by the OECD’s Action Plan 4

The use of the recommendations suggested by the BEPS package will align the location of profits with its activity and value creation, whilst ensuring proper application of domestic

⁹⁷ The Organisation for the Economic Co-operation and Development op cit note 4 at 19

⁹⁸ Ibid.

⁹⁹ The Organisation for the Economic Co-operation and Development op cit note 4 at 22

¹⁰⁰ The Organisation for the Economic Co-operation and Development op cit note 4 at 19

tax rules by tax authorities.¹⁰¹ The BEPS package (which provides a wide array of actions) is split into the following categories, namely;

- Minimum Standards (Actions 5,6,13,14),
- Reinforcing International Practice (Actions 2,7,8,9,10), and
- Common approaches and Best practice for domestic rules (Actions 2,3,4,12).¹⁰²

The best practice approach prescribed by Action Plan 4 is a fixed ratio rule, which limits an entity's taxable interest deductions to a "fixed percentage of its profit, measured using earnings before interest, taxes, depreciation and amortisation (EBITDA) based on tax numbers".¹⁰³ This rule ensures that the interest deductions are strictly linked to the economic activity of the entity. While Action Plan 4 encourages the use of EBITDA as the measure of earnings, "best practice allows a country the flexibility to introduce rules based on Earnings Before Interest and Taxes (EBIT)".¹⁰⁴ The recommended benchmark ratio for the fixed ratio rule is within a corridor of 10% to 30%.¹⁰⁵

The recommended fixed ratio rule, which should apply to entities that form part of a multinational group, combats BEPS to a certain degree, however it does not take into account that groups in different sectors may require different amounts of leverage.¹⁰⁶ Also "even within a sector some groups are more highly leveraged for non-tax reasons".¹⁰⁷ Where an entity implements a benchmark fixed ratio at the appropriate level to combat BEPS, it could lead to double taxation for groups which are leveraged above this benchmark ratio.¹⁰⁸ "Therefore, countries are encouraged to combine a robust and effective fixed ratio rule with a group ratio rule which allows an entity to deduct more

¹⁰¹ Davis Tax Committee: Second Interim Report on Base Erosion and Profit Shifting in South Africa: Introduction (2015).https://www.taxcom.org.za/docs/New_Folder3/2%20BEPS%20Final%20Report%20%20Introductory%20Report.pdf, accessed on 14 December 2021. Page 52

¹⁰² OECD/G20 Base Erosion and Profit Shifting Project: Explanatory Statement. 2015 Final Report. <https://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf>, accessed on 14 December 2021

¹⁰³ The Organisation for the Economic Co-operation and Development op cit note 4 at 29

¹⁰⁴ The Organisation for the Economic Co-operation and Development op cit note 4 at 30

¹⁰⁵ Ibid.

¹⁰⁶ Ibid.

¹⁰⁷ Ibid.

¹⁰⁸ Ibid.

interest expense in certain circumstances. A group ratio rule may be introduced as a separate provision from the fixed ratio rule, or as an integral part of an overall rule including both fixed ratio and group ratio tests".¹⁰⁹

The recommended approach (ie the fixed ratio rule and group ratio rule) makes provision for certain entities or situations which do not pose a BEPS risk. These entities or situations, listed in Action Plan 4, are (ie situations which pose less of a BEPS risk due to excessive interest deductions):

- the introduction of a *de minimis* threshold, which excludes entities with low levels of net interest expense. This threshold should be applied to the total net interest of a group, where a group has more than one entity in a country;
- the instance where interest is paid to third party lenders, where the loan funding is used for public benefit projects. An entity may have excessive interest deductions as a result of the loan funding, however the nature of the projects indicates a low BEPS risk; and
- where an entity has unused interest capacity or carry forward of disallowed interest for use in future years. This means excessive deductions are not taken upfront and any unused interest capacity can be offset against future profits.¹¹⁰

Action Plan 4 was updated in 2016 to cater for the banking and insurance sectors. Given their specific features, the OECD developed a specific set of rules to address the BEPS in these sectors (a discussion on these sectors is however beyond the scope of this dissertation).

The structure and operation of the best practice approach, (which is to be used as the benchmark against which the South African proposed interest limitation rules will be measured) as prescribed by Action Plan 4, is discussed in further detail below. The focus will be on the following aspects:

- interest and payments economically equivalent to interest;
- who a best practice approach should apply to;
- measuring economic activity using asset values or earnings; and
- a fixed ratio rule; and
- a group ratio rule.

¹⁰⁹ Ibid.

¹¹⁰ The Organisation for the Economic Co-operation and Development op cit note 4 at 14

3.4.1 Interest and payments economically equivalent to interest

Interest expenses may be widely considered as tax deductible however, different countries will apply their own set of rules determining whether or not an amount is regarded as interest. In order to define a best practice approach for the purpose of combating BEPS, “there are benefits in countries taking a broadly consistent approach to the items that should be covered by such rules ensuring a coherent approach to tackling BEPS across countries”.¹¹¹

Interest is defined in the Cambridge Dictionary as “money that is charged by a bank or other financial organization for borrowing money”.¹¹² Action Plan 4 however states that, if a best practice rule is restricted to such a narrowly defined concept, the following issues would arise:

- “It would fail to address the range of base erosion and profit shifting risks that countries face in relation to interest deductions and similar payments.
- It would reduce fairness by applying a different treatment to groups that are in the same economic position but use different forms of financing arrangements.
- Its effect could be easily avoided by groups re-structuring loans into other forms of financing arrangement”.¹¹³

In order to avoid the abovementioned issues, the best practice approach should apply to interest on all forms of debt and other financial payments that are economically equivalent to interest.¹¹⁴ “Payments that are economically equivalent to interest include those which are linked to the financing of an entity and are determined by applying a fixed or variable percentage to an actual or notional principal over time”.¹¹⁵ The economic substance of the interest will determine whether it a payment is economically equivalent to interest.

¹¹¹ The Organisation for the Economic Co-operation and Development op cit note 4 at 33

¹¹² Cambridge Online Dictionary. <https://dictionary.cambridge.org/dictionary/english/interest>, accessed on 4 October 2021.

¹¹³ The Organisation for the Economic Co-operation and Development op cit note at 33

¹¹⁴ Ibid.

¹¹⁵ Ibid.

“A best practice rule to address base erosion and profit shifting using interest expense should therefore apply to: (i) interest on all forms of debt; (ii) payments economically equivalent to interest; and (iii) expenses incurred in connection with the raising of finance”.¹¹⁶ Foreign exchange gains and losses derived from financial instruments are not generally regarded as economically equivalent to interest. A country may however want to treat these gains and losses on the financial instruments as economically equivalent to interest depending on local legislation.¹¹⁷ “However, any payments (including those listed above) may be subject to limitation under the best practice approach where they are used as part of an arrangement which, taken as a whole, gives rise to amounts which are economically equivalent to interest”.¹¹⁸

3.4.2 Who a best practice approach should apply to

“BEPS arise in a range of scenarios, including within a group, with related parties outside a group and through the use of structured arrangements with third parties”.¹¹⁹ Therefore, Action Plan 4 considers the following categories of entities to which the best practice approach may apply to. These are:

- entities which are part of a multinational group;
- entities which are part of a domestic group; and
- standalone entities which are not part of a group.

“It is recommended that, as a minimum, the best practice approach should apply to all entities that are part of a multinational group”.¹²⁰

Entities part of a multinational group

Interest deductibility becomes a BEPS risk in both inbound and outbound investment scenarios. Action Plan 4 therefore recommends that as a “minimum, a fixed ratio rule should apply to all entities which are part of a multinational group”.¹²¹ An entity is part of a group if such an entity is directly or indirectly controlled by a company, or the entity

¹¹⁶ Ibid.

¹¹⁷ The Organisation for the Economic Co-operation and Development op cit note 4 at 34

¹¹⁸ Ibid.

¹¹⁹ The Organisation for the Economic Co-operation and Development op cit note 4 at 37

¹²⁰ Ibid.

¹²¹ Ibid.

is a company which directly or indirectly controls one or more other entities. A group is a multinational group where it operates in more than one jurisdiction, including through a permanent establishment.

Where a group has more than one entity in a jurisdiction, the fixed ratio rule may be applied to each entity separately or to the overall position of all the group entities in such a jurisdiction. If the benchmark fixed ratio is set at an appropriate level, the fixed ratio rule should address the BEPS risks involving interest deductions for payments by entities which are part of a multinational group.¹²² “To ensure the fixed ratio rule is effective in tackling BEPS, Action Plan 4 recommends that all entities which are subject to the fixed ratio rule are also subject to targeted provisions¹²³ which reduce the impact of the rule”.¹²⁴ These targeted rules are important especially in the event that there may be specific risks not covered by the fixed ratio.¹²⁵

Entities part of a domestic group

A BEPS risk is more likely to arise in a multinational group and therefore the fixed ratio rules application may be limited to such a group. A country may however want to apply the fixed ratio rule to include entities in a domestic group. “This may be part of a broad approach to tackle base erosion and profit shifting in all types of entity or may be in order to meet other policy goals”.¹²⁶ A country may apply the rule in a domestic group, provided that the fixed ratio rule addresses BEPS concerns involving interest.¹²⁷

Entities which are not part of a group

The risk of BEPS occurring in a scenario where an entity does not form part of a group is relatively low and therefore applying the fixed ratio rule may not be necessary. Where, however, a standalone entity forms part of a complex group structure a BEPS risk may arise and therefore a ratio may need to be applied. These standalone entities

¹²² The Organisation for the Economic Co-operation and Development op cit note 4 at 38

¹²³ Targeted rules are “interest limitation rules include any provisions which apply to restrict interest deductions on payments made under specific transactions or arrangements”.

¹²⁴ The Organisation for the Economic Co-operation and Development op cit note 4 at 38

¹²⁵ Ibid.

¹²⁶ Ibid.

¹²⁷ Ibid.

are usually small entities, “owned directly by an individual, where there are no other entities under common control”.¹²⁸

De minimis threshold

The *de minimis* threshold as referred to above, would ensure that the cost of administering the fixed ratio and group ratio rule is reduced and allows tax authorities to direct its resources towards the entities posing a greater BEPS risk.¹²⁹

“Action Plan 4 recommends that such a threshold should be based on the total net interest expense of all entities in the local group”.¹³⁰ A rule of this nature should be relatively simple to administer and ensures that “highly-leveraged entities are required to apply a general interest limitation rule regardless of their size”.¹³¹ A country may want to apply the *de minimis* threshold based on net interest expense of each entity separately. Where this is the case (ie where the threshold is applied separately), countries should consider introducing certain anti-avoidance rules to ensure this rule is not abused by groups creating multiple entities, each of which would fall below the threshold.¹³²

3.4.3 Measuring economic activity using asset values or earnings

One of the objectives of the introduction of the BEPS project is to address practices that “artificially separate taxable income from the activities that generate it”.¹³³ In order to address this, Action Plan 4 advises countries to introduce a fixed ratio rule to restrict an entity to deduct interest expenses based on its economic activity.¹³⁴ Action Plan 4 suggests that for a fixed ratio rule, the most appropriate measure of economic activity is ‘earnings’, for groups operating in many sectors and in different countries.¹³⁵

¹²⁸ Ibid.

¹²⁹ The Organisation for the Economic Co-operation and Development op cit note 4 at 39

¹³⁰ Ibid.

¹³¹ Ibid.

¹³² Ibid.

¹³³ The Organisation for the Economic Co-operation and Development op cit note 4 at 47

¹³⁴ Ibid.

¹³⁵ The Organisation for the Economic Co-operation and Development op cit note 4 at 49

The suggested 'earnings' as a measure of economic activity is an effective way to ensure that the interest expense tax deduction is linked to the activity that generated taxable income. This measure is also a useful indicator in determining an entity's ability to pay interest and the amount of debt an entity may borrow.¹³⁶ Using earnings also assists companies with forecasting potential profits, given that where an interest deduction is linked to earnings, "a group can only increase a net interest deduction in a country by increasing earnings in that country".¹³⁷ A further benefit of using an earnings based approach is that the definition of earnings can be amended to exclude certain income which is subject to favourable tax treatment. This exclusion refers to dividend income which is exempt from tax in many countries or subject to reduced DTA rate.¹³⁸

'Earnings' is defined as either EBITDA or EBIT. Each country may decide which of the two options to apply. As mentioned above, dividend income is excluded from both these options, given that it often benefits from a participation exemption. Using the earnings- based approach means non-cash items such as depreciation and amortization are excluded, which is an indicator of an entity's ability to settle its debt.

In addition to using earnings as a measure of economic activity, the OECD explored the possibility of using asset values as a measure of economic activity. Using general asset values is considered more stable and would result in a more "predictable limit on the level of interest relief that can be claimed".¹³⁹ This would also mean greater certainty, as the limit would be more predictable. While using asset values as a measure appears more stable, Action Plan 4 acknowledges that the key issue with using asset values when applying the fixed ratio rule is determining a "consistent and acceptable model for valuing each of the classes of assets" an entity may have.¹⁴⁰ Different classes of assets will have different accounting valuation methods and may require different accounting policies. The inconsistencies around this would result in greater complexity with the application and implementation of the fixed ratio rule and

¹³⁶ The Organisation for the Economic Co-operation and Development op cit note 4 at 47

¹³⁷ Ibid.

¹³⁸ The Organisation for the Economic Co-operation and Development op cit note 4 at 48

¹³⁹ Ibid.

¹⁴⁰ The Organisation for the Economic Co-operation and Development op cit note 4 at 49

may also result in a situation where a group's most valuable assets are not taken into account for the purpose of the fixed ratio rule.¹⁴¹ Therefore, based on its analysis, the OECD rejected asset values as a measure of economic activity and proposed using earnings as the most appropriate measure.

3.4.4 Fixed ratio rule

The purpose of the fixed ratio rule

The aim of the fixed ratio rule is to ensure that an entity's profit is subject to tax after deducting an interest expense up to a proportion of EBITDA. The portion of EBITDA is a fixed benchmark ratio rule which is determined by the policy makers. "Interest paid to third parties, related parties and group entities is deductible up to this fixed ratio, but any interest which takes the entity's ratio above this benchmark is disallowed".¹⁴²

While the fixed ratio rule should be relatively simple for companies to apply, it does not consider the fact that different groups require different amounts of leverage for the application of the rule may cause a disadvantage. This will require the application of different ratios to different groups, which would make the fixed ratio more complex to apply and administer.¹⁴³ Action Plan 4 recommends that the fixed ratio rule be applied consistently using the same fixed ratio for groups operating in all sectors (but cautions that countries may need to exercise its discretion based on certain policy goals).

Operation of the fixed ratio rule

The maximum deductible interest expense amount is determined by using the benchmark fixed ratio and applying it to earnings.¹⁴⁴ In order to determine the disallowed interest expense using the fixed ratio rule, the following applies:

- "EBITDA must be determined,
- the fixed ratio rule must be applied to EBITDA, and
- the maximum allowable interest deduction must be compared to the actual interest expense".¹⁴⁵

¹⁴¹ Ibid.

¹⁴² The Organisation for the Economic Co-operation and Development op cit note 79 at 51

¹⁴³ Ibid.

¹⁴⁴ Ibid.

¹⁴⁵ Ibid.

“Earnings (ie EBITDA) should be determined by using the country specific tax legislation.¹⁴⁶ Applying tax numbers to determine EBITDA “reduces the risk that an entity with negative EBITDA is required to pay taxes as a result of an interest disallowance”¹⁴⁷ and it would be rather complex to increase the net interest deduction without increasing taxable income.

Action Plan 4 suggests EBITDA be calculated as follows:

“EBITDA should be calculated by adding back to its taxable income, the tax values for:

- (i) net interest expense and net payments equivalent to interest payments; and
- (ii) depreciation and amortization.

Tax exempt income, such as exempt dividend income or foreign earnings that are tax exempt, should not form part of the entity’s EBITDA figure”.¹⁴⁸

Determining benchmark for fixed ratio rule

An effective fixed ratio rule set by a country should be at an appropriate level to curb BEPS while working together with other tax rules which have been specifically introduced to address BEPS risks involving interest.¹⁴⁹ The deductibility of interest normally attracts investment into a country and results in a greater competitive advantage. This results in countries “adopting a benchmark fixed ratio at a high level which would allow more interest expense to be deducted and reduce the effectiveness of the rule in tackling the BEPS risk”.¹⁵⁰ Therefore Action Plan 4 recommends an agreed best practice approach that will protect the fiscus while maintaining a consistent approach in the application of the benchmark rule, ensuring BEPS is curbed appropriately.

Action Plan 4 recommends countries set their “benchmark fixed ratio within a best practice range or ‘corridor’”. This would ensure that the fixed ratio set is not too high nor too low to address the risk. In order to determine the appropriate benchmark for the fixed ratio rule, PWC performed a financial analysis (provided to the OECD and

¹⁴⁶ The Organisation for the Economic Co-operation and Development op cit note 4 at 52

¹⁴⁷ Ibid.

¹⁴⁸ Ibid.

¹⁴⁹ The Organisation for the Economic Co-operation and Development op cit note 4 at 52

¹⁵⁰ Ibid.

included in Action Plan 4), which illustrates the “proportion of publicly traded multinational groups with positive EBITDA that would in principle be able to deduct an amount equivalent to their net third party interest expense, if a benchmark fixed ratio is set at different levels”.¹⁵¹ Annexure A shows the percentage of companies affected by an interest deduction limitation over a period of 5 years (2009 to 2013), as extracted from this study. This table excludes companies with negative EBITDA’s. The table shows that, for example, in 2013 where the benchmark fixed ratio is set at 10%, 38% of multinational companies would be affected by the interest limitation rule. Annexure B (Table B.2) represents the percentage of companies affected by the interest deduction limitation as an average over the 5-year period. Annexure B (Table B.3) shows the percentage of companies that would in principle be able to deduct an amount equivalent to their net third party interest expense. The percentage in table B.3 is derived by taking the difference between the ratios in table B.2 and the ratio of 100%.

Based on the review of table B.2, where the benchmark fixed ratio rule exceeds 30%, the rate at which groups are allowed to deduct their third-party interest expense increases. Therefore, it appears that where a ratio is set at a corridor of 10% to 30%, the risk of BEPS is neutralised and the fiscus is reasonably protected. Any ratio set below 10% or above 30% will create a BEPS risk or be too restrictive for companies. At a ratio of 30%, a significant proportion of groups may have an incentive to increase the level of intragroup debt in order to claim net interest deductions in excess of their net third party interest expense. In order to demonstrate this the Action Plan 4 uses the following example:

“based on the financial data in Annexure A, around half of publicly traded multinational groups with positive EBITDA have a net third party interest/EBITDA ratio of 5% or below. Therefore, at a benchmark fixed ratio of 30%, there is a risk that these groups could deduct up to six times their actual net third party interest, assuming there are no impediments to the use of intragroup debt”.¹⁵²

Each country may decide exactly which percentage to apply and where a corridor is applied, many groups may be able to deduct all of their third-party interest expenses.

¹⁵¹ The Organisation for the Economic Co-operation and Development op cit note 4 at 53

¹⁵² Ibid.

Further, where the risk of BEPS is low, countries may alter the best practice approach to ensure entities can deduct a greater interest expense portion.¹⁵³

In addition to the fixed ratio rule discussed above, the principles of a group ratio rule is discussed below as an additional BEPS redress measure in certain circumstances.

3.4.5 Group ratio rule

The purpose of the group ratio rule

The above discussion introduces the fixed ratio rule where interest expense may be deducted up to a certain fixed percentage. One of the downfalls of this rule is that it does not cater for groups operating in highly leveraged industries.¹⁵⁴ There may be certain groups operating in different sectors where higher levels of debt funding may be required. This means, that where the fixed ratio rule is applied, “groups which have a net third party interest/EBITDA ratio above the benchmark fixed ratio would be unable to deduct all of their net third party interest expense”.¹⁵⁵

In acknowledgment of this downfall, Action Plan 4 recommends that countries combine the fixed ratio rule with a group ratio rule.¹⁵⁶ The group ratio rule may be applied as additional BEPS control measure (specifically tackling the above downfall) or as forming part of a larger BEPS control measure which includes the fixed ratio rule. In other words, where a net interest to EBITDA ratio is applied, countries may introduce a rule which states that an entity may deduct the higher of the “benchmark of the fixed ratio or group ratio”.¹⁵⁷

The OECD, in Action Plan 4, suggests a best practice approach (other than the fixed ratio rule) which allows an entity to deduct net interest expense up to its group ratio rule, provided that such rule is higher than the benchmark fixed ratio rule.¹⁵⁸ “Where the net interest/EBITDA ratio of an entity exceeds that of its group, the entity can claim

¹⁵³ Ibid.

¹⁵⁴ The Organisation for the Economic Co-operation and Development op cit note 4 at 61

¹⁵⁵ Ibid.

¹⁵⁶ Ibid.

¹⁵⁷ Ibid.

¹⁵⁸ Ibid.

deductions up to its group's ratio".¹⁵⁹ Where the resultant net interest expense is more than benchmark fixed ratio and group ratio rule, such net interest expense should be disallowed.¹⁶⁰ Further, whether a group ratio rule is applied or not or even a different group ratio is applied (other than the rule prescribed by Action Plan 4), Action Plan 4 recommends that, as a best practice approach, a fixed ratio rule with a benchmark ratio within a corridor of 10% to 30% is at least implemented by a country.¹⁶¹

Operation of the group ratio rule

In order to apply the group ratio rule, an entity must be able to determine the net third party interest/EBITDA ratio of the its worldwide group.¹⁶² The entity should use information on the group that is easily accessible to the tax authorities, in the event that such tax authorities need to re-perform any calculations. The best practice approach should therefore be "designed in such a manner that it is reasonable for both the group and tax authorities to apply".¹⁶³ Action Plan 4 recommends that the group ratio rule be determined using consolidated financial statements as it is the most reliable source of financial information on the worldwide group.¹⁶⁴ For the purpose of the group ratio rule the OECD, in Action Plan 4, defines a 'group' to include a "parent company and all entities which are fully consolidated on a line-by-line basis in the parent's consolidated financial statements".¹⁶⁵

Determining the group ratio rule

Action Plan 4 lists a two-stage test in order to determine the total net interest expense deductible under the group ratio rule, namely;

- "Determine the group's net third party interest/EBITDA ratio¹⁶⁶, and

¹⁵⁹ Ibid.

¹⁶⁰ Ibid.

¹⁶¹ The Organisation for the Economic Co-operation and Development op cit note 4 at 62

¹⁶² Ibid.

¹⁶³ Ibid.

¹⁶⁴ The Organisation for the Economic Co-operation and Development op cit note 4 at 63

¹⁶⁵ Ibid.

¹⁶⁶ In Action Plan 4 this is determined as Net third party interest expense / Group EBITDA = Group ratio

- Apply the group's ratio to an entity's EBITDA".^{167 168}

In order to perform stage one of the group ratio rule, the net third party interest/EBITDA ratio must be determined. The most simple and reliable manner to determine this, is by using the group's consolidated financial statements.¹⁶⁹ Using consolidated financial statements ensures that groups can easily apply the ratio and tax authorities can easily verify such a ratio.¹⁷⁰ EBITDA is generally not included on the consolidated financial statements, but for the purpose of applying the group ratio rule the consolidated financial statements must be used to determine the EBITDA.¹⁷¹ EBITDA for the purpose of the group ratio rule is determined in a similar manner as discussed under the fixed ratio rule above. The second stage can commence once the group's net third party interest expense and EBITDA have been determined. The group's net third party interest/EBITDA ratio may then be applied to the EBITDA of a group entity in order to determine the limit on that net interest deductions which may be claimed under such a group ratio rule.

3.5 The African Tax Administration Forum

As recognized by the OECD, ATAF acknowledges that parent companies in multinational groups are often subject to non-taxation on interest while its equity holdings benefit from a participation exemption.¹⁷² On the other side, the subsidiary company gets an interest expense deduction which, often because of high leverage, is excessive.¹⁷³ These opportunities, created by the controlling parent company, lead to BEPS practices.

The developing African nations are often the subsidiaries in the above scenario, with the more developed nations being the parent companies. In most instances, these

¹⁶⁷ The second leg of the test (ie limit to be applied) is calculated as Group ratio x Entity EBITDA = Limit on net interest deductions.

¹⁶⁸ The Organisation for the Economic Co-operation and Development op cit note 4 at 64

¹⁶⁹ Ibid.

¹⁷⁰ Ibid.

¹⁷¹ The Organisation for the Economic Co-operation and Development op cit note 4 at 67

¹⁷² African Tax Administration Forum op cit note 3 at 1

¹⁷³ Ibid.

subsidiaries are usually the “net payers of interest rather than net payees”.¹⁷⁴ This indicates that the profit shifting techniques are often prevalent to reduce taxes in these developing nations.

In an effort to address these BEPS practices, most developing nations, including South Africa, have, at some stage, introduced a debt/equity test which links interest deductibility to the level of equity.¹⁷⁵ In South Africa this ratio was set at 3:1. ATAF acknowledges that the main advantage of this method is ease of application by tax authorities and provides groups with a fair amount of certainty for financial planning purposes.¹⁷⁶ In contrast however, the debt/equity ratio still allows considerable flexibility with the rate of interest payable on debt which is potentially disadvantageous.¹⁷⁷ Also, the equity test would allow “entities with higher levels of equity capital to deduct more interest expense”¹⁷⁸ which would result in groups increasing their level of equity in an attempt to get a greater interest deduction.¹⁷⁹ This debt/equity ratio is a thin capitalization (TCR) mechanism, which is considered a ‘safe harbour’. A safe harbour is essentially a threshold provided by “tax authorities for select taxpayers covered by transfer pricing regulations”.¹⁸⁰ In other words, where a transfer price is prescribed by such transfer pricing regulations, no further scrutiny is will be undertaken by the tax authority.¹⁸¹ The TCR appears relatively simple to administer and provides taxpayers with certainty, however the above mentioned issues are still prevalent.

Based on the work performed by ATAF and its participation in the BEPS project on Action Plan 4, it is acknowledged that countries have increasingly introduced fixed ratio tests

¹⁷⁴ Ibid.

¹⁷⁵ Ibid.

¹⁷⁶ Ibid.

¹⁷⁷ Ibid.

¹⁷⁸ Ibid.

¹⁷⁹ Ibid.

¹⁸⁰ Jonathan Sweidan ‘Why SARS should consider transfer pricing safe harbours’ at <https://www.thesait.org.za/news/198312/Why-SARS-should-consider-transfer-pricing-safe-harbours.htm>, accessed on 30 January 2022.

¹⁸¹ Ibid.

based on an entity's interest/earnings ratio, which has been found to better curb BEPS.¹⁸² The fixed ratio test is based on earnings and expressed as EBITDA . The ATAF Cross Border Taxation Technical Committee assisted with the development of Action Plan 4 and is of the "view that the recommendations in the Action Plan 4 report provides an appropriate basis for drafting interest deductibility rules in Africa".¹⁸³ The fixed ratio benchmark is regarded as relatively simple to apply and ensures that the interest deduction is linked to the economic activity that produces it.¹⁸⁴

There is also an acknowledgement that groups operating in different sectors may require different amounts of debt funding and may be highly leveraged and therefore ATAF's 'Suggested Approach' is to supplement the fixed ratio rule with a group ratio rule.¹⁸⁵ This would allow a greater interest expense deduction in certain circumstances.¹⁸⁶ There have however been concerns by the tax authorities of African nations surrounding the verification of information relation related to the group ratio rule.¹⁸⁷

Tax authorities would need to "obtain sufficient information such as group consolidated accounts to carry out that verification".¹⁸⁸ In light of this, ATAF recommends that where a country introduces the group ratio rule, such a country should introduce a provision stating that any additional interest deduction should only be allowed to the extent that a taxpayer provides the tax authority with sufficient information required to verify the group ratio rule.¹⁸⁹ Furthermore, much like Action Plan 4, ATAF encourages that the scope of the fixed ratio be limited to companies who pose a material BEPS risk and exclude certain companies that may pose a lower BEPS risk.¹⁹⁰ ATAF thus also suggests that a *De*

¹⁸² African Tax Administration Forum op cit note 3 at 2

¹⁸³ Ibid.

¹⁸⁴ Ibid.

¹⁸⁵ Ibid.

¹⁸⁶ Ibid.

¹⁸⁷ African Tax Administration Forum op cit note 3 at 10

¹⁸⁸ Ibid.

¹⁸⁹ Ibid.

¹⁹⁰ African Tax Administration Forum op cit note 3 at 2

Minimis threshold is applied “based on a monetary value of net interest expense”.¹⁹¹ Where a taxpayer falls below this threshold, there is no restriction on the interest expense deduction.

The ‘Suggested Approach’ takes into account the fact that earnings and interest deductions may arise in different periods, owing to either volatility in earnings or expenses incurred to fund an investment which will produce earnings in a later period.¹⁹² As a means to prevent this, ATAF suggests a carry forward of disallowed interest or unused interest capacity for use in future. This carry forward should however be limited to a maximum of five years.¹⁹³

3.5.1 ATAF’s Suggested Approach to Drafting Interest Deductibility Legislation

The abovementioned ‘Suggested Approach’ can be found in Annexures D and E and will be discussed further below. The interest deductibility legislation is drafted in such a manner that it would only apply to multinational enterprises and not to standalone entities.¹⁹⁴ This is aligned with the recommendations in the OECD’s BEPS Action Plan 4.

Fixed ratio rule

ATAF’s Suggested Approach provides three options applicable to limiting interest where a fixed ratio rule limitation is introduced. The fixed ratio rule is proposed to be set at a corridor of between “10% and 30% of the taxable profit or tax EBITDA”.¹⁹⁵ This aligns to the recommendation made by Action Plan 4. ATAF suggests three options which countries may adopt as interest deductibility legislation:

1. The first option provides an interest expense disallowance where the net interest expense is in excess of the fixed ratio.¹⁹⁶

¹⁹¹ Ibid.

¹⁹² Ibid.

¹⁹³ African Tax Administration Forum op cit note 3 at 11

¹⁹⁴ African Tax Administration Forum op cit note 3 at 6

¹⁹⁵ African Tax Administration Forum op cit note 3 at 7

¹⁹⁶ African Tax Administration Forum op cit note 3 at 6

2. The second option “disallows all of the excess interest expense (i.e. the gross interest expense) not just the net interest expense”.¹⁹⁷ The interest disallowance in this instance refers to the total interest paid or accrued as exceeds the fixed ratio.¹⁹⁸
3. The third option compares total interest paid or accrued to the fixed ratio.¹⁹⁹ The interest disallowance in this instance is gross interest as exceeds the fixed ratio.²⁰⁰

For the purpose of the fixed ratio rule, net interest refers to interest paid or accrued by a company less interest included in taxable income of such company.²⁰¹ ATAF also states that interest should include “all forms of debt; payments economically equivalent to interest; and expenses incurred with the raising of finance”.²⁰² This definition extends itself to including both connected person and third-party debt. ATAF’s Suggest Approach however provides that the above ‘interest’ definition may end in the following optional wording:²⁰³ “where the interest arises from a transaction directly or indirectly with a related person”.²⁰⁴ This indicates that a country may wish to apply the fixed ratio rule only to connected person debt.²⁰⁵

The Suggested Approach proposes that a country use either tax EBITDA or taxable profits as the measure of economic activity in the calculation of the fixed ratio.²⁰⁶ Tax EBITDA is defined in the Suggested Approach, however where taxable profits are used

¹⁹⁷ Ibid.

¹⁹⁸ Ibid.

¹⁹⁹ African Tax Administration Forum op cit note 3 at 7

²⁰⁰ Ibid.

²⁰¹ African Tax Administration Forum op cit note 3 at 4

²⁰² African Tax Administration Forum op cit note 3 at 3

²⁰³ In other words, interest would be defined as follows “interest includes interest on all forms of debt; payments economically equivalent to interest; and expenses incurred in connection with the raising of finance where the interest arises from a transaction directly or indirectly with a related person” where it relates to connected person debt only.

²⁰⁴ African Tax Administration Forum op cit note 3 at 3

²⁰⁵ African Tax Administration Forum op cit note 3 at 8

²⁰⁶ Ibid.

in the calculation a country should consider how this concept is defined for the purpose of the calculation and BEPS prevention.²⁰⁷

Where a country decides to apply the fixed ratio rule as its best practice approach, one of the above three options can be selected and implemented accordingly.

Group ratio rule

The Suggested Approach also makes provision for a group ratio rule. Similar to the fixed ratio rule, three options are provided (found in Annexure E). These options follow exactly the same approach as the three options for the fixed ratio rule, listed above, except it states that the limitation will apply where the interest expense is in excess of the greater of either the fixed ratio or group ratio.

The same principle as discussed above applies to the definition of interest where the group ratio is applied. For the purpose of the group ratio rule, group net interest “means the total third-party net interest expense of the group of companies to which the company belongs”.²⁰⁸

The recommendations suggested by ATAF thus align to what Action Plan 4 suggest as an approach to achieving a best practice standard. Refer to discussion point 3.7 indicating the recommendations which are aligned.

3.6 The International Monetary Fund

The IMF considers the fact that entities opt for debt over equity as a widely recognized policy concern.²⁰⁹ As previously mentioned, entities make this election given that most income tax systems allow a deduction for interest but no deduction for returns on equity (ie dividends).²¹⁰ Given the debt bias and the risk of BEPS, the IMF suggests two manners in which this can be prevented:

²⁰⁷ Ibid.

²⁰⁸ African Tax Administration Forum op cit note 3 at 5

²⁰⁹ The IMF refers to this scenario as a ‘debt bias’.

²¹⁰ Ruud de Mooij and Shafik Hebous. 2017. ‘IMF working paper: Curbing Corporate Debt Bias: Do Limitations to Interest Deductibility Work? [WP/17/22]. Page 4

- treating equity more similar to debt by adding an allowance for corporate equity (ACE), or
- the tax treatment of debt and equity is more similar by denying interest deductibility for corporations.²¹¹

The ACE method provides a deductible allowance for equity when determining taxable income.²¹² This means the ACE method deems equity to be treated in a similar manner to loan funding. ACE is treated similarly to an interest deduction from the income tax base, and is determined as the product of an entities total equity multiplied by a nominal interest rate.²¹³ This means that the corporate tax is limited to only economic profits given that only taxable profits in excess of the ACE are subject to corporate tax.²¹⁴ Inevitably, the ACE method does not allow for a preference between debt and equity when seeking sources of funding.²¹⁵ The ACE method has been applied by a few countries and while proven to reduce debt bias's "many countries are still reluctant to introduce an ACE due to the expected revenue loss associated with a narrower tax base".²¹⁶ Many other countries have imposed a limitation on the interest deductibility, instead of the full denial of interest deductibility (as recommend by (ii) above). The imposed limitation is a partial restriction "which denies interest deductibility beyond a certain fixed level of interest"²¹⁷ which varies on a country-by-country basis, which is referred to as the TCR.²¹⁸

The TCR has proven to be effective in reducing debt bias, however the way it is designed and operated contributes to its overall efficacy.²¹⁹ Based on a regression analysis performed by the IMF, it was found that where a TCR is applied to all debt (ie related party

²¹¹ Ibid.

²¹² The Organisation for the Economic Co-operation and Development: Fundamental Reform of Corporate Income Tax, No. 16. 2007, <https://www.oecd.org/tax/tax-policy/39672005.pdf> , accessed on 15 December 2021. Page 11

²¹³ Ibid.

²¹⁴ Ibid.

²¹⁵ Ibid.

²¹⁶ de Mooij and Hebous op cit note 210 at 4

²¹⁷ Ibid.

²¹⁸ Before the introduction of the transfer pricing rules in 1995, the debt to equity ratio in South Africa was 3:1

²¹⁹ de Mooij and Hebous op cit note 210 at 16

and external lending), such a TCR is “estimated to reduce the consolidated debt ratio of a group by about 5 percentage points, while the impact of the TCR applied solely to intragroup interest deductions was substantially lower”.²²⁰ The IMF regression analysis also indicated that a TCR applied only to related party lending has no impact on the deductibility of interest on external lending, however “restrictions to intragroup debt might indirectly affect external debt”.²²¹ Companies may override intragroup rules by using back-to-back loans, which are essentially intragroup loans, however channeled through a third party. In the absence of suitable anti-avoidance provisions this would mean that, effectively, the external/internal debt is not subject to the TCR.²²²

Based on the above and the regression analysis, the IMF recommends that the TCR’s apply to all debt (both related party and external) in order to properly address debt bias concerns.²²³

3.7 Summary remarks

To reiterate the analysis above, the recommendations by the OECD’s Action Plan 4 and the recommendations provided by ATAF are largely the same. Both these organizations suggest the following:

- (i) The introduction of a best practice approach being a fixed ratio rule set at a corridor of between 10% to 30% of tax EBITDA applicable to entities forming part of a multinational group.
- (ii) The fixed ratio rule should apply to wider definition of interest, which should refer to both connected part debt and third-party debt.
- (iii) The fixed ratio rule may be supplemented by an optional group ratio rule to cater for industries operating in highly leveraged sectors.
- (iv) The carry forward of disallowed interest or unused interest capacity for use in future periods. A limit should be placed on the carry forward of unused interest capacity.
- (v) The introduction of a *de minimis* threshold.

The difference in recommendations between these two organizations is that ATAF’s ‘Suggested Approach’ includes suggestions to countries to drafting interest deductibility legislation, whereas the OECD does not make such a prescription.

²²⁰ Ibid.

²²¹ de Mooij and Hebous op cit note 210 at 5

²²² Ibid.

²²³ de Mooij and Hebous op cit note 210 at 6

The IMF on the other hand, suggests the introduction of an ACE (vi); or TCR (vii) system. These options are totally different to those suggested by the OECD and ATAF.

- (vi) The ACE suggestion is rooted in treating debt and equity in a similar manner, with the aim of avoiding the preference for debt and the corresponding excessive interest deduction.
- (vii) The TCR reduces the preference for debt over equity with the introduction of a debt-to-equity ratio.

Based on the discussion in chapter two, the current (ie pre amendments) section 23M requires a few improvements in order to conform to the best practice stands. The shortcomings of the section as it currently stands are:

- (viii) The section is only applicable insofar as there is a controlling relationship between creditor and debtor, which indicates that only connected party debt will be limited.
- (ix) The section is also only applicable where the controlling entities/lender is not subject to tax in South Africa. Which means even if the DTA reduces the WTI rate to 1% (for example), the limitation on the section will not be applicable and the full deduction will be allowed. This creates a benefit to the taxpayer (but a BEPS risk for the fiscus) because the limitation is not triggered and for the recipient the interest income is taxed a lower rate.
- (x) The rate of limitation currently reflected is at rate of 40%, which may be ineffective with redressing BEPS.
- (xi) A carry forward of unused interest capacity is allowed, however there is no limitation on the carry forward of this unused capacity and may lead to an excessive build-up of unused interest capacity, which goes against the aim of the section.

These shortcomings will be assessed with the analysis performed in chapter four with the aim of determining whether the newly promulgated section 23M address these points.

3.8 Conclusion

Based on the analysis of this chapter, developing countries are encouraged by these international organisations to use the recommendations provided by Action Plan 4 together with the ATAF Suggested Approach to circumvent certain BEPS risks. These publications suggest that a fixed ratio benchmark be applied to earnings (more specifically EBITDA determined with reference to tax) as the measure of economic activity. It also highlights that the risk of BEPS may present itself in a multinational group. The ATAF has

essentially reiterated the best practice approach provided by Action Plan 4 and suggested the way African countries may apply the approach when drafting its local legislation.

While it appears that the IMF and the OECD are aligned in the sense that both organisations encourage a restriction on interest deductibility, the conclusion reached by each organisation is different. The IMF encourages the use of TCR for its restriction, which is based on debt to equity, whereas the OECD and ATAF's restrictions are based on EBITDA. Using the IMF suggestion, countries are encouraged to apply a partial restriction on the deductibility of interest up to a certain level of debt (ie introduce a -TCR). Further, the IMF suggests that the only manner in which to neutralise the BEPS risk, is to broaden the scope to cover all debt.

The fourth chapter will use the recommendations provided by the OECD's BEPS Action Plan 4, ATAF's Suggested Approach and the commentary provided by the IMF to compare to the proposed amendments to the South African interest limitation rules.

4. Chapter Four: International conformity

4.1 Introduction

The third chapter considered the global and African recommendations to addressing the risk of excessive interest deductions. This chapter will compare the newly promulgated amendments from the Government Gazette, dated 19 January 2022, as provided in section 23M to the recommendations in the previous chapter. The purpose of this comparison is to assess whether the South African amendments (they will, however, only be effective from the date as and when the Minister of Finance announces a reduction of the corporate tax rate) align to the recommendations suggested by the international bodies in chapter three.

4.2 Proposed amendments to interest limitation rules by South African Government

The research for this dissertation was explored before the introduction of the final 2021 TLAB and newly promulgated tax legislation (i.e. TLA). Considering this, the Discussion Paper,²²⁴ released by National Treasury suggested that the new interest limitation rules would replace section 23M. However, based on a review of the newly promulgated law, contained in Annexure F, section 23M was not replaced but rather amended to include and exclude certain provisions with the aim of protecting the tax base from excessive interest deductions. The section below will examine some of the pertinent amendments to section 23M.

4.2.1 Interest

The definition of 'interest' in section 23M(1) was amended to not only include interest as defined in section 24J, but to also include;

- payments under interest rate swaps,
- finance costs included in finance lease payments, and
- foreign exchange differences.²²⁵

Interest rates swaps arise when one stream of interest expense is swapped out for another stream of interest expense.²²⁶ Lease agreements are defined as those that

²²⁴ The Discussion Paper released on 26 February 2020 titled Reviewing the Tax Treatment of Excessive Debt Financing, Interest Deductions and Other Financial Payments

²²⁵ National Treasury 'Draft Explanatory Memorandum on the Taxation Laws Amendment Bill 2021 [W.P.-'21]' <http://www.treasury.gov.za/public%20comments/Tax%20Bills%202021%20Draft/2021%20Draft%20Explanatory%20Memoradum%20on%202021%20TLAB%20-%2028%20July%202021.pdf>, accessed on 14 January 2022.

²²⁶ Interest rate swaps are defined in section 24K(1) of the Act.

arise in terms of International Financial Reporting Standards (IFRS) 16 and the amendment will limit the finance cost element included in the lease payment, provided there is a controlling relationship.²²⁷ Lastly, foreign exchange gains and losses refer to those determined for the purposes of section 24I(3) and (10A).²²⁸ Thus, the wider scope of the definition of interest has the effect of including any other specific payments which may be said to be economically equivalent to interest.²²⁹ This aligns to the OECD and ATAF Suggested Approaches.

4.2.2 Amendment to section 23M(2)

This subsection was amended to ensure that new interest limitation rules apply in instances where “ a debtor incurs an amount of interest owed to a creditor that is in a controlling relationship with that debtor, if that creditor, directly or indirectly through another creditor that is in a controlling relationship with that creditor, obtained the funding for the debt advanced to the debtor from a person that is in a controlling relationship with that creditor and that other creditor and would not be taxed on interest accrued”.²³⁰ The effect of this amendment is to ensure that back-to-back loan arrangements do not circumvent the provisions. These back-to-back loan arrangements are situations where taxpayers channel loans between two or more group entities, which are ultimately owned by another company not subject to tax in South Africa.²³¹ The issue with these arrangements is that they are normally entered into by entities in a controlling relationship and the net effect of this arrangement is that the SA fiscus ends up bearing a large interest deduction. Effectively section 23M is side stepped and the interest incurred is not subject to tax in the hands of the entity to which it accrues.²³²

The example provided in the Draft 2021 Explanatory Memorandum provides as follows: A structure of three entities “(i) exempt entity (parent co) (ii) SA HoldCo and (iii) SA OpCo. The SA HoldCo incurs interest expense of R1million and OpCo incurs

²²⁷ National Treasury op cit note 225 at 21

²²⁸ Ibid.

²²⁹ National Treasury op cit note 16 at 45

²³⁰ National Treasury op cit not 225 at 21

²³¹ National Treasury op cit not 225 at 19

²³² Ibid.

interest expense of R1,05million on loans of R10 million and interest rates of 10% and 10.5% p.a respectively. The result is that the net interest income for HoldCo is R50k while the expense deduction for OpCo is R1,05million. In this instance SARS is worse off by R1million (net interest deduction) as this amount is likely not to be limited by section 23M and the R1million interest income is also not subject to tax”.²³³ It is also clear that although the Discussion Paper seems to have indicated that the new interest limitation rules will apply to total net interest (ie connected party and third party debt), the promulgated law indicates that the rules will continue to apply where there is a controlling relationship (to connected party debt) rather than applying to total interest expense.²³⁴

The concept of ‘subject to tax’ was discussed in detail in chapter two and further listed as an item of contention in chapter three. This concept was considered an item of contention (in the pre-promulgated section 23M) because if WTI was levied at a rate 1% (for example where the DTA reduces the rate from 15%), the transaction would be regarded as subject to tax and the limitation in section 23M would not apply in terms of section 23M(2). The proviso to section 23M(2) was added to ensure that when a resident debtor makes an interest payment and the WTI rate is reduced or the interest income is not included in the creditors income, only a portion of the interest expense deduction will be considered to be subject to tax in terms of the newly promulgated section 23M. The remainder will be not subject to tax and section 23M will be applied. The example provided in the 2021 Explanatory Memorandum explains the amendment as follows:

“if a resident debtor pays R100 of interest to a non-resident creditor (which is in a controlling relationship with the debtor), and the relevant treaty reduces the WHT rate to 5 per cent, the debtor can fully deduct 5/15^{ths} of the interest expense and the remaining interest amount will be subject to the section 23M limitation. In this example, the amount subject to section 23M would be $(15-5)/15 \times 100$, which equals R66.67”.²³⁵

²³³ National Treasury op cite note 225 at 20

²³⁴ National Treasury op cit note 225 at 19

²³⁵ National Treasury ‘Explanatory Memorandum on the Taxation Laws Amendment Bill 2021 (25 January 2021)’ <https://www.sars.gov.za/wp-content/uploads/Legal/ExplMemo/LPrep-EM-2021-01-Explanatory-Memoradum-to-2021-Taxation-Laws-Amendment-Bill-25-January-2022.pdf>, accessed 4 February 2022. Page 20

The R66.67 will therefore be subject to the benchmark fixed ratio rule. This clearly indicates that there is no longer an incentive for entities to route their interest payments via countries with DTA's with South Africa that apply low WTI rates.²³⁶ It also clearly indicates that Government considers it to be equitable for the interest limitation legislation not to apply regardless of how the interest income is taxed in the recipients hands i.e corporate tax or WTI.²³⁷ To reiterate the workings from this example, at least 5/15^{ths} of the interest expense is deductible, while the rest is subject to the section 23M limitation. The only other requirement necessary for section 23M to apply (under the newly promulgated law) is that a controlling relationship exist between the debtor and the creditor.

4.2.3 Controlling relationship

The 'controlling relationship' definition was amended to ensure connected persons are referenced. The premise of a 'controlling relationship' remains the same as discussed in chapter two, in that there must be an exercise of control by the parent company over its South African subsidiary, where such a parent holds at least 50% of the equity shares or 50% of the voting rights in the subsidiary. Based on this relationship of control, any excessive interest deduction will be limited by the updated limitation formula.

4.2.4 Who the new interest limitation rules should apply to

The Discussion Paper produced by National Treasury recommends that the new interest limitation rules should apply to all entities "operating in South Africa that form part of a foreign or South African multinational group".²³⁸ This indicates that the intention of that the net interest expense paid by a South African company forming part of a multinational group would be subject to the new interest limitation rules.²³⁹ A 'group' is defined by the OECD in the Country-by-Country Report (CbCR) Standard for Multinational Enterprises as:

"The term "Group" means a collection of enterprises related through ownership

²³⁶ National Treasury op cit note 235 at 18

²³⁷ National Treasury op cit note 235 at 21

²³⁸ National Treasury op cit note 16 at 45

²³⁹ Ibid.

or control such that it is either required to prepare Consolidated Financial Statements for financial reporting purposes under applicable accounting principles or would be so required if equity interests in any of the enterprises were traded on a public securities exchange.”²⁴⁰

Although South Africa does not use this term for a ‘group’ in section 23M, the section mimics this definition, to some extent, in the newly promulgated legislation with the update effected to the controlling relationship definition. As indicated above, the update now refers to connected persons with a 50% interest.

Using this definition and ensuring the interest limitation rules apply to the multinational groups in South Africa, ensures that the amended interest limitation rules target the economic activity where the debt is used and the attempt of such a multinational to reduce its tax liability.²⁴¹

4.2.5 The measure of economic activity

Earnings

The Discussion Paper proposed that earnings should be used for the purpose of measuring economic activity.²⁴² Earnings is essentially referring to a tax EBITDA number which is calculated as the sum of “taxable income, net interest expense and deductions in respect of capital assets”.²⁴³ The newly promulgated law makes reference to a slightly amendment to ‘adjusted taxable income’. Based on how tax EBITDA is calculated, as prescribed by the OECD, and how adjusted taxable income is currently calculated, these two concepts are essentially the same, albeit referred to using different names. As indicated, adjusted taxable income has not been vastly amended from its current version and will remain as it is currently reflected in the Act. The only change brought into the definition of adjusted taxable income is the inclusion of a qualifying distribution as per section 25BB.

²⁴⁰ South African Revenue Services, Government Gazette No. 40516 23 December 2016, https://www.gov.za/sites/default/files/gcis_document/201612/40516rg10677gon1598.pdf, accessed on 14 January 2022.

²⁴¹ National Treasury op cit note 16 at 45

²⁴² National Treasury op cit note 16 at 46

²⁴³ Ibid.

Fixed ratio rule

The Government considered the corridor of 10% to 30% as the limit to the fixed ratio rule.²⁴⁴ It was proposed that the ratio be set at 30%, given that at this rate, “many taxpayers with positive “tax EBITDA” will be able to deduct all of their net interest expense in the year of incurral” where there is a controlling relationship.²⁴⁵ Therefore, section 23M has been amended to include the fixed ratio rule with a limit set 30%.²⁴⁶ This ensures that South Africa is reasonably equipped to tackle a BEPS risk.

The new fixed ratio rule provided for in section 23M(3) states that the amount of interest a taxpayer is allowed to deduct in respect of all connected party debts (all debts as provided for in section 23M(2)) must not exceed the sum of interest received by or accrued to the debtor and an amount determined by multiplying adjusted taxable income for the debtor by 30%.²⁴⁷ This is further reduced by an amount of interest incurred by the debtor in respect of any other debts which exceeds any amount not allowed to be deducted in terms of section 23N.²⁴⁸ The amendment to section 23M will thus not also replace section 23N, which will remain in place as a further anti-avoidance measure.

The changes to the fixed ratio rule (ie the deduction formula), is that interest expenses will be limited to 30% of adjusted taxable income as opposed to the current calculated percentage of adjusted taxable income.²⁴⁹ This provides a better strategy to address BEPS and is not dependant on the national repo rate, which is how the formula is currently laid out (refer to discussion in chapter two). Inevitably, given the change to the deduction formula, the reference to average repo rate and repo rate is deleted from the formula.²⁵⁰ These changes are also affected in section 23N.

²⁴⁴ National Treasury op cit note 16 at 46

²⁴⁵ Ibid.

²⁴⁶ National Treasury ‘Taxation Laws Amendment Bill B22B - 2021’ <https://www.sars.gov.za/wp-content/uploads/Legal/Bills/LPrep-Bills-2021-02b-Taxation-Laws-Amendment-Bill-B22B-2021.pdf>, accessed on 15 January 2022. Page 15.

²⁴⁷ Ibid.

²⁴⁸ Ibid.

²⁴⁹ National Treasury op cit note 225 at 21

²⁵⁰ Ibid.

To the extent that a taxpayer is not able to fully deduct its net interest expense after the application of the deduction formula, the excess may be carried forward indefinitely. This carry forward is currently provided for in section 23M and no further amendment was made.

In the 2021 Draft Explanatory Memorandum to the TCAA, National Treasury indicates it considered imposing a restriction on the carry forward of any excess, however decided against this as it would be too stringent if taken together with the proposed restriction on the offset of assessed losses.²⁵¹ ²⁵² There is no further commentary on this, apart from the fact that National Treasury will review the absence of the carry forward restriction in five years.²⁵³ There is also an acknowledgement, that if net interest expense deductions are excessive and there is an indefinite carry forward of excess net interest, this would defeat the purpose of the introducing the updated interest limitation policy because taxpayers would enter into loan agreements with the purpose of claiming an excessive interest deduction and would build up a considerable balance of excess net interest.²⁵⁴

This would also mean that entities are, in the long term, allowed a deduction for interest which is considered as excessive. Albeit that this contradiction may exist, National Treasury also recognises that different businesses operate differently, and such business may be worse off should a restriction be imposed owing to the timeframes between investing and yielding profits. In contrast, it was proposed in the Discussion Paper that the carry forward be “limited to 5 years on an annual FIFO basis, which is deemed to be a fair period for enabling smoothing of earnings”.²⁵⁵ As indicated, this proposal however, was not implemented on inspection of the newly promulgated law.

²⁵¹ In the 2020 Budget speech the Minister of Finance proposed a restriction on the offset of the balance of assessed losses carried forward to 80 per cent of taxable income which should assist with the broadening of the tax base. The restriction on the offset of assessed losses is not yet instituted and will be implemented in respect of years of assessments commencing on or after 1 April 2022.

²⁵² National Treasury op cit note 225 at 19

²⁵³ Ibid.

²⁵⁴ Ibid.

²⁵⁵ National Treasury op cit note 13 at 46

4.3 Comparison with international bodies

4.3.1 The OECD

The BEPS Project significantly impacted the need in South Africa to revisit its interest limitation rules in an attempt to achieve a set of best practice principles. Action Plan 4 has encouraged Government to strengthen the rules dealing with interest limitation deductions in respect of debts owed to persons not subject to tax. While the majority of the guidance provided by Action Plan 4 was introduced by South Africa and promulgated as such, not all of the suggestions have been implemented.

Action Plan 4 recommends that the best approach for preventing BEPS relating to interest deductions is to ensure that the interest limitation rules apply to all forms of debt and other payments equivalent to interest. Based on the promulgated law, 'interest' as defined in section 23M was amended to include other forms of financial payments which is economically equivalent to interest.

A BEPS risk is more likely to occur in a situation involving a multinational group. The controlling relationship definition was amended in section 23M to bring in connected persons. This connected person definition extends itself to all groups. By virtue of having the controlling relationship definition in the section (pre and post new interest limitation rules, but now expanded) it's clear that the section would apply to most groups where control is exercised by the parent company which results in excessive interest deductions. This control is where there is a connected person relationship and the company directly or indirectly hold at least 50 per cent of the equity shares or can exercise at least 50 per cent of the voting rights or participation rights, in the subsidiary company. Furthermore, unlike the suggestion in Action Plan 4, the updated rules do not introduce a *De minimis*²⁵⁶ threshold and therefore these rules would apply to all entities should the specific requirements be met.

The recommendation by Action Plan 4 is that 'earnings' is the most appropriate measure of economic activity that reflects the activity that produced taxable income. More specifically, earnings is defined as EBITDA. Section 23M does not refer to EBITDA, however, the section refers to the concept of 'adjusted taxable income' which is essentially the same as tax EBITDA. The newly promulgated section 23M reflects an update to the adjusted taxable income definition, however the amendment to this

²⁵⁶ Action Plan 4 acknowledges certain entities may pose an immaterial BEPS risks and therefore should be excluded from the fixed ratio and group ratio rule

definition does not change the concept, which indicates the similarity between it and EBITDA.

The cornerstone of the best practice approach is rooted in the 'fixed ratio rule'. It is this ratio that ensures profits are subject to tax after deducting an interest expense up to a proportion of EBITDA. Action Plan 4 suggests this fixed ratio rule is a relatively simple formula for entities to apply and for tax authorities to audit. The level at which this fixed ratio is set plays an important role in redressing BEPS. The recommendation made by Action Plan 4 is that countries should set its benchmark fixed ratio rule within a corridor of 10% to 30% as a best practice approach to circumventing BEPS. This OECD suggestion has now been fully adopted by South Africa and implemented as such in section 23M(3). The fixed ratio limitation formula, which limits the interest expense incurred on connected party debt, provides that an interest deduction cannot exceed the sum of interest received by or accrued to the debtor and an amount of adjusted taxable income multiplied by 30%. Any excess interest expense remaining after the application of the formula will disallowed in the current year and may be carried forward to the future.

Action Plan 4 also suggests a 'group ratio rule' which makes provision for the situation where groups in different sectors may be more highly leveraged than others and require higher interest expense deductions. The fixed ratio rule does not take this risk into account. This group ratio rules allows a deduction by an entity that exceeds the fixed ratio rule to "deduct net interest expense up to the group's third party (external borrowing) net interest to EBITDA ratio".²⁵⁷ It is clear that this group ratio rule is premised on group third party debt. The group ratio has not been introduced in South Africa, and the reason for the rejection of this suggestion is not clear. However, barring the complexity involved with administering the group ratio rule (specifically obtaining the necessary information), in the third chapter its noted that there is a contention around the verification of information related to the group ratio rule where specific information relating to the group ratio rule is held outside a specific country (ie outside South Africa). In order to carry out such verification sufficient information would be required. Therefore, it could be assumed that the reason for the rejection of the group ratio rule, for South Africa, is that it may not always be practical to carry out such a verification exercise. The Discussion Paper alluded to the situation where the new

²⁵⁷ National Treasury op cit note 16 at 18

interest limitation rules would apply to total net interest expense, however as legislation currently stands, this is not the case.

Lastly, Action Plan 4 acknowledges that BEPS will be circumvented where its fixed ratio rule is applicable to total net interest expense.

Based on the above discussion, it is clear that the South African legislator has considered all the recommendations made by the BEPS Project in relation to Action Plan 4 when implementing the updated section 23M provisions. The direction taken, by, to a large extent, following the OECD Suggested Approach, will thus assist South Africa as a developing nation to better protect the tax base. Barring the fact that the fixed ratio rule is only applied to connected person debt and the optional group ratio rule was not applied, all other recommendations made by Action Plan 4 have been implemented and brought into law by the newly introduced section 23M. The reason the fixed ratio rule is applied to connected party debt only, is as a consequence of the suggestion made by ATAF (see discussion below), which is designed to assist developing nations.

4.3.2 The ATAF

As indicated in chapter three, ATAF aims to provide African nations with support to improve their tax systems and assist both the taxpayer and tax authorities with efficiencies related to tax administration. It is therefore particularly important for South Africa, being a developing African nation, to consider the work performed by ATAF given that the organisation specifically considers the tax landscape of its member countries (South Africa being an ATAF member country). The recommendations by ATAF's Suggested Approach have also largely been adopted by South Africa with the newly updated section 23M.

The Suggested Approach provides that interest should be widely defined to include interest on all forms of debt, other financial payments and costs incurred with raising finance. This definition is applicable to both connected person and third-party debt. However, ATAF also provides countries with the option of restricting its best practice approach (which would include the interest definition) to only connected persons. In Annexure D it can be seen that ATAF includes some optional wording, related to connected party debt only. Interest as defined in the newly promulgated section 23M was updated to include a wide array of other forms of the cost of debt and financial payments economically equivalent to interest. The new section 23M is however only

applicable to connected party debt and while the optional wording provided by ATAF was not explicitly included in the section, the section will only apply where there is a controlling relationship between the parent entity and subsidiary entity.

A BEPS risk more likely to occur in a multinational group is where the controlling parent entity is absolved from tax on the interest receipt arising from providing debt funding and the subsidiary entity is entitled to interest deduction. The wording provided in ATAF's Suggested Approach is specifically phrased to tackle this type of BEPS in multinational groups.²⁵⁸ The update to the controlling relationship, which speaks to the connected person definition, lends itself to the understanding that section 23M is applicable to a multinational group *and* a local 'group' where the recipient entity is not subject to full tax. The reason why the legislation refers to the parent entity (be it local or offshore) not being subject to tax, is because without this requirement the non-discrimination clause in the DTA would apply.

Depending upon whether a country decides to introduce a fixed ratio rule or combines such fixed ratio rule with the group ratio rule, the measure of economic activity is either tax EBITDA or EBITDA. The definitions of these concepts are included in Annexures D and E. Section 23M includes a definition for adjusted taxable income which is essentially the same concept as tax EBITDA.

The newly updated section 23M provides for a fixed ratio rule set at a limit of 30% of adjusted taxable income. Based on the understanding that ATAF suggested a corridor limit of 10% to 30% of tax EBITDA, South Africa has introduced the fixed ratio rule recommended. Insofar as the three options provided for the fixed ratio rule, as per the discussion above, South Africa elected option 1, where net interest expense in excess of the fixed ratio will be disallowed. South Africa had disregarded the group ratio rule and therefore the newly promulgated section 23M contains no reference to a group ratio rule.

Based on the above discussion, all of the recommendations provided by ATAF have been brought into section 23M, barring the group ratio rule. In certain aspects ATAF includes optional wording which countries are at liberty to include or exclude as they deem fit. Based on the fact that section 23M is only applicable in situations where there is a 'controlling relationship' between parent and subsidiary entity, the optional wording

²⁵⁸ African Tax Administration Forum op cit note 3 at 6

provided by ATAF (in Annexure D) which suggests the interest deductibility legislation may be applied to connected person debt only was indirectly included in section 23M.

4.3.3 The IMF

The IMF suggests two manners in which BEPS can be prevented, namely; (i) the introduction of an ACE and (ii) partial denial of interest deductions for entities, ie TCR.

ACE

Based on the review of section 23M, this suggestion (ACE) was not taken into account nor introduced. The updated section reflects a fixed ratio rule limitation applicable to connected party debt, where such ratio is limited at 30%. The current section 23M is not similar to this suggestion by the IMF nor has aspects of this suggestion been implemented.

TCR

South Africa previously had a TCR system in place as part of its transfer pricing regime, which relied on a 3:1 debt to equity ratio which denied interest deductibility beyond that ratio level. This TCR system was however amended to a more facts and circumstance approach to align to the international transfer pricing standards. The IMF suggests that the TCR would need be applicable to both connected person and third-party debt in order for it to be effective. It would be largely counterintuitive for South Africa to go back to introducing a TCR system especially given that policymakers are aware of the pitfalls of this system (see discussion in chapter two). Section 23M is thus based on a different concept to the TCR, being rather based on earnings as a representation of economic activity, and also is only applicable to connected party debt.

While the IMF suggests that certain limitations may be put in place to curb BEPS, none of the recommendations were introduced when considering the newly promulgated section 23M. As mentioned in chapter three, the TCR is considered a 'safe harbour' and given the issues noted, this would explain why SARS does not consider safe harbours effective as they do not provide good protection to the tax base.

4.4 Summary remarks

As mentioned in chapter three, there are a few shortcomings with section 23M as it currently stands and the aim with the overhaul of this section is to address these. Based on this chapter three discussion, it is clear that the overhaul of section 23M has taken into account a few of the recommendations by these international bodies (specifically the

OECD and ATAF), however even after this update, a few of the shortcomings have not been addressed:

- (i) The section is still only applicable to connected party debt and ignores debt arrangements entered into with third parties.
- (ii) There is still no clarity regarding the time limitation of the carry forward of unused interest capacity, and as the newly promulgated legislation currently stands, this carry forward may be indefinitely. As previously mentioned, this is counterintuitive to the section aims to achieve.

4.5 Illustrative example

The facts for the following illustrative example were taken from “Notes on South African Income Tax by Phillip Haupt 2015”. The example is slightly amended and is used to portray the difference between the previous section 23M limitation and the newly promulgated section. The purpose of the example is to understand whether the new limitation formula is more effective in curbing BEPS.

Example

Hen (Pty) Ltd borrowed EUR 4million from its foreign parent company Zen AG on 1 June 2022. Hen pays interest at 6% per annum on the loan. The loan was used to acquire commercial property, on which Hen earns rental income. For the 2022 year of assessment Hen incurred of R 3million (after being translated to Rands). The average repo rate for the year is 6%.

Hen (Pty) Ltd has the following statement for the 2022 year of assessment:

Taxable income (already determined taking adjustments below adjustments in account)	712,000
Interest on overdraft to fund running costs	(200,000)
Interest earned on bank deposit	30,000
Section 8(4)(a) recoupment - sale of equipment	70,000
Capital gain on sale	40,000
Section 11(e) - wear and tear	(60,000)
Interest on Zen loan	(3,000,000)
Assessed loss brought forward	(110,000)
Loss made on different trade by Hen	(50,000)

No withholding tax was levied on the interest on Zen loan because Zen AG is tax -resident in Austria, and the DTA between South Africa and Austria prevents South Africans from tax the interest.

Source: Notes on South African Income Tax by Phillip Haupt 2015

A. Determining the section 23M limitation before amendments

Analysis by Phillip Haupt:

<u>Adjusted Taxable Income</u>		
	Taxable income	712,000
Less	Interest income	(30,000)
	Recoupments	(70,000)
Add	Interest expense on loan	3,000,000
	Interest expense on overdraft	200,000
	Capital allowance	60,000
	Assessed loss and balance of assessed loss	160,000
	Adjusted taxable income	4,032,000

Section 23M limitation

	Interest received	30,000
Add	A' % of adjusted taxable income	
	A = B x C/D	
	A = 40 x (6+4)/10 = 40%	
	40% of 4,032,000	1,612,800
Less	Other (non-section 23M debts) interest expense	(200,000)
	Deductible loan interest amount	1,442,800

Amount disallowed

	Connected party Interest expense on loan	3,000,000
Less	Deductible loan interest amount	(1,442,800)
	Portion of disallowed interest on loan	1,557,200

B. Determining the section 23M limitation after amendments**My analysis:****Section 23M limitation**

	Interest received	30,000
Add	30% of adjusted taxable income	
	30% of 4,032,000	1,209,600
Less	Other (non-section 23M debts y) interest expense	(200,000)
	Deductible loan interest amount	1,039,600

Amount disallowed

	Interest expense on connected party loan	3,000,000
	Deductible loan interest amount	(1,039,600)
	Portion of disallowed interest on loan	1,960,400

My analysis continued

The newly promulgated section 23M will be introduced for years of assessment commencing on or after 1 April 2022 only if the Minister reduces the tax rate (this outcome will be public on 23 February 2022).

Is section 23M applicable?

Section 23M can only be applied where the (i) creditor is a person not subject to tax; and (ii) the debtor and creditor is in a controlling relationship. The section is applicable due to the following:

- (i) Zen AG is the creditor in this instance, domiciled in Austria. Based on the facts provided Zen AG is not subject to WTI given the DTA application between South Africa and Austria. If such DTA had merely reduced the rate of WTI, the current section 23M would not be applied since Zen AG would be subject to tax under the pre-promulgated section 23M. The amendment to the proviso of section 23M(2) now states that although the DTA reduced the WTI rate to a rate higher than zero, the section still applies to the proportion of the interest representing the reduction in the rate over 15%.
- (ii) Zen AG and Hen (Pty) Ltd is in a controlling relationship because these two entities are connected persons.

Review of example A (pre section 23M amendments) and example B (post section 23M amendments)

- (i) Taxable income of R 712 000, as provided in the facts, is calculated by taking all of the adjustments in the table above into account. The capital gain on sale is calculated using an inclusion rate of 80% even though the example above is from 2015, when the inclusion rate was 66.6%. This taxable income is necessary to calculate adjusted taxable income.
- (ii) This adjusted taxable income is the equivalent to 'tax EBITDA' as mentioned in the earlier sections of this chapter. The amount for adjusted taxable income of R 4 032 000 remains the same under both example A and B.
- (iii) Based on inspection of the workings under example A above, the percentage for 'A' to be determined is highly dependent on the repo rate. This said, the repo rate will determine ultimate amount of deductible interest. The varying repo rate will ensure the value for 'A' increases or decreases, which impacts the overall portion of interest disallowed.
- (iv) There was an acknowledgment by Government that the 40% 'B' value was too high and therefore ineffective in curbing BEPS since the limitation renders a greater amount of interest as deductible. There was also an acknowledgment that the 40% limitation would be reviewed, and this was carried out given the 2020 Discussion Paper and then, inevitably, after the review, the promulgation of the new section 23M.
- (v) Under example B there is no reliance placed on the repo rate to determine the deductible loan interest amount (R 1 039 600). A flat rate of 30% is used which is within the corridor of 10% to 30% as prescribed by the OECD's Action Plan 4 and ATAF (refer to chapter three).

- (vi) On comparison of example A and B above it is evident that the flat rate of 30% is not only easier to apply but it also renders a lower interest deductible amount, being R1 442 800 compared to R1 039 600 in the example, respectively. A lower interest deductible amount means a larger portion of disallowed interest on the Zen AG loan. Based on the numbers above, the amount not deductible under example B (R1 960 440) is larger compared to example A (R1 557 200). Since the amount disallowed is greater, this indicates that the new section 23M is more effective as a BEPS anti-avoidance provision.
- (vii) This result indicates that the new section 23M would better assist with the prevention of BEPS and protection offered to the fiscus. It also provides clarity to the question regarding whether the 30% limitation will be more effective than the current interest limitation formula.

4.6 Conclusion

The introduction of the amendments to section 23M thus increases the protection of the tax base insofar as the payment of interest to connected non-resident group companies is concerned (refer to above illustrative example). The newly promulgated section 23M, takes into account the pertinent suggestions made by the OECD and ATAF. The section incorporates provisions which are effective in addressing BEPS. This implementation also ensures that South Africa's tax landscape may be compared to other more developed nations.

While the suggestions of two of the international organisations were relatively adopted, the suggestions of the IMF were not applied at all. This is not to say that the suggestions were not important but rather that they do not align to the required outcome South Africa wants to achieve. South Africa has taken its own approach to the suggestions provided by the OECD and ATAF in an attempt to curb BEPS. While most of the OECD/ATAF suggestions were implemented, as discussed above, they weren't all implemented and therefore the section is not overly restrictive. The adoption of some of the recommendations by OECD and ATAF also ensures South Africa maintains its competitive edge.²⁵⁹ Based on the numerical data above (point 4.5), the newly introduced fixed ratio rule, serves its purpose of allowing a smaller and more accurate interest deduction for connected party debt in its attempt to curtail BEPS. Further, while the OECD and ATAF looks at the concept of 'subject to tax' in the context of a low taxing jurisdiction (referring to the recipient receiving interest income), South Africa takes a different approach, in that

²⁵⁹ National Treasury op cit note 13 at 6

it doesn't look at the recipient country as long as there is enough tax (at least 15%) paid here. The update to section 23M(2) ensures that the issue of subject to tax is no longer a flaw, given that the section will apply even if the DTA reduces the WTI rate (to a rate lower than the standard rate) and the interest income is not included in the recipients income.

5. Chapter Five: Conclusion

This dissertation sought to answer the research question: will the restriction on deductibility of interest on connected party debt, which is proposed for South Africa to be at 30% of earnings, align with international best practice?

The transfer pricing rules, WTI and the current section 23M were all introduced with the intention of assisting with the curtailing BEPS pertaining to interest deductions in South Africa. However, even though these tax provisions may be used in combination, it appears that they are not serving their purpose adequately. This motivated policymakers to revisit their strategy around interest deductibility legislation. This issue, related specifically to section 23M, is largely highlighted in chapter one. Section 23M is the anti-avoidance section aimed at limiting the interest deductions in respect of debts owed to persons not subject to tax in South Africa. However, as this section currently stands, excessive interest deductions are still prevalent, which results in considerable losses to the fiscus.

The second chapter of this dissertation analyses section 23M and its specific requirements. The analysis finds that the section will only apply where a controlling relationship exists between a debtor and creditor and such a creditor provides financing to the debtor and the creditor is not subject to tax in South Africa. Where these requirements are met, the deduction limitation formula in section 23M is triggered and restricts interest expense on the connected party debt up to 40% of adjusted taxable income. In an attempt to simplify these rules and provide better tax base protection, certain changes to the interest deductibility rules were proposed by the Minister of Finance. This prompted the Government to produce a Discussion Document depicting its review of excessive debt arrangements and how an update of section 23M may assist with redressing BEPS.

In putting this Discussion Document together, National Treasury relied on the insights and work performed by the OECD with its BEPS Initiative, ATAF's Suggested Approach to drafting interest deductibility legislation and IMF commentary. The insights sought from these international bodies assisted policymakers in South Africa to improve their strategy around interest deductions and provided a foundation for improvement. Based on the analysis of the work performed by these bodies, the OECD and ATAF are aligned in that the best manner in which to curb BEPS is to introduce a benchmark fixed ratio rule limited within a corridor of 10% to 30% of tax EBITDA and such a best practice approach should apply to both connected party and third-party debt. Based on the work performed by the OECD, where the ratio is set between 10% and 30% of tax EBITDA the risk of BEPS is neutralised, and the tax base is

reasonably protected. Where a ratio is set below or above this corridor, such a situation would create a BEPS risk or be too restrictive to companies.

Further, these bodies indicated that interest related to the targeted financing arrangements should also be widely defined. ATAF goes as far as providing suggestions to countries on how to draft its interest deductibility legislation.

The IMF suggested the introduction of an ACE or TCR system, which were rejected based on the fact that the legislature considered the OECD/ATAF suggestions more appropriate for South Africa, particularly since SARS is not overly keen on safe harbours due to the fact that they are open to abuse. With the review of the work performed by these organisations, the shortcomings of the current section 23M became prevalent. These included; the fact that the section only applies to connected person debt and there is no certainty regarding the time limitation of the carry forward of unused interest capacity.

The objective of this dissertation has been to assess whether the interest deductibility legislation prescribed in the newly promulgated section 23M would conform to international best practice rules. These best practice rules laid out by the three international bodies, mentioned above, were reviewed. Policymakers in South Africa adopted most the recommendations by the OECD and ATAF. These include the fact that the interest limitation formula is limited to 30% of adjusted taxable income and the formula is no longer dependant on the repo rate. Interest as defined in section 23M has a wider scope to include other financial payments economically equivalent to interest. The section has also been refined to ensure that it captures the intended interest expenses ie interest that is not subject to tax in the non-resident's hands at at least 15%. This detailed analysis was performed in chapter four. Based on the illustrative example in discussion point 4.5, it is a clear that the updated rules increase the chance of restricting BEPS in South Africa. The example shows that the amended rules result in a greater portion of the interest expense being rendered non-deductible. The update to the formula itself is indicative of its effectiveness and proves an increase in protection to the tax base.

Finally, based the analysis performed in this dissertation indicates that, given that the recommendations provided by the OECD and ATAF have been introduced by South Africa, the newly promulgated section 23M, which restricts interest deductibility on connected party debt, at 30% of earnings, does in fact align with international best practice. Further, while there is a degree of international conformity by South Africa, certain shortcomings still exist and section 23M will mostly undergo another overhaul.

5.1 Areas for future research

The items of contention which have not yet been addressed with the amendments to section 23M, which may be subject to future research include:

- (i) The section is still only applicable to connected party debt and ignores debt arrangements entered into with third parties. The question of whether South Africa should implement the section to connected party and third-party debt requires further research.
- (ii) There is still no clarity regarding the extent of the timing of the carry forward of unused interest capacity, and as the newly promulgated legislation currently stands, this carry forward may be indefinitely. The question that requires further research is whether the indefinite carry forward of the unused capacity is the right approach or should there be a limit issued on such a carry forward of unused interest capacity for South Africa.

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7. Annexures

Annexure A – Current section 23M of the Act

Section 23M. Limitation of interest deductions in respect of debts owed to persons not subject to tax

(1) For the purposes of this section—

“adjusted taxable income” means taxable income calculated before applying this section—

(a) reduced by—

- (i) any amount of interest received or accrued that forms part of taxable income;
- (ii) any amount included in the income of a person as contemplated in section 9D (2);
- (iii) any amount recovered or recouped in respect of an allowance contemplated in this Act in respect of a capital asset as defined in section 19; and

(b) with the addition of—

- (i) any amount of interest incurred that has been allowed as a deduction from income
- (ii) any amount allowed as a deduction in terms of this Act in respect of a capital asset as defined in section 19 for purposes other than the determination of any capital gain or capital loss; and
- (iii) any assessed loss or balance of assessed loss allowed to be set off against income in terms of section 20;

“average repo rate” in relation to a year of assessment means the average of all ruling repo rates determined by using the daily repo rates during that year of assessment;

“controlling relationship” means a relationship where a person directly or indirectly holds at least 50 per cent of the equity shares in a company or at least 50 per cent of the voting rights in a company is exercisable by a person;

“debtor” means a debtor who is—

- (a) a person that is a resident; or
- (b) any other person who is not a resident that has a permanent establishment in the Republic in respect of any debt claim that is effectively connected with that permanent establishment;

“interest” means interest as defined in section 24J;

“lending institution” means a foreign bank which is comparable to a bank contemplated in the Banks Act;

“repo rate” means the interest rate at which the South African Reserve Bank enters into a repurchase agreement contemplated in section 10 (1) (j) of the South African Reserve Bank Act

- (2) Where an amount of interest is incurred by a debtor during a year of assessment in respect of a debt owed to—
 - (a) a creditor that is in a controlling relationship with that debtor; or
 - (b) a creditor that is not in a controlling relationship with that debtor, if that creditor obtained the funding for the debt advanced to the debtor from a person that is in a controlling relationship with that debtor,and the amount of interest so incurred is not during that year of assessment—
 - (i) (aa) subject to tax in the hands of the person to which the interest accrues; or (bb) included in the net income of a controlled foreign company as contemplated in section 9D in the foreign tax year of the controlled foreign company commencing or ending within that year of assessment; and
 - (ii) disallowed under section 23N,the amount of interest allowed to be deducted may not exceed the amount determined in accordance with subsection (3).
- (3) The amount of interest allowed to be deducted in respect of all debts owed as contemplated in subsection (2), in respect of any year of assessment must not exceed the sum of—
 - (a) the amount of interest received by or accrued to the debtor; and
 - (b) an amount determined by multiplying the adjusted taxable income of that debtor for that year of assessment by a percentage to be determined in accordance with the formula—

$$A = B \times \frac{C}{D}$$

in which formula—

- (a) “A” represents the percentage to be determined;
- (b) “B” represents the number 40;
- (c) “C” represents the average repo rate plus 400 basis points; and
- (d) “D” represents the number 10,
but not exceeding 60 per cent of the adjusted taxable income of that debtor

reduced by so much of any amount of interest incurred by the debtor in respect of debts other than debts contemplated in subsection (2) as exceeds any amount not allowed to be deducted in terms of section 23N.

- (4) So much of any amount of interest as exceeds the amount determined in terms of subsection (3) may be carried forward to the immediately succeeding year of assessment and, subject to subsection (2), must be deemed to be an amount of interest incurred in that succeeding year of assessment.
- (5) Where an amount of interest is to be taken into account in terms of this section and in terms of section 23N, that amount of interest shall only be taken into account in terms of this section after section 23N has been applied.
- (6) This section does not apply—
 - (a) to so much of the interest as is incurred by a debtor in respect of a debt owed to a creditor as contemplated in subsection (2) where—
 - (i) that creditor funded that debt amount advanced to that debtor with funding granted by a lending institution that is not in a controlling relationship with that debtor; and
 - (ii) that interest is determined with reference to a rate of interest that does not exceed the official rate of interest plus 100 basis points.
 - (b) to any interest incurred by a debtor in respect of any linked unit that is held by a creditor as contemplated in subsection (2) where that creditor is a long-term insurer as defined in the Long-term Insurance Act, a pension fund or a provident fund, if—
 - (i) the long-term insurer, pension fund or provident fund holds at least 20 per cent of the linked units in that debtor;

- (ii) the long-term insurer, pension fund or provident fund acquired those linked units before 1 January 2013; and
- (iii) at the end of the previous year of assessment 80 per cent or more of the value of the assets of that debtor, reflected in the annual financial statements prepared in accordance with the Companies Act for the previous year of assessment, is directly or indirectly attributable to immovable property.

Annexure B – OECD's Table B1

Table B.1 Tabulations for multinational and non-multinational companies, excluding companies with negative EBITDA, 2009-2013

Percentage of companies affected by interest deduction limitation

Percent of EBITDA limit on net interest deductibility	2009		2010		2011		2012		2013	
	Non-MNC	MNC	Non-MNC	MNC	Non-MNC	MNC	Non-MNC	MNC	Non-MNC	MNC
5%	59%	56%	57%	51%	57%	52%	57%	54%	56%	53%
10%	47%	41%	44%	35%	44%	37%	45%	39%	43%	38%
15%	37%	30%	34%	25%	35%	27%	36%	29%	34%	29%
20%	29%	23%	27%	19%	28%	20%	29%	23%	28%	23%
25%	24%	18%	22%	14%	23%	16%	25%	18%	22%	18%
30%	20%	14%	17%	11%	19%	13%	20%	15%	19%	14%
35%	16%	12%	14%	9%	16%	11%	17%	12%	16%	12%
40%	13%	9%	12%	7%	13%	9%	14%	11%	13%	10%
45%	11%	8%	9%	6%	11%	7%	12%	9%	11%	8%
50%	9%	7%	8%	5%	9%	6%	11%	8%	10%	7%
55%	8%	6%	7%	4%	8%	5%	9%	7%	9%	6%
60%	7%	5%	6%	4%	7%	4%	8%	6%	7%	6%
65%	6%	5%	5%	3%	6%	4%	7%	5%	7%	5%
70%	6%	4%	5%	3%	5%	4%	6%	5%	6%	5%
75%	5%	4%	4%	3%	5%	3%	5%	5%	6%	4%
80%	5%	3%	4%	2%	5%	3%	5%	4%	5%	4%
85%	4%	3%	4%	2%	4%	3%	5%	4%	5%	4%
90%	4%	3%	3%	2%	4%	3%	4%	3%	5%	3%
95%	4%	3%	3%	2%	3%	2%	4%	3%	4%	3%
100%	3%	3%	3%	2%	3%	2%	4%	3%	4%	3%
Observations	6,472	10,911	6,675	11,372	6,631	11,165	6,547	11,015	6,523	10,908

Source: PwC calculations based on consolidated financial statement information from Standard & Poor's GlobalVantage database.
LIMITING BASE EROSION INVOLVING INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS © OECD 2015

Source: The Organisation for Economic Co-operation and Development - Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update

Annexure C – OECD's Table B2 and B3

Table B.2 Tabulations for multinational and non-multinational companies, excluding companies with negative EBITDA, average for 2009-2013

Percentage of companies affected by interest deduction limitation

Percent of EBITDA limit on net interest deductibility	Average 2009-2013	
	Non-MNC	MNC
5%	57%	53%
10%	45%	38%
15%	35%	28%
20%	28%	22%
25%	23%	17%
30%	19%	13%
35%	16%	11%
40%	13%	9%
45%	11%	8%
50%	9%	7%
55%	8%	6%
60%	7%	5%
65%	6%	4%
70%	6%	4%
75%	5%	4%
80%	5%	3%
85%	4%	3%
90%	4%	3%
95%	4%	3%
100%	3%	3%

Source: OECD Secretariat calculations based on data in Table B.1.

Table B.3 Tabulations for multinational and non-multinational companies, excluding companies with negative EBITDA, average for 2009-2013

Percentage of companies that would in principle be able to deduct an amount equivalent to their net third party interest expense

Percent of EBITDA limit on net interest deductibility	Average 2009-2013	
	Non-MNC	MNC
5%	43%	47%
10%	55%	62%
15%	65%	72%
20%	72%	78%
25%	77%	83%
30%	81%	87%
35%	84%	89%
40%	87%	91%
45%	89%	92%
50%	91%	93%
55%	92%	94%
60%	93%	95%
65%	94%	96%
70%	94%	96%
75%	95%	96%
80%	95%	97%
85%	96%	97%
90%	96%	97%
95%	96%	97%
100%	97%	97%

Source: OECD Secretariat calculations based on data in Table B.1.

Table B.2 includes the companies affected by a particular fixed ratio. Table B.3 includes the companies that in principle are not affected. Taken together, numbers from these tables for a particular ratio should add to 100%. Table B.3 assumes that net interest expense is spread around a group in accordance with EBITDA. In practice there may be barriers which prevent a group achieving this.

LIMITING BASE EROSION INVOLVING INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS © OECD 2015

Source: The Organisation for Economic Co-operation and Development - Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update

Annexure D – ATAF’s Suggested Approach

Text in red denotes optional wording.

Text in blue denotes issues where a country will need to take a policy decision

1. Interest Deductibility Legislation

Section XX

1. Notwithstanding any other provision of this Act, no deduction shall be allowed for the purpose of ascertaining the taxable profits of any company[Optional wording]: that is a member of a group of companies, except a company whose main business is banking or insurance, in respect of-

Option 1

Any amount of net interest expense in respect of any period that exceeds 10 – 30 percent of the taxable profits/tax EBITDA of the company

Option 1A

Any amount of interest in respect of any period that exceeds 10 – 30 percent of the taxable profits/ tax EBITDA if the company’s net interest expense exceeds 10 -30 percent of the taxable profits/tax EBITDA of the company

Option 1B

- a) Any amount of interest expense in respect of any period that exceeds 10 – 30percent of the taxable profits/tax EBITDA of the company
- b) For the purposes of this section net interest expense means,
 - i) The interest paid or accrued by the company during the period minus
 - ii) the amount of interest included in the taxable income of such company for that period
- c) For the purposes of sub-section (b) interest includes: interest on all forms of debt; payments economically equivalent to interest; and expenses incurred in connection with the raising of finance [Optional wording]: where the interest arises from a transaction directly or indirectly with a related person. These should include, but not be restricted to, the following:
 - i. payments under profit participating loans
 - ii. imputed interest on instruments such as convertible bonds and zero-coupon bonds
 - iii. amounts under alternative financing arrangements, such as Islamic finance
 - iv. the finance cost element of finance lease payments
 - v. capitalised interest included in the balance sheet value of a related asset, or the amortisation of capitalised interest
 - vi. amounts measured by reference to a funding return under transfer pricing rules
 - vii. where applicable notional interest amounts under derivative instruments or hedging arrangements related to an entity’s borrowings
 - viii. certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance
 - ix. guarantee fees with respect to financing arrangements
 - x. arrangement fees and similar costs related to the borrowing of funds.

- d) For the purposes of this section, tax EBITDA means the sum of:
- i. Taxable profits, and
 - ii. Net interest expense, and
 - iii. Depreciation, and
 - iv. Amortisation

Annexure E – ATAF’s Suggested Approach

Alternative Sub-section 1

Option 2

- (a) Any amount of net interest expense in respect of any period that exceeds the greater of:
- i. 10 -30 percent of the taxable profits/tax EBITDA of the company, or
 - ii. The group’s net interest ratio multiplied by the company’s tax EBITDA or EBITDA

Option 2A

- (a) Any amount of interest expense in respect of any period that exceeds the greater of sub-section(a)(i) or (ii) if the company’s net interest expense exceeds the greater of:
- i. 10 -30 percent of the taxable profits/tax EBITDA of the company, or
 - ii. The group’s net interest ratio multiplied by the company’s tax EBITDA or EBITDA

Option 2B

- (a) Any amount of interest expense in respect of any period that exceeds the greater of:
- i. 10 -30 percent of the taxable profits/tax EBITDA of the company, or
 - ii. The group’s interest ratio multiplied by the company’s tax EBITDA or EBITDA
- (b) For the purposes of sub-section (a) net interest expense means,
- i) the interest paid or accrued by the company during the period, minus
 - ii) the amount of interest included in the taxable income of such company for that period.
- (c) Interest includes: interest on all forms of debt; payments economically equivalent to interest; and expenses incurred in connection with the raising of finance [Optional wording]: where the interest arises from a transaction directly or indirectly with a related person. These should include, but not be restricted to, the following:
- i. payments under profit participating loans
 - ii. imputed interest on instruments such as convertible bonds and zero-coupon bonds
 - iii. amounts under alternative financing arrangements, such as Islamic finance
 - iv. the finance cost element of finance lease payments
 - v. capitalised interest included in the balance sheet value of a related asset, or the amortisation of capitalised interest
 - vi. amounts measured by reference to a funding return under transfer pricing rules
 - vii. where applicable notional interest amounts under derivative instruments or hedging
 - viii. certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance
 - ix. guarantee fees with respect to financing arrangements
 - x. arrangement fees and similar costs related to the borrowing of funds.
- (d) For the purposes of this section, tax EBITDA means the sum of:
- i. Taxable profits, and

- ii. Net interest expense, and
 - iii. Depreciation, and
 - iv. Amortisation
- (e) For the purposes of this section EBITDA means the sum of;
- i. Net profit before tax, and
 - ii. Net interest expense, and
 - iii. Depreciation, and
 - iv. Amortisation
- (f) For the purposes of Section XX, a group of companies means:
- i. The company's ultimate parent company, and all companies that are fully consolidated in the parent's consolidated financial statements, or
 - ii. Where the company is itself the ultimate parent company, all companies that are fully consolidated in that company's consolidated financial statements.
 - iii. Where consolidated financial statements are not prepared, any two companies, where one controls the other, or
 - iv. Where consolidated financial statements are not prepared, all companies that are under common control of another company or individual, group of individuals, including family members of such individuals or a partnership
 - v. This section shall apply also in respect of interest expense incurred in respect of a loan made to a company directly or indirectly from a shareholder who is an individual, or a partner or a family member of that individual.
- (g) For the purposes of this section:
- i. Group net interest means the total third-party net interest expense of the group of companies to which the company belongs.
 - ii. Group net interest ratio means the group net interest divided by the total EBITDA of the group of companies to which the company belongs.
- (h) For the purposes of subsection (g) above net interest expense means:
- i) the interest paid or accrued by the group during the period, minus
 - ii) the amount of interest received or receivable by the group for that period

Additional optional provisions:

- (i) This section shall not apply to a company that is a member of a group of companies composed solely of companies resident in [COUNTRY] OR
- (j) This section shall not apply to a company that is a member of a group of companies composed solely of companies resident in [COUNTRY] and none of the companies are subject to any of the following Parts or Sections of the Income Tax Acts [*Country to add relevant parts or sections*]

- (k) In cases where interest is paid or payable directly or indirectly to a person resident outside [COUNTRY] in a jurisdiction considered by the Commissioner-General/Commissioner to provide a taxable benefit in relation to that interest no deduction shall be made in respect of that interest and such interest shall not be included for the purposes of sub-section (b)(i).
- (l) Where under section XX (K) no deduction is made in respect of an amount of interest and foreign tax is payable by the recipient in relation to that interest of an amount that is calculated by reference to that interest then the taxable income of the company shall be reduced by the amount of that foreign tax.
- (m) This section shall not apply to a company if the total net interest expense incurred by members of the group of companies that are resident in [COUNTRY] is less than US\$XXX, unless that total net interest expense is paid directly or indirectly to a person resident outside [COUNTRY] in a jurisdiction considered by the Commissioner-General/Commissioner to provide a taxable benefit in relation to that interest
- (n) Interest for which a deduction is denied under this section may be carried forward and treated as incurred during the next taxable period. Interest so denied may be carried forward for no more than X years. **This sub-section shall not apply in respect of interest denied under sub-section (k) above [delete if not applying sub-section (k)].**

Annexure F – Newly promulgated section 23 provided in Government Gazette No.45787 dated 19 January 2022

1) Section 23M of the Income Tax Act, 1962, is hereby amended—

(a) by the substitution in subsection (1) for the definition of “adjusted taxable income” of the following definition:

“**adjusted taxable income**’ means taxable income calculated before applying this section—

(a) reduced by—

- (i) any amount of interest received or accrued that forms part of taxable income;
- (ii) any amount included in the income of a person as contemplated in section 9D(2);
- (iii) any amount recovered or recouped in respect of an allowance contemplated in this Act in respect of a capital asset as defined in section 19; and

(b) with the addition of—

- (i) any amount of interest incurred that has been allowed as a deduction from income;
- (ii) any amount allowed as a deduction in terms of this Act in respect of a capital asset as defined in section 19 for purposes other than the determination of any capital gain or capital loss;

[and]

- (iii) any assessed loss or balance of assessed loss allowed to be set off against income in terms of section 20, before applying this section; and
- (iv) any qualifying distribution as defined in section 25BB that is deductible under subsection (2) of that section;”;

(b) by the deletion in subsection (1) of the definition of “average repo rate”;

(c) by the substitution in subsection (1) for the definition of “controlling relationship” of the following definition:

“**controlling relationship**’ means a relationship where—

- (a) a person, whether alone or together with any one or more persons that are connected persons in relation to that person; or
- (b) persons that are connected persons in relation to that person, directly or indirectly hold at least 50 per cent of the equity shares or can

exercise at least 50 per cent of the voting rights or participation rights, in a company;”;

(d) by the insertion after the definition of “controlling relationship” of the following definition:

“**debt**’ includes any amount in respect of which interest is determined or incurred, and such amount must be regarded as owed, but does not include a tax debt as defined in section 1(1) of the Tax Administration Act;”;

(e) by the substitution for the definition of “debtor” of the following definition:

“**debtor**’ means a [debtor who is] person that incurs an amount of interest and—

(a) **[a person that]** is a resident; or

(b) **[any other person who]** in the case of a person that is not a resident **[that has a permanent establishment in the Republic in respect of any debt claim]**, owes a debt that is effectively connected with [that] a permanent establishment of that person in the Republic;”;

(f) by the substitution in subsection (1) for the definition of “interest” of the following definition:

“**interest**’ means interest as defined in section 24J, and includes—

(a) amounts incurred or accrued under any ‘interest rate agreement’ as defined in section 24K(1);

(b) any finance cost element recognised for purposes of IFRS in respect of any lease arrangement that constitutes a finance lease as defined in IFRS 16;

(c) amounts taken into account in determining taxable income in terms of section 24I(3) and (10A); and

(d) any amount deemed to be interest under section 24JA, but excludes any amount that is deemed to be a dividend in specie as contemplated in sections 8F and 8FA;”;

(g) by the insertion in subsection (1) after the definition of “lending institution” of the following definition:

“**participation rights**’ means—

(a) the right to participate in all or part of the benefits of the rights (other than voting rights) attaching to a share, or any interest of a similar nature, in a company; or

(b) in the case where no person has any right in that company as contemplated in paragraph (a) or no such rights can be determined for any person, the right to exercise any voting rights in that company;”;

- (h) by the deletion in subsection (1) of the definition of “repo rate”;
- (i) by the deletion in subsection (2) of the word “or” at the end of paragraph (a), the substitution for the comma at the end of paragraph (b) of the expression “;” and the addition of the following paragraphs:

“(c) a creditor that is not in a controlling relationship with that debtor, if that creditor forms part of the same group of companies as that debtor if the expression ‘at least 70 per cent of the equity shares in’ in paragraphs (a) and (b) of the definition of ‘group of companies’ in section 1 were replaced by the expression ‘more than 50 per cent of the equity shares or voting rights in’; or

(d) a creditor that is in a controlling relationship with that debtor, if that creditor, directly or indirectly through another creditor that is in a controlling relationship with that creditor, obtained the funding for the debt advanced to the debtor from a person that is in a controlling relationship with that creditor or that other creditor,”;

- (j) by the substitution in subsection (2) for the words preceding subparagraph (i) of the following words:

“and the amount of interest so incurred or related interest is not during that year of assessment—”;

- (k) by the substitution in subsection (2)(i) for item (aa) of the following item:

“(aa) subject to tax in the hands of the person, creditor or other creditor referred to in paragraphs (a), (b), (c) and (d), to which the interest or related interest accrues; or”;

- (l) by the addition to subsection (2) after the words following paragraph (ii) of the following proviso:

“: Provided that where any amount of interest incurred or related interest is not included in the income of the person referred to in paragraph (i)(aa), the amount of interest to be regarded as not subject to tax as contemplated in paragraph (i)(aa) will be determined in accordance with the formula:

$$A = B \times \frac{(C-D)}{C}$$

in which formula—

- (i) ‘A’ represents the amount to be determined;
- (ii) ‘B’ represents the aggregate of any amount of interest incurred or paid in respect to which the provisions of Part IVB of this Chapter are or will be applicable;
- (iii) ‘C’ represents the number 15; and

(iv) 'D' represents the rate at which withholding tax on interest has been or will be levied on such amount of interest under the provisions of Part IVB of this Chapter, multiplied by the number 100.”;

(m) by the substitution for subsection (3) of the following subsection:

“(3) The amount of interest allowed to be deducted in respect of all debts owed as contemplated in subsection (2), in respect of any year of assessment must not exceed the sum of—

(a) the amount of interest received by or accrued to the debtor; and

(b) an amount determined by multiplying the adjusted taxable income of that debtor for that year of assessment by **[a percentage to be determined in accordance with the formula—**

$$A = B \times C/D$$

in which formula—

(a) 'A' represents the percentage to be determined;

(b) 'B' represents the number 40;

(c) 'C' represents the average repo rate plus 400 basis points;

and

(d) 'D' represents the number 10,

but not exceeding 60 per cent of the adjusted taxable income of that debtor] 0,3,

reduced by so much of any amount of interest incurred by the debtor in respect of debts other than debts contemplated in subsection (2) as exceeds any amount not allowed to be deducted in terms of section 23N.”; and

(n) by the addition after subsection (6) of the following subsection:

“(7) For purposes of this section any exchange difference deducted from the income of a person as contemplated in section 24I(3) or (10A) is deemed to have been incurred by the person.”.

2) Subsection (1) comes into operation on the date on which the rate of tax in respect of the taxable income of a company is first reduced after announcement by the Minister of Finance in the annual National Budget and applies in respect of years of assessment commencing on or after that date.