



SIEZING THE BEPS: AN ASSESSMENT OF THE EFFICACY OF SOUTH AFRICA'S THIN CAPITALISATION REGIME IN COMBATING BASE EROSION AND PROFIT SHIFTING (BEPS) THROUGH EXCESSIVE INTEREST DEDUCTIONS

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ABSTRACT

This study serves to critically assess the effectiveness of South Africa's thin capitalisation framework in dealing with Base Erosion and Profit Shifting (BEPS) through excessive interest deductions by multinational enterprises (MNEs). Given the impact of globalisation in interconnecting economic activities across multiple countries, BEPS presents a major policy concern both internationally and domestically. Thin capitalisation, a situation in which an entity utilises to their tax benefit the deductions/exemption mismatch that arises from cross-border debt financing, is one of the most common methods of BEPS utilised by MNEs.

This study aims to ascertain whether the framework is effective in dealing with thin capitalisation whilst balancing the need to attract investment and boost economic development and, to assess whether the framework is reflective of South Africa's contextual realities. It achieves this by engaging with the South Africa's legislative framework consisting of s 31 and s 23M of the Income Tax Act and the Draft Note on Thin Capitalisation and their relationship with international tax norms and standards. The study relies on the Organisation for Economic Cooperation and Development (OECD) to identify the international standards and contrasts South Africa's framework with Canada, a developed and OECD member state.

The study concludes that the framework is fraught with uncertainties and administrative difficulties that hinder its effectiveness. It also concludes that the framework's reliance on the OECD's standards is misguided and does not reflect South Africa's contextual realities. This is a stark contrast to Canada which opted for a thin capitalisation approach outside the OECD's recommendations which more reflects its context. The study thus concludes that South Africa's thin capitalisation framework is ineffective in dealing with BEPS by way of thin capitalisation.

Keywords: Globalisation; base erosion and profit shifting (BEPS); thin capitalisation; interest deductions, arm's length; South Africa.

KEY DEFINITIONS AND ACRONYMS

Term	Definition
ALR	The arm's length rule.
BEPS	Base erosion and profit shifting.
EBITDA	Earnings before interests, taxes, depreciation and amortisations.
G20	Group of Twenty, an international forum for the governments and central bank governors from the 19 top state economies and the European Union (EU).
ITA	Income Tax Act of South Africa 58 of 1962.
MNE	Multinational enterprises, also commonly known as multinational companies. These are groups of integrated companies operated worldwide through local subsidiary companies, permanent establishments and sometimes joint ventures or partnerships.
OECD	Organisation for Economic Cooperation and Development, an intergovernmental economic organisation with 36, mostly high-income member countries.
SARS	The South African Revenue Service.
UN	The United Nations, an intergovernmental organization tasked with maintaining international peace and security, developing friendly relations among nations, achieving international co-operation, and being a centre for harmonizing the actions of nations.
OECD BEPS Project	In this study's context refers to the initiatives by the OECD and G20 from 2012 which aims to set up an international framework to combat tax avoidance by MNES using BEPS tools.
Globalisation	In this study's context refers to the gradual removal of trade barriers, the increase in technological and telecommunication developments.
Safe Harbour	This refers to a provision in the tax law, regulations or guidelines stating that transactions falling within a certain range will be accepted by the tax authorities without further investigation.

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CHAPTER ONE

1.1 OVERVIEW

South Africa has not been safe from the overarching impact of globalisation. As the National Treasury observes, the biggest companies in the South African economy are foreign owned subsidiaries of major international multinational enterprises (MNE).¹ A big part of the nation's capital is therefore foreign-sourced, a position that results in foreign enterprises holding deep interests in the operation of South Africa's fiscal system. From a taxation perspective, it is this foreign vested interest that results in most of these companies adopting some aggressive tax-planning and avoidance strategies to exploit gaps in the nation's transfer pricing and thin capitalisation regimes whose success effectively results in the deprivation of much-needed revenue to the national fiscus.²

Although current trends in the international tax domain show that most countries are seized with the task of sustainably curbing these tax 'leakages' that fall under the broader base erosion and profit shifting (BEPS) phenomenon, South Africa, as the second biggest economy in Africa and an affiliate of the Organisation for Economic Cooperation and Development (OECD), is still riddled with shortcomings in its BEPS regulatory framework. This dissertation serves to critically assess the efficacy of the current South African regulatory framework through a contrasting analysis of the framework against its Canadian counterpart, a developed and OECD member country, and the OECD framework. Using the OECD BEPS Project as a reference point in the assessment, this dissertation thus goes further to evaluate the above measures' compatibility within the South African context. It is from this perspective that it arrives at the main proposition that the South African regime should strive for more certainty, clarity and contextual sensitivity.

¹ National Treasury, 'Ownership of JSE-listed companies Research Report,' (2017) National Treasury, September 2017. Available at: http://www.treasury.gov.za/comm_media/press/2017/2017100301%20Ownership%20monitor%20-%20Sept%202017.pdf Accessed on: 12 April 2018.

² A 2015 report by the OECD noted that about US \$ 100-240 billion in global corporate income tax was lost to base erosion and profit shifting activities. See OECD Final Reports, 'OECD/G20 Base Erosion and Profit Shifting Project,' (2015). Available at: <https://www.oecd.org/ctp/beps-reports-2015-information-brief.pdf> Accessed on: 15 April 2018.

1.2 OBJECTIVES

The primary objective of this study is to provide an appraisal of the effectiveness of the South African thin capitalisation regime in dealing with BEPS by way of excessive interest deductions.

1.3 KEY QUESTIONS

In its critical pursuit the research will be guided by the following key questions:

- i) Is the thin capitalisation framework, when assessed from a legal design perspective, effective in curbing the phenomenon of BEPS by MNEs?
- ii) Is the framework sufficiently sensitive to the need to promote investment and economic development in South Africa?
- iii) Does the framework reflect the contextual realities of South Africa?

1.4 JUSTIFICATION

a) Topical Relevance

As globalisation³ becomes the normative reality, South Africa as the gateway to Africa⁴ finds itself as a major host to several MNEs whose footprints include subsidiaries, branches and even headquarter establishments. Unfortunately, the increased investment comes with the associated incidences of tax avoidance by these MNEs who utilise intricate strategies to reduce their tax obligations. It is for this reason that the question of BEPS by way of manipulating cross-border intergroup transactions, mainly transfer pricing and thin capitalisation, has arisen as a prominent issue in both the international and national sphere.

In the South African context, thin capitalisation is regarded as a strategic focus area and has been the subject of various legislative drives since 2012 when its framework was melded into the transfer pricing rules in s 31 and further bolstered by s 23M of the Income Tax Act (ITA) of 1962. This new framework is still undergoing development, with the practice note issued by

³ Globalisation is defined as ‘the gradual removal of trade barriers, the increase in technological and telecommunication developments’ by the OECD. See OECD ‘Action Plan on Base Erosion and Profit Shifting’ (2013) at 27-28.

⁴ See M J Kahn ‘The BRICs and South Africa as the Gateway to Africa’ (2011) vol 111 no 7 *Journal of Southern African Institute of Mining and Metallurgy* 493-496.

SARS still in its draft form (and therefore of diminished legal relevance). Furthermore, thin capitalisation was also under the scope of the Davis Tax Committee⁵ which had been tasked with investigating modifications to key areas of the South African tax regulatory system. The Committee's final reports were only issued in April 2018. Thin capitalisation is therefore a relevant area and it is the aim of this study to also contribute to the discussion concerning the future of the legal framework governing the area.

b) Significance of Comparators

(i) The OECD Framework

Thin capitalisation is an international taxation law issue, and the Organisation for Economic Cooperation and Development (OECD) is the leading organisation spearheading the effort to comprehensively curb BEPS at the international level. Hence, as the accepted international standard setter,⁶ the OECD's input is very influential in the individual states' approach to addressing BEPS through thin capitalisation. Furthermore, South Africa, although not a member of the OECD, is an ardent partner of the organisation and has had observer status since 2004.⁷ More so, as a member of the G20, and a member of the OECD BEPS Committee, it played a prominent role in the development of the latest OECD guidelines in combating BEPS.⁸ It is therefore natural that the OECD framework would be the most suitable baseline on which to evaluate the workings of the South African regime.

(ii) Canada

As a developed and OECD member-country whose law is well-regarded in South African jurisprudence, the purpose of the Canadian comparator is to show how a developed nation responded to the OECD's guidelines by fashioning its own context-specific framework. Underlying this demonstration is the study's desire to showcase how the OECD framework is context-specific and should not simply be transplanted without being adapted to the South African and developing country realities.

⁵ See Davis Tax Committee, *Davis Tax Committee: Second Interim Report on Base Erosion and Profit Shifting (BEPS) In South Africa* 'Annexure 4 BEPS Final Report- Action 4' (2018).

⁶ K Futi 'OECD as an International Standard Setter in the Area of Tax' (2015) vol 24 *International Economic Law* 30-31.

⁷ A W Oguttu *International Tax Law Offshore Tax Avoidance in South Africa* (2015) at 46.

⁸ *Ibid.*

1.5 METHOD

The study shall take the form of a qualitative desktop-based assessment that will focus on;

- i) Primary material such as the domestic legislation and case law and international conventions,
- ii) Secondary material such as revenue authority guidance notes, academic textbooks and scholarly articles and commentaries, and
- iii) The various international organisation guidelines and manuals such as the BEPS Action Plan and the OECD and UN Model Tax Treaties.

In its efforts to fully address the research questions, it should be noted that the study will follow a legal doctrinal approach when engaging with the above.

1.6 LIMITATIONS

Thin capitalisation is contextually related to other broader issues. However, as the focus of the study is on thin capitalisation, these broader issues will not be considered. Amongst the related issues that do not fall into the scope of this study are the general taxation of controlled foreign companies and headquarter companies, issues of debt pushdown structuring, exchange control regulations, detailed assessment of hybrid mismatch rules and the broader transfer pricing field. In addition, the study does not enter into a detailed engagement of the administrative and documentary requirements tied to the thin capitalisation regime.

1.7 STRUCTURE OVERVIEW

a) Chapter One

Serving as the introduction to the study, this chapter lays out the scope and limitations of the research, the research questions to be discoursed and the methodology to be utilised. The chapter also offers justification for the study's focus; outlining the relevance of the issues it raises and the rationale behind the choice of comparators. Last, the chapter provides a chapter breakdown of how the study will be structured.

b) Chapter Two

Chapter Two's provides the historical and contextual grounding of the study. It briefly traces the development of the concept of a corporation before engaging in a synopsis of corporate financing structures. It also looks at the relationship between these financing structures and taxation law, highlighting the relevance of the issue of thin capitalisation and its significance in the current international and South African economic system. This chapter places into perspective the development of globalisation and its link to the issue of BEPS in South Africa. Additionally, in order to alert the reader to the assessment principles that shall thread through the study, the chapter also details the tax policy norms that are applied in the assessment of South Africa's thin capitalisation regime.

c) Chapter Three

This chapter discusses the substantive matters to the study. In doing so it breaks down the OECD's thin capitalisation framework which in the next chapter is used as the baseline from which the South African, and in contrast, the Canadian regimes are to be critically analysed. This chapter also extensively presents the South African framework (ie both policy and legislative) and briefly outlines its Canadian counterpart to facilitate the contrasting exercise in the next chapter.

d) Chapter Four

This chapter contains a critical analysis of the South African regime which is guided by the set of norms that relate to the key research questions and which have been expressed earlier in Chapter Two. In building up to the analysis of the regime, it presents an extensive critique of the OECD's role in international tax, in general, and a more specific critique of the OECD's relevant guidelines to dealing with thin capitalisation. Emphasis will be placed on the political, policy and substantive critiques of the OECD.

Following the above, the chapter engages with the South African regime, paying attention to the arm's length rule (ALR) and the lack of concrete administrative rules to support the regime. Subsequently, a discussion of the Canadian regime's relationship with the OECD framework in contrast to South Africa's is given before finally tying up the chapter with an evaluation of the efficacy of the SA framework.

e) Chapter Five

As the overall concluding chapter that ties together all the previous chapters, this chapter provides a summary of the issues discussed. It also recaps the key points raised and findings made in the study and outline the areas that in the future might need further elaboration. In addition, this chapter contains concise recommendations that might assist the legislature in formulating a comprehensive thin capitalisation regime that not only balances the desire for effectiveness in curbing the issue of BEPS and the need for an investment-friendly regime, but also accounts for South Africa's contextual realities.

CHAPTER TWO

2.1 OVERVIEW

The purpose of this chapter is to provide the contextual background that informs the focus of the present study. It explores the historical developments of the concepts most pertinent to the study such as the concept of the corporation, corporate financing structures, globalisation and base erosion and profit shifting (BEPS). In the process, it outlines the linkages that these concepts have in shaping the relevance of thin capitalisation regulation in the South African context. Furthermore, it offers more clarity on the significance of the two factors raised in Chapter One as influences on the thin capitalisation regulation policy approach namely, (i) the need to promote foreign investment, and (ii) the contrasting interest in safeguarding and expanding country's tax base, highlighting how globalisation, if left unchecked, distorts their interaction. Finally, it offers an outline of the tax policy norms that guide the framework's analysis in Chapter Four.

2.2 HISTORY OF THE CORPORATION

Humans have from a very early period understood the importance of co-operation to their survival. Not only did this piece of wisdom contribute to the evolutionary development of the human mental and intellectual ability, it has also, through millennia of co-operation, contributed to the rise (and fall) of civilisations of impressive scale. Of major interest to this chapter is the role that co-operation played in the historical development of the modern-day corporation⁹ and the resultant impact on economic development. Although first developed in Mesopotamia as far back as the 17th century BC, in the Global North the concept of corporation is believed to have emerged in its earliest form in the Roman Empire involving craftsmen, artisans and traders who banded together in pursuance of collective business objectives.¹⁰ These *collegia* were understood to take on an independent existence that was separate, although intangible, from the constituent members who continued to retain their own *species* even if constituting parts of the

⁹ In this study corporation is understood '... as a de jure legal person: that is, a legal entity distinct from its constituent members and recognised by the relevant public authority.' See Leonardo Davoudi, Christopher McKenna & Rowena Olegario 'The historical role of the corporation in society,' (2018) vol 6 *Journal of the British Academy* at 20.

¹⁰ *Ibid* at 21.

corpora.¹¹ Some municipalities, towns and universities also utilised this rudimentary corporate notion.

In contrast to the modern understanding of the concept, these early corporations were not regarded as fictitious persons nor entities with artificial state-endowed personalities but as natural entities.¹² This position gradually shifted from 58 BC when the state started governing the existence of these *societas* or *collegia*, with Augustus Caesar passing a law that required any new college to seek Senate decree and later Marcus Aurelius recognising them as juristic persons.¹³ Notably, by this period of increased state control other editions of the early corporation such as the *societas publicanorum*, which focused on public works such as the erection of temples and allowed for pooling of resources to form joint-stock companies with tradable limited liability shares, had also developed.¹⁴ Unfortunately, this early development of the concept was retarded by the decline of the Roman Empire.

Further development only gathered form again during the 12th Century in Europe, and England in particular, albeit in an elementary form involving loose associations or guilds.¹⁵ These were refined into *universitas* which had a distinction between the unit and its members.¹⁶ It is from these *universitas* – usually counties or communes with their own signifiers of independent existences – that the early form of a body corporate evolved around the 14th Century. In time, these body corporates with separate personality were accorded royal charters as protection to engage in commerce within England itself and abroad.¹⁷ A useful innovation that promoted commercial speculation by offering a veneer of royal privileges to ‘corporates’ who possessed it and in the case of corporates engaging in overseas voyages, the charter facilitated the cooperation of merchants to gain monopolies against their foreign rivals.

It is within this backdrop that the great chartered corporations of the Mercantile Age (circa early 1600s) blossomed, with their focus being on overseas voyages to India and the newly discovered

¹¹ Jeffrey L Patterson ‘The Development of the Concept of Corporation from Earliest Roman Times to A.D. 476,’ (1983) vol 10 no. 1 *The Accounting Historians Journal* at 92.

¹² *Ibid.*

¹³ *Ibid.*

¹⁴ Ulrike Malmendier ‘Law and Finance “at the Origin” (2009) vol 47:4 *Journal of Economic Literature* at 1085-10586.

¹⁵ In Spain they were known as *gremios*, *zunfte* in Switzerland and *corps de metiers* in France.

¹⁶ Harold T Laski ‘The Early History of the Corporation in England’ (1917) vol 30 no. 6 *Harvard Law Review* 564.

¹⁷ *Ibid.*

Americas, therefore essentially operating as the first multinational companies. The dominant companies of this time, the Dutch East India Company (VOC) and the English East India Company incorporated the concept of capital pooling to an immense degree, sourcing their funds from the general public through issuing bonds during the initial voyages and later by issuing shares of stock to the general public who would become entitled to dividends and could transfer their shares.¹⁸ The VOC itself is oft credited for being the first multinational to be listed on the first official stock exchange established in the Netherlands in the 17th Century, which at that point had the world's leading financial centre in Amsterdam.¹⁹ In England, however, the English East India Company could not enjoy as great a monopoly as its Dutch counterpart due to the 'manic' increase of new corporations which was later to lead to a capital market crash in 1720.²⁰ Afterwards, the government passed legislation that made it illegal to issue or raise transferable shares without operating under a royal charter or authority of an Act of parliament, signifying the beginning of corporation law as is currently understood.

2.3 GLOBALISATION AND MULTINATIONAL ENTERPRISES

At the height of the Mercantile Age, the notable chartered companies operated across several continents and were the prime drivers of international trade and economic development in Europe.²¹ As they gained more power and autonomy, they made enormous contributions to resource exploitation of the Americas, Africa and Asia and the colonial enterprise was to develop from simple stop-over outposts for the chartered company voyagers to full-blown interior excursions in search of more resources and trade. Eventually, with the dawn of industrialisation and the increase in state dominance over the corporations, the scramble for colonial territories was taken over by the European states, culminating in the establishment of complex colonial systems ranging from the French assimilationist approach to the British indirect rule method. Primarily serving the purpose of providing Europe and the Americas with resources such as gold, slaves and ivory to fuel their industrial endeavours, the colonial enterprise effectively resulted in an increase in the interconnectedness and integration of the world's economies – albeit in a

¹⁸ Geoffrey Fuller *The Law and Practice of International Capital Markets* (2009) 2 ed at 86-87.

¹⁹ *Ibid.*

²⁰ Laski *op cit* fn16.

²¹ *Ibid.*

skewed way in favour of the colonial powers with only residual infrastructural, technological and knowledge innovations percolating to the colonies.²²

But this disproportionate form of ‘globalisation’ was to witness a shift after the end of the Second World War as decolonisation efforts strengthened. With the youthful former colonial nations now engaging at an equal footing with their former colonisers and most of the West, the inclination for more liberalised and integrated markets began to drive major developments in globalisation that led to it gaining more traction than it had earned in the past century. In its present form, globalisation demands open economies that allow for free movement of goods and services amongst the markets. The effect is that economies are now not only embedded in the global market, but there is an unrivalled diffusion of people, cultures, technologies, media and communications and information at an international scale.

As a result, more prominence has shone onto the MNEs whom, like their predecessors, thrive and stimulate this globalised environment which enables them to maximise on production factors such as global value chains, cheap but skilled labour and ease of market access. It is MNEs that are at the forefront of the global investments²³ that complement globalisation, as they pump massive resources in several outposts to maximise on the productive factors prevalent in the places. However, unlike their chartered predecessors whose operations trammelled even states, these contemporary MNEs are subject to legal regulations, particularly corporation and revenue laws of the various countries they operate in, which at times fetter their revenue maximisations. Nonetheless, with their growth in dominance and economic influence since the close of the Cold War, these MNEs have attempted, and mostly succeeded, in unshackling themselves of the state fetters by utilising sophisticated mechanisms – one of which is the subject of this study – which allow them to abundantly reap the gains of globalisation despite the plethora of regulations.

2.4 CORPORATE FINANCING STRUCTURES

Before discussing the avoidance mechanism relevant to this inquiry, it is necessary to offer some background as to how corporations are commonly financed. Echoing the discussion above, the

²² Joseph Stiglitz *Making Globalization Work* (2007) at 11.

²³ These investments are not only financial nor infrastructural but also include employment creation, human resource development and information exchange.

initial corporations were financed through the issuance of shares or stock to investors in exchange for financial contributions to fund the corporation's objectives. Fuller also mentions the role that debt from financial institutions such as the banking families in Europe also played in the capitalisation of corporations.²⁴ Undoubtedly, the two main methods of corporate financing, viz. by way of equity and or by way of debt, were from the onset key to the capitalisation and the growth of the corporations and consequently the MNEs. It must be highlighted, however, that over the years the distinction between these two methods has grown more tenuous, thus opening them up for exploitation by corporations. This section offers a brief and simplified outline of these financing methods.

a) Equity

Equity financing is a method that involves the raising of capital by way of issuing share stock to investors either via official stock exchanges or privately.²⁵ Through the receipt of the investors' financial contributions, the company grants an ownership, participation and control interest to the investor who then becomes a shareholder.²⁶ It must be noted that although the original idea was to entitle them to a proportional share of the profits that the corporation made during the pursuit of its objectives,²⁷ the modern position especially in South African law, is that shareholding does not necessarily entail an entitlement to a share of the profits. Instead, the granting of dividends is understood as a gratuitous benefit of the holding of stock in a corporation that is not legally-enforceable but is granted after due consideration by the directors of the corporation.²⁸ The effect of this legal conception is that equity financing is a fairly safe and long-term investment for investors and is attractive to companies when raising capital before it has sufficient revenues, cash-flow and assets to operate effectively. Furthermore, because of the limited role that the state plays in regulating dividends, dividends tend to be exempt from tax or taxed at a lower rate.²⁹

²⁴ Fuller op cit fn18 at 82.

²⁵ Ibid at 4.

²⁶ Peter Harris *Corporate Tax Law; structure, policy and structure* (2013) at 186. Also see Lynette Olivier & Michel Honiball *International Tax: A South African Perspective* (2008) 4 ed at 192-194.

²⁷ Fuller ibid at 86.

²⁸ This position is premised on the fact that s 46 of the Companies Act of 2008 explicitly requires authorisation of distributions, including dividends, by the board of directors after due satisfaction of the requirements in the section.

²⁹ Serena Fatica, Thomas Hemmelgarn & Gaëtan Nicodème 'The Debt-Equity Tax Bias: Consequences and Solutions' (2013) 2013/1 Tome LII *Reflets et perspectives de la vie économique* at 9.

b) Debt

Debt financing, on the other hand, involves the granting of a contribution by way of a loan to the company that will be repayable together with interest to the creditor. Contra to an equity contribution, the creditor does not gain any share of ownership or right to participation in the company nor any of the underlying risks that arise from a shareholding relationship.³⁰ Instead, they hold a legally-enforceable personal entitlement to the repayment of their capital contribution and the interest payment within a fixed period and which is usually backed-up by some form of legal security.³¹ This entitlement is not subject to the profitability of the enterprise nor the discretion of the directors as is fundamental in an equity entitlement but is enforceable against the company even when it does not perform viably. This means that even in case of insolvency, the debt holders have a prior right to the firm's assets whilst the equity holders will only receive proportions of the residue as they rank behind creditors.³² Consequently, debt financing is usually utilized as a short-term solution in instances where the company requires a quick injection of capital but already has a record of effective operations and tangible assets that will assure the creditor to take the risk of investing in the enterprise.

2.5 TAX CONSEQUENCES OF FINANCING METHODS AND THE RELEVANCE OF THIN CAPITALISATION

Similar to the ancient roots of the corporation is the history of corporate financing. Fuller propounds that financing can be traced to the time of ancient Mesopotamia where capital was offered to profit-seeking ventures such as trades and farming by the financiers (whom were also bankers) whom in turn would earn interest.³³ Akin to the modern conception of a loan, these early forms of financing gradually developed further across the centuries until the period of the Roman Empire when a new method of financing arose.³⁴ This method entailed that capital could be provided to separate personality *societas* whose purpose was to partake in public works and

³⁰ Peter Harris *Corporate Tax Law; structure, policy and structure* (2013) at 186.

³¹ *Ibid.*

³² Fuller *op cit* fn18 at 9.

³³ *Ibid* at 75.

³⁴ It should be noted that Roman laws did not provide for the notion of interest on its concept of a loan. To provide for this disjuncture, the financiers would enter into a complementary contract for interest called a *stipulatio* which could not be transferred without the involvement of the debtor. See Fuller at 79.

thus required a great deal of capital to fulfil. However, diverging from the early financing approaches, capital injection came with a tradable shareholding entitlement that assured the financiers- usually the members of the college - of a share of the profits from the venture, a relationship that would evolve into the modern-day equity financing method. These two methods were to develop further throughout the first millennium and are to this day still the dominant forms of corporate capitalisation approaches.

It is often said the only two constants are death and taxes. Being of major relevance to the emergence of civilisations, taxes have historically always played a crucial role in the operation of governments, public service provision and to an extent the economic insurance of the citizenry.³⁵ It thus comes as no surprise that throughout the historical evolution of the concept of the corporation along with its financing structures, the question of their taxation has always loomed large. Nonetheless, for the purposes of this section, focus shall be directed at how the tax consequences of the corporate financing structures differ.

Historically, tax has typically been attached to wealth, and is chargeable mostly on property and income earnings.³⁶ This means that even those Mesopotamian financiers in ancient times, or the Roman capitalist *societas* were subject to a taxation on their profits. However, with a more nuanced advancement of the science of revenue collection, distinctions arose between the taxation of the equity profits disbursed to the equity shareholders and the profits dispatched as debt interests to the corporate creditors. These distinctions became even more relevant with the advent of globalisation as it meant more than one state could be involved in the taxation of a corporation's profits.

Whilst both equity and debt financiers receive a portion of the company's profit, conceptually the disbursements are understood differently in the field of taxation, markedly because interest, as indicated above, is an obligation whereas equity distributions are more discretionary.³⁷ The result of this distinction is that interest payments are regarded as a company's expenditure and are in most modern taxation systems exempted from the company's profit calculation.

³⁵ This last role is more prominent states such as South Africa in which the state plays a leading role in promotion of inclusive economic growth, employment creation and development. See the Davis Tax Committee Final Report, 2018.

³⁶ See further Peter Harris & David Olivier *International Commercial Tax* (2010) at 9.

³⁷ More on the different policy treatment between interest and equity will be provided in Chapter Three.

Distributions, on the other hand, are only calculated on a company's declaration of profits and are regarded as a discretionary transfer of income and thus are either taxed as part of the company's profit or in some jurisdiction are subject to a dividend's tax chargeable to the shareholder. This distinction is further emphasised by the fact that interest payments to the creditor, unlike dividends, diminish the taxable income of a company but in certain jurisdictions are not necessarily subjected to a corresponding tax in the hands of the creditor. Financing by way of debt is much more attractive as it means that their tax burden is reduced without impacting their business profits.

It is this very attractiveness that gives rise to the notion of thin capitalisation. Recalling the effect of globalisation on the corporation, companies not only have their operations across several nations, their capitalisation, control and management also span various states thus complicating the process of their taxation. Fortunately, the domain of international taxation serves the purpose of regulating how revenue is to be collected and apportioned across this network of states. Nevertheless, the field still holds back when it comes to the substantive application of each country's revenue systems. Consequently, this allows for discrepancies in taxation rates and, in this case, the tax treatments of interest. The effect is that corporations can utilise these discrepancies to their advantage through capitalising their subsidiaries in highly taxed jurisdictions with more debt than equity to reduce their overall tax burdens. The effectiveness of this mechanism is further enhanced if the corporations strategically locate the crediting operation in not only a low taxed jurisdiction but one that also has no provision for the taxation of interest. The consequence of this avoidance mechanism is that a big proportion of profits are shifted across the jurisdictions that the MNC operate in towards jurisdictions that are regarded as tax-havens,³⁸ thus minimising their tax burden whilst maximising the corporation's profits. Fortunately, since 1987³⁹ this phenomenon has received greater focus by the international fiscal

³⁸ A tax haven is generally understood as a state or jurisdiction that offers foreign taxpayers (both individual or businesses) little or no tax liability. These taxpayers do not necessarily have to reside or operate in the territory to receive the tax benefits. Tax havens also offer high levels of financial information secrecy.

³⁹ See OECD *Issues in International Taxation no. 2, Thin Capitalisation; Taxation of entertainers, artistes and sportsmen* (1987) para 54.

regulation bodies such as the OECD and the UN and individual countries which have all made headways in crafting rules to combat it.⁴⁰

2.6 SIGNIFICANCE OF COMBATING BEPS

As an emerging economy, South Africa places a great emphasis on ensuring that its policy is open and favourable for investment as this is instrumental to sustainable economic development.⁴¹ In its quest, several measures have been put in place such as the marketing of South Africa as the gateway to investing on the African continent through the headquarter company taxation regime and various other commercially favourable measures.⁴² These, in combination with the lure of the vastness of South Africa's human capital and natural resources, have been key in attracting the multitude of MNEs and foreign enterprises plying their trade in the nation. And indeed, the policies have reaped benefits that include increased capital injection in the economy, job creation, technological and skills transfer and contribution to the broader global value chains. Thus, from an economic perspective the presence of MNEs in the South African economy has no doubt been beneficial to the growth of its Gross Domestic Income and the economy more broadly.

However, the openness to MNE and foreign investments has also brought its own problems. A common assertion is that globalization has failed to deliver on its most tangible promises such as the provision of higher standards of living and poverty reduction.⁴³ Instead it has been condemned for bringing problems that range from threatening and even stifling of the nations' infant industries which are incapable of efficiently competing with the global behemoths to political outcries of economic exploitation and neo-colonialism of the nation's resources.⁴⁴ Most notable of these problematic effects of the presence of sophisticated and well-heeled MNEs is the manipulation of the nation's and international revenue laws in ways that greatly reduce their South African tax burdens. This latter issue drastically affects the state's capacity to meet its

⁴⁰ Thin capitalisation has also fallen under greater scrutiny since the OECD's publication of the BEPS Action Plan in 2013.

⁴¹ DTI 'South Africa's Trade and Investment Policy- Presentation to the Parliamentary Portfolio on Trade and Investment,' (2015), Department of Trade and Industry.

⁴² Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010 at 77.

⁴³ This is particularly pertinent, as shall be shown below, in South Africa's context.

⁴⁴ Rabbah Arezki, Gregoire Rota-Graziosi, & Lemma Senbet 'Capital Flight Risk' (2013) vol 50:3, *Finance & Development*.

service delivery obligations and has severe knock-on effects upon the general socio-economic well-being of the South African citizenry, especially when notice is taken of the central role that social assistance plays in the economic upliftment of the people in South Africa.

It cannot be overlooked that South Africa, being a young democracy with stark wealth inequalities, is arguably a welfare state⁴⁵ that largely depends on its tax revenue as a tool for redistribution. With most of its population living in poverty⁴⁶ whilst a major proportion of its youthful and economically active population is not in formal employ,⁴⁷ the state has a massive burden to cater for the social, health, educational and economic welfare of this dependent demographic constituency. Moreover, South Africa utilises a progressive income tax system which means that the poor are not taxed (outside Value Added Tax), leaving the small economically well-off minority and corporates to shoulder the tax burden. It therefore means that erosion of the tax base further reduces the percentage of the taxpaying group and ultimately retards the state's capacity to meet its obligation. This is more unsettling when one considers how South Africa is already plagued with corrupt and failing governance institutions – SARS included⁴⁸ – which engage in systematic squandering of state resources that in a way indirectly fosters tax base erosion and corrodes the legitimacy of fighting BEPS.

Hence the issue of BEPS by MNEs is of great policy concern to South Africa as it poses a question of how the state can balance its policy in favour of investment with the need to maintain and grow the tax base to meet its many obligations. It is from this position that this study focuses on thin capitalisation as a BEPS mechanism and interrogates the revenue laws' effectiveness in curbing the abuse of the phenomenon by MNEs in a bid to avoid their tax obligations to South Africa. The section below outlines in detail the norms that will frame this assessment.

⁴⁵ See J Seekings 'The 'Developmental' and 'Welfare' State in South Africa: lessons for the Southern African Region' (2015) Working Paper 358 Centre for Social Science Research.

⁴⁶ According to Statistics South Africa (StatsSA), the percentage of people living in poverty calculated per the upper-bound poverty line in 2015 were 55,5%. See Statistics South Africa 'Men, Women and Children: Findings on the Living Conditions Survey, 2014/15' (2015) Statistics South Africa at 3.

⁴⁷ The StatsSA figures for the second quarter of 2019 (April to June) show that unemployment for the 15-24 age group is 56,4% whilst for the 25-34 group unemployment is 35,6 %. See Statistics South Africa 'Quarterly Labour Force Survey Quarter 3: 2019' (2019) at 23.

⁴⁸ See Final Report of the Commission of Inquiry into tax administration and governance by SARS, 2018. Note however, a new SARS Commissioner has since been appointed and he is determined to root out corruption in the institution.

2.7 OUTLINE OF PILLARS OF ASSESSMENT

Coming up with a good tax policy is not an easy task. It is even more daunting when one must factor in the complexities that arise from the various objectives that each context-specific tax policy should reflect. Nonetheless, there are some vital principles that ought to be factored in when fashioning a responsive and effective tax policy. These are usually drawn from Adam Smith's seminal 1776 work, *An Inquiry into the Nature and Causes of the Wealth of Nations* in which he outlined four principles that are essential for a good tax system. Of these are *equity* which requires the system to warrant each subject of the state to contribute to the fiscus in proportion to their abilities; *certainty* which entails that one's contribution ought to be certain and not arbitrary; *simplicity* which requires that the levy must be in a manner and time which is most convenient to the contributor; and *efficiency* which demands that the tax cost the contributor as little as possible above the tax to the fiscus.⁴⁹

Below I outline the derivative principles that shall be employed as key norms in assessing the efficacy of South Africa's thin capitalisation framework.

a) *Neutrality*

It is crucial that a tax policy has the most minimal effect on the taxpayer's business and or transactional decisions. This is possible if it ensures that similar activities are treated in the same way thereby reducing distortions over taxpayers' choices and behaviours.⁵⁰ A neutral policy means there is more fairness in the regime and guarantees that the decisions of the taxpayer are mainly driven by business and or other considerations and not tax considerations.⁵¹

b) *Simplicity*

Too much complexity in a tax policy deters the taxpayer's understanding of the regime and can be a hindrance to compliance. Complexity also affects transparency and increases compliance

⁴⁹ See further Adam Smith Book V of *An Inquiry into the Nature and Causes of the Wealth of Nations* (1976) vol 2 Glasgow Edition at 827-828.

⁵⁰ James Mirrlees et al. *Tax by Design* (2011) at 40.

⁵¹ Association of International Certified Professional Accountants 'Guiding principles of good tax policy: A framework for evaluating tax proposals' (2017) Tax Policy Concept Statement 1 (hereinafter Guiding Principles) at 9.

costs.⁵² Accordingly, a simple tax regime is necessary to ensure not only easier understanding of the law but correct and cost-efficient compliance by the taxpayer.⁵³ This tends to reduce errors and allows a taxpayer to properly comprehend the consequences of their intended transaction.⁵⁴ Moreover, simplicity induces efficiency and reduces avoidance behaviour⁵⁵ or the possibility of taxpayer exploitation by unscrupulous tax authorities and tax advisers.⁵⁶

c) Certainty

Analogous to the principle of simplicity, a good tax policy requires certainty and should clearly specify the way the tax rules operate. This entails clarity as to what is subject to tax, the amount of tax payable, how it is determined, when the payment ought to occur and the way in which this payment is to be made.⁵⁷ Certainty also entails stability in the tax rules and system.⁵⁸ Certainty, like simplicity, is an important factor in improving efficient compliance and respect for the tax system⁵⁹ and allows taxpayers to make long-term decisions without facing much difficulties of instability.

d) Transparency and Visibility

The existence of a tax or tax consequence must not come as a surprise for a taxpayer. For a good tax system should be transparent enough for a taxpayer to know of the existence of the taxes and or consequences.⁶⁰ The visibility that results from knowing how and when a tax is imposed upon the taxpayer allows them to identify the true cost of the transactions and the total tax liability they ought to pay.⁶¹ Transparency and visibility also allows ‘taxpayers to evaluate the services received and the accountability of the government relative to the tax burden faced.’⁶²

⁵² Mirrlees op cit fn50 at 42.

⁵³ Guiding Principles op cit fn51 at 8.

⁵⁴ Ibid.

⁵⁵ P Pistone et al (eds) Chapter 2 ‘Principles of Taxation’ in *Fundamentals of Taxation: An Introduction to Tax Policy, Tax Law and Tax Administration* (2019) IBFD Online Books at 2.1.3.4. Accessed on 26 July 2019.

⁵⁶ Ibid at 2.1.4.4.

⁵⁷ Ibid at 2.1.4.2. See also Guiding Principles op cit fn51 at 7.

⁵⁸ Mirrlees op cit fn50 at 44.

⁵⁹ Guiding Principles op cit fn 51 at 7.

⁶⁰ Guiding Principles op cit fn51 at 9.

⁶¹ Ibid.

⁶² Pistone op cit fn55 at 2.1.4.2.

e) Effective Administration

Following from the above norms, too much complexity and opacity in a tax system increases the costs of compliance and administration. It is therefore critical that a good tax system minimises the administrative and compliance costs for both the taxpayer and the administration.⁶³ A tax system should not be too cumbersome for the administration to administer effectively.⁶⁴ A tax regime should also not be incoherent within itself and in relation to other complementary regimes, nor inflexible.⁶⁵ Similarly, it should also not be too costly for the taxpayer to comply with the regime as this hampers compliance and can promote avoidance.

f) Economic Growth and efficiency

Finally, it is important to ensure that the tax framework does not impede on economic growth and efficiency. Although it is inevitable for taxes to somehow affect economic efficiency, a good tax system should minimise these effects. This is made possible by ensuring that the tax policy is reflective of the broader economic goals and principles of the jurisdiction.⁶⁶ Corresponding with this principle is the requirement that the rules not pose any competitive disadvantages to firms operating within that jurisdiction or a particular industry.⁶⁷ A tax policy that promotes efficiency and productive growth is a magnet for investment as investors will be attracted to the jurisdiction. Furthermore, a tax policy can also be grounded on the principle of tax competitiveness⁶⁸ which encourages a jurisdiction to ensure that its tax policy is more attractive, be it in terms of simplicity, effectiveness of administration and low tax rates, when compared with other jurisdictions.

A pertinent question is how much weight each of the above principles should carry and how do these principles relate to each other when assessing a tax regime. This study takes the view that each of the principles is important and weigh equally in relation to the other. It cannot be

⁶³ Pistone op cit fn55 at 2.1.4.3.

⁶⁴ Guiding Principles op cit fn51 at 9.

⁶⁵ Pistone ibid at 2.1.5.2.

⁶⁶ Guiding Principles ibid at 9.

⁶⁷ Ibid at 9.

⁶⁸ The notion of tax competitiveness is a controversial concept and is regarded with infamy by civil organisations and other commentators who condemn it for fuelling tax havens and the resultant tax avoidance that arises. It will be explored in further detail in Chapter Four.

discounted, however, that depending on the fiscal policy and economic needs of the state, instances will exist where more prominence must be given to one principle at the expense of another. Hence an optimal tax system must be able to satisfy each principle in a way that appropriately balances the principles per the regime's relevant circumstances.⁶⁹

However, it must be noted that the mere satisfaction of the principles does not a good tax system make. A key ingredient usually ill-considered when appraising a tax system is effective design conditions and processes. Thuronyi (ed) is of the view that conditions and processes are crucial to achieving contextual sensitivity as it is within the processes that the various stakeholders and players, from tax experts, drafters, accountants, tax administrators, economists and the public, can air their views and engage on the potential impacts and issues involving the rules.⁷⁰ An inclusive and continuous design process that takes into account open, transparent and well-informed public debates fosters acceptability and stability of the resultant regime.⁷¹ This is most critical for developing country design processes involving complex rules such as thin capitalisation rules since in most cases the processes are driven by foreign experts without much knowledge of local issues and complexities. A good tax system thus needs to reflect the above principles and its design conditions and process must be inclusive and reflective of the local issues relating to the rules.⁷²

⁶⁹ Pistone op cit fn55 at 2.1.6.1.

⁷⁰ Victor Thuronyi (ed) 'Chapter 2: Tax Legislative Processes' in *Tax Law Design and Drafting* (1996) vol 1, IMF. Available at <https://www.imf.org/external/pubs/nft/1998/tlaw/eng/> Accessed on 27/07/2019.

⁷¹ Mirrlees op cit fn50 at 19.

⁷² Regarding designing an effective system, Mirrlees op cit fn50 at 20 aptly notes the following:

'To improve things, we need to see the system as a whole, we need to design the system with a clear understanding of the population and economy on which it operates, and we need to apply economic insights and evidence to the design. We also need a much more informed public debate and a much better set of political processes than the ones we currently have.'

CHAPTER THREE

3.1 OVERVIEW

This chapter presents the relevant legislative frameworks dealing with thin capitalisation for the OECD, South Africa and Canada. It will begin by offering a brief discussion of the policy considerations behind the different tax treatment of debt and equity and the meaning of thin capitalisation. This chapter will also offer brief outlines of the historical developments of the relevant frameworks as this not only helps in understanding the rationale behind the regimes but will also be useful in the analysis provided in Chapter Four. Eventually, it will present an overview of the OECD, South African and Canadian legislative frameworks that form the focus of this study.

3.2 BUILDING BLOCKS OF THE THIN CAPITALISATION REGIME

a) Debt/Equity deductions mismatch

An enquiry into thin capitalisation rules is incomplete if one is not confronted with the underlying tax distinction of debt and equity which provides a loophole for the phenomenon of thin capitalisation. Recapping the discussion in the previous chapter, most modern tax systems treat debt financing differently to equity financing. Returns from equity financing, whether dividends or capital gains on shares, are taxed as part of the company's corporate income tax before the declaration of dividends.⁷³ They also fall into a second level of taxation either as part of the income of the recipient or as dividends tax.⁷⁴ Returns from debt financing, on the other hand, are generally not subjected to the same treatment in the hands of the company, instead they are deducted from the payable corporate income tax since they are viewed as a business cost.⁷⁵ There is therefore an imbalance in the tax treatment of the forms of capital financing that is more favourable to debt financing. This results in it being more attractive to capitalise using debt, with some corporations even going as far as disguising equity financing as debt by utilising hybrid instruments.

⁷³ Geerten M M Michielse & Victor Thuronyi (eds) *Tax Design Issues Worldwide*, (2015) at 121.

⁷⁴ *Ibid.*

⁷⁵ *Ibid.*

The question then is why such a debt bias continues to persist even when it has become trite knowledge that debt and equity are essentially indistinguishable when assessing a company's capital structure.⁷⁶ Michielse and Thuronyi (eds) assert that there is no compelling reason to be found in legal, administrative and economic considerations to justify this financing discrimination.⁷⁷ Boltar concurs and expounds that of the possible policy considerations, the distinction is mostly driven by a socio-economic objective that aims to encourage companies to plough back their profits into the business rather than distributing them as dividends.⁷⁸ A related economic rationale is raised by De Mooij who states that theoretically the distinction would be desirable in the presence of market imperfections⁷⁹ as the government can promote the use of debt to raise investment and improve efficiency of firms' decision-making.⁸⁰ He however disproves this rationale by pointing out that the debt relief would reduce firm dynamics and hamper long-term economic growth.⁸¹

The legal justification, which ostensibly is the original rationale for the distortion, is premised on the fact that interest expenses, unlike dividends, are not conditional on profitability and thus qualify as a cost of doing business whilst equity returns reflect returns on income.⁸² This means that since interest expenses arise from the production of income and stem from capital by way of a loan which is legally required to be repaid, deducting interest payments as opposed to dividends is justified.⁸³

Related to the above is the assertion that the distinction facilitates administrative convenience as it is easier to tax equity at the company than individual level, a situation which is more realisable

⁷⁶ See A O Emmerich 'Hybrid Instruments and the Debt-Equity Distinction in Corporate Taxation' (1985) vol 52 *University of Chicago Law Report* at 142 and J Boltar 'Corporate Taxation and the Interest-Dividend Dilemma,' (1996) 113 *SALJ* at 456 for a more detailed discussion on the attempts by tax practitioners and administrators to distinguish debt and equity.

⁷⁷ Michielse & Thuronyi op cit fn73. It is interesting to note that Brazil and Belgium have implemented a framework called the Allowance for Corporate Equity that levels the treatment of debt and equity by offering equity deductions. See further Ruud A De Mooij 'Tax Biases to Debt Finances: Assessing the Problem, Finding Solutions' (2012) vol 33 no. 4 *Fiscal Studies* at 505-507.

⁷⁸ Boltar op cit fn76 at 457.

⁷⁹ De Mooij op cit fn77 at 497.

⁸⁰ Ibid at 499.

⁸¹ Ibid.

⁸² Ibid at 496.

⁸³ Boltar op cit fn76 at 257.

with interest receipts as they are usually in cash.⁸⁴ De Mooij again refutes this argument because equity may also take the form of cash and the high administrative costs of maintaining a corporate-based equity tax system expose the flaws in the argument.⁸⁵ Boltar also mentions that another administrative and practical consideration is that allowing a deduction for dividends would be too costly to the fiscus.⁸⁶

Additionally, another prominent reason premised on corporate finance theory is that the distinction is predicated on the fact that shareholders have protection from personal liability due to investing through the corporate form which makes it legitimate to only exempt interest expenses made to creditors as this offers some protection and ensures that their investment are repaid.⁸⁷

Nevertheless, these reasons are clearly too tenuous to support the continued debt bias prominent in most tax systems. It is not surprising that companies, particularly MNEs, have so strategically utilised this disparity to reduce their tax burdens.

b) Meaning of Thin Capitalisation

Given its centrality to this research, it would be a disservice to enter into a deeper engagement with the key issues without offering a comprehensive explanation of the concept of thin capitalisation.⁸⁸ The United Nations describes ‘thin capitalisation’ as the use of unusual proportions of debt to equity in a bid to gain a tax advantage.⁸⁹ The OECD on the other hand looks at the concept from a more general viewpoint, regarding situations in which a company is financed by way of a relatively higher level of debt compared to equity as indications of thin capitalisation.⁹⁰ What is common to both positions is that thin capitalisation refers to a situation in which a company has a relatively higher capitalisation by way of debt as opposed to equity. In addition to the above, the relationship between the lending and debtor company is of key concern

⁸⁴ De Mooij op cit fn77 at 497.

⁸⁵ Ibid.

⁸⁶ Boltar op cit fn76 at 465.

⁸⁷ Ibid at 459. See also Emmerich op cit fn76.

⁸⁸ The discussion offered in chapter 2 was rather cursory and tailored to the chapter’s concept of discussing the role of MNEs in utilising thin capitalisation to skirt around legal regulations.

⁸⁹ United Nations Ad Hoc Group of Experts on International Cooperation in Tax Matters at 18.

⁹⁰ Tax & Development, ‘Thin Capitalisation Legislation, A background Paper for Country Tax Administrations (draft version)’ (2012) OECD. Available at: http://www.oecd.org/ctp/tax-global/5.%20thin_capitalisation_background.pdf Accessed on: 14/06/2019.

to thin capitalisation. The general position is that thin capitalisation is an issue if there is a connection between the parties. It is therefore common cause that a close relationship between the parties, for example a parent-subsidary relationship, is often an indicator of an intention to gain a tax advantage.

Before illustrating the above, it is necessary to reiterate that there are different tax implications for debt and equity and this difference becomes of greater interest when the debt financing is being sourced from an entity that is not a resident in the state in which the debtor company is based. This is due to the different ways in which jurisdictions treat interest. In addition, MNEs tend to base the crediting entity in jurisdictions where interest tax is low or non-existent, thus increasing their tax advantage.

To illustrate, in instances of ‘classic’ thin capitalisation the foreign related company, instead of investing by way of equity, lends a related company a high level of debt with an equally high rate of interest.⁹¹ This results in the interest deductions that the related debtor company claims eroding its profit base from which it can be taxed, instead shifting a greater portion of the profits to a foreign jurisdiction which has a lower or non-existent tax on interest, in effect maximising the profit gain for both entities.

‘Hidden capitalisation,’ on the other hand, blurs the equity-debt line. It usually involves what are referred to as hybrid instruments in which the capitalisation may be presented as debt whilst in fact there is attached an option to convert it to equity at some stage which ties the interests to the profits of the company.⁹² By disguising the method of capitalisation, the MNEs gain access to the tax advantages attached to debt whilst also safeguarding the economic benefits of an equity capitalisation.

Companies also utilise the system of ‘back-to-back’ transactions to distort the relational link, with the inter-company loans being funnelled through a third party intermediary, for example an international bank, which then lends to the related company.⁹³ By guaranteeing the loan or even lending the intermediary the loan amount, companies create a scheme in which profits are shifted from high-taxed jurisdictions in which their debtor ‘relations’ are located, through making

⁹¹ See B Croome (Ed) *Tax Law: An Introduction* (2013).

⁹² Ibid. See also Oguttu *International Tax Law* op cit fn7.

⁹³ Croome *ibid*.

excessive interest payments (and tax deductions) to the intermediary whom subsequently pays-over those tax-free interest payments to the guaranteeing/original lender company.

c) Historical Development of the Thin Capitalisation Frameworks

(i) Canadian Innovation

Although the phenomenon of tax avoidance using ‘thin capitalisation’ had been of interest in the international sphere since the time of the League of Nations, no concrete policy or legislative measures had been adopted to address it. It was only in 1972 when Canada, following the recommendations by the Carter Report,⁹⁴ pioneered the regulation of thin capitalisation by introducing mechanical thin capitalisation rules.⁹⁵ Applying to internal debt financing of Canadian resident corporations, these rules hinged on a 3:1 debt ratio, with interest on debt to a specified non-resident shareholders⁹⁶ that exceeded the ratio being denied a deduction under section 18(4) of the Income Tax Act of Canada.⁹⁷ Pursuant to this innovation, many other developed countries and the OECD were to follow suit in setting up and implementing rules regulating thin capitalisation.

(ii) The Role of the OECD

Closely after the end of the First World War, the League of Nations was established as an intergovernmental organisation with the aim of maintaining world peace and promoting global welfare, amongst its other vast objectives. The issue of an international tax system⁹⁸ and combating tax avoidance was also part of its mandate.⁹⁹ However, inasmuch as it produced some standards for tax conventions, not much progress was made until the League’s dissolution after the end of the Second World War. Instead, the newly established United Nations, noticing its insufficient resourcing, tasked the nascent Organisation for European Economic Corporation to assume the work on model tax treaties. The OEED was quick to appreciate the importance of an international tax system to its objective of promoting economic cooperation and development,

⁹⁴ Canada, Royal Commission on Taxation Report, 1966.

⁹⁵ Canada, Report of the Technical Committee on Business Taxation, 1997.

⁹⁶ Defined as a shareholder holding 25 percent or more of the shares in the resident corporation.

⁹⁷ Canada, 1997 *ibid.*

⁹⁸ This was to be done by way of drafting a Model Income Tax Treaty that countries would use as a benchmark to their inter-state tax corporation.

⁹⁹ M C Durst ‘Chapter 4: The OECD’s BEPS Project and Lower-Income Countries,’ vol 90 no. 11 *Tax Notes International* (2018) at 1157.

hence, by building on already existing treaty practice, it compiled and published its first Draft Model Tax Convention in 1963, two years after its evolution into the OECD.¹⁰⁰ Therein it began its pioneering norm-setting role in the international tax system which even at present is modelled around the OECD convention.¹⁰¹

However, although the challenge of base erosion as a form of tax avoidance had been acknowledged in international tax law developments since the 1920s,¹⁰² a focus on measures to internationally address base erosion through thin capitalisation intensified in 1979, when the OECD published its Report on Transfer Pricing and Multinational Enterprises.¹⁰³ In-fact, the report itself only briefly addressed thin capitalisation in its consideration of whether in the transfer pricing of loans the interest in question was derived from a loan.¹⁰⁴ Greater emphasis was to be tendered in the successive 1987 Report on Thin Capitalisation¹⁰⁵ which clarified that Article 9 of the Model Convention also applied to thin capitalisation provided it was used hand in hand with the national rules. Furthermore, the report highlighted the role of the ALR approach, particularly how it was necessary not only in determining the rate of interest as qualifying for the deduction but also the characterisation of the loan.¹⁰⁶

Further developments were to be introduced to the international thin capitalisation rules,¹⁰⁷ with the most prominent arising in the OECD Action Plan on Addressing Base Erosion and Profit

¹⁰⁰Durst op cit fn99 at 1158. See also M Koomen 'International- transfer pricing in a BEPS Era: Rethinking the Arm's length Principle- part I' (2015) vol 22 no. 3 *International Transfer Pricing Journal* at 143.

¹⁰¹ Durst ibid at 1158.

¹⁰² After World War One, there was a massive increase in income tax rates and issues of double taxation which led to the League of Nations and Interstate Commerce Commission commencing work on model tax treaty law in the early 1920s. However, this work was disrupted by the Second World War and since the United Nations was not sufficiently resourced this work was tasked to the OEEC (later the OECD) which began working on a model in the 1950s, incorporating in their work already existing treaty practices. It is this work that the OECD took over and hence the immediate publication of the model after its establishment. See D R Whitaker 'An Examination of the O.E.C.D. and U.N. Model Tax Treaties: History, Provisions and Application to U.S. Foreign Policy.' (1982) vol 8:1 *North Carolina Journal of International Law and Commercial Regulation*.

¹⁰³ Note that the OECD reports are critical to the interpretation and application of the Model Convention and are therefore regarded as a 'part' of the convention.

¹⁰⁴ OECD, 'Thin Capitalisation Chapter' *OECD Model Tax Convention on Income and on Capital (Full Version)* (2012).

¹⁰⁵Published in *OECD Issues in International Taxation no. 2, Thin Capitalisation; Taxation of entertainers, artistes and sportsmen* (1987) para 54.

¹⁰⁶ OECD 'Commentary on Article 9' in *OECD Model Tax Convention on Income and on Capital (Full Version)* (2015) (hereinafter Commentary).

¹⁰⁷ The 1992 Model Convention and the Commentary added the interplay between thin capitalisation rules and transfer pricing whilst the 1995 OECD Guidelines introduces the principle of substance over form in assessing contractual arrangements.

Shifting endorsed by the G20 leaders and policymakers in 2013 and the finalised Report on the BEPS Project in 2015.¹⁰⁸ Calling for a more co-operative approach to addressing the scourge of BEPS, the report makes proposals for the development of instruments to combat the effects of hybrid mismatch arrangements, the reinforcement of anti-avoidance measures and introduction of rules governing intra-group transactions.¹⁰⁹ Finally, the last round on the development of the thin capitalisation framework came in the 2016 Update on the BEPS Project,¹¹⁰ a development that is laudable for its greater inclusion of emerging non-OECD/G20 nations in its preparation.¹¹¹ This update shifts the recommended approach from just the ALR to the use of a debt to EBITDA ratio of between 10 percent to 30 percent applied in conjunction with a group ratio rule.¹¹²

(iii) South African Developments

South Africa introduced thin capitalisation provisions soon after the advent of constitutionalism in 1995. This was at the recommendation of the Katz Commission which felt they were necessary to correct the imbalance resulting from the allure of investing via debt as opposed to equity.¹¹³ Influenced by the dominant trend at the time, the provisions integrated an ALR approach together with a fixed ratio approach and thus regarded an entity to be thinly capitalised if its connected debt was above the legislatively determined debt to equity threshold.¹¹⁴ Should the amount be in excess of the 3:1 ratio then the next step was to determine whether the transaction had been at arm's length as this determined whether an entity was thinly capitalised. In the absence of justification as to why the borrower was thinly capitalised then deductions to

¹⁰⁸ OECD 'BEPS Project Explanatory Statement: 2015 Final Reports' (2016) OECD/G20 Base Erosion and Profit Shifting Project. The OECD touts the BEPS package as 'the first substantial- and overdue- renovation of the international standards.'

¹⁰⁹ OECD, 'Update: Base Erosion and profit Shifting' (2012) OECD/G20 Base Erosion and Profit Shifting Project.

¹¹⁰ OECD *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update: Inclusive Framework on BEPS*, (2016) OECD/G20 Base Erosion and Profit Shifting Project.

¹¹¹ This inclusion came after questions were raised as to the ability of the OECD to facilitate international tax cooperation after the initial BEPS phase had lacked engagement with developing countries. This was to be remedies in the subsequent phases in which the project was opened to more role-players and included substantive outreach that involved regional meetings and technical support to the developing participants. See more A Christians & Stephen E Shay "Assessing BEPS: Origins, Standards, and Responses" (2017) General Report 102A *Cahiers de Droit Fiscal International*.

¹¹² *Ibid.*

¹¹³ Second Interim Report of the Commission of Inquiry into Certain Aspects of the Income Tax Structure of South Africa, 1995.

¹¹⁴ This was provided for in the earlier version of section 31 of the Income Tax Act when read in conjunction with the SARS Practice Note 2 of 1995.

the interests, financial charges and other considerations relating to the excessive debt were disallowed.

On 1 April 2012 the previous provision applicable to thin capitalisation together with the practice notes were repealed as they were regarded as too narrow in their application and thus easily manipulated.¹¹⁵ It was also argued that the repeal was necessary to align the thin capitalisation regime with the international standard and best practices. As shall be discussed in detail below, the thin capitalisation regime was merged with the transfer pricing provision in s 31 and the ALR principle became the determinative method instead of the fixed ratio principle.¹¹⁶

3.3 THE OECD LEGAL FRAMEWORK

As stated earlier, the OECD has been the most prominent norm-setter in the field of global tax legislation. However, as it is not the global taxing body, its work is of a guidance nature only unless the state, like South Africa has done, specifically accepts the standards as its law. In this section, the relevant thin capitalisation legislative principles set in the Model Tax Convention are discussed together with the outlined measures raised in the BEPS Action Plan and Reports. It is these standards that will be regarded as the OECD legal framework.

a) Article 9 of the OECD Model Convention, 2017

Arrangements involving associated enterprises are covered by Article 9 of the OECD Model Convention, 2017.¹¹⁷ Transfer pricing and thin capitalisation both fall under this provision. The first part of the Article states that in cases where an enterprise or the same persons from one state (State A) ‘participates directly or indirectly in the management, control or capital of an enterprise’ from another state (State B), and conditions are made to the arrangement between the two enterprises¹¹⁸ which differ in their commercial or financial nature from those that would arise had the arrangement been between independent entities, the profits which would have

¹¹⁵ Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010.

¹¹⁶ SARS, ‘Draft Note in Determination of Taxable income in International Transaction: Thin Capitalisation’ (2013).

¹¹⁷ Note that the United Nation’s version of the provision is a reproduction of the OECD version except for a third paragraph which allows for the (ii) adjustment to not be considered when a final ruling on the payments has been granted on the grounds of fraud, gross negligence or wilful default. See UN *United Nations Model Double Taxation Convention between Developed and Developing Countries 2017* (2017) at 175.

¹¹⁸ The 2016 Update on the BEPS Action Plan makes provision for the inclusion of disguised third party arrangements to be regarded as transactions between connected parties and therefore covered by the ambit of the Article.

arisen (ie to the receiving enterprise), but for those conditions, then the amounts may be included in the tax calculation of the receiving enterprise by State B.¹¹⁹

In other words, should connected enterprises in different jurisdictions contract with special conditions that would not be possible had the enterprises contracted like unconnected parties on normal open market terms, then the tax authorities can re-adjust the enterprises accounts. Notably, the Commentary emphasises that the adjustment and consequent tax charge will only be possible should the transaction not have been at arm's length.¹²⁰ It can be observed that central to the provision is the ALR which will be discussed in detail below.

The second part of the provision is more concerned with the prevention of double taxation resulting from the re-adjustment made under sub-art. 9(1).¹²¹ It states that should State B make a readjustment and tax the profits of the receiving enterprise as if the contracting was between independent entities, then State A shall also make an 'appropriate' adjustment to its tax charge on the profits of the lending enterprise or persons.¹²² Before making the adjustment, it is necessary that State A establish that the tax adjustment initially made in State B correctly reflects the profit amount that would have been should the transaction been at arm's length.

According to the OECD Commentary, should the adjustment made on the receiving enterprise's profits by State B not correctly reflect the profits that would have been, then State A will not have any commitment to readjust its tax charge.¹²³ Adjustments are only to be effected if the initial adjustment made is justified in both principle and with regards to the amount.¹²⁴ Nevertheless, the sub-provision does not cover adjustments that constitute a 'secondary adjustment' ie adjustments which are made to ensure that the situation is established as it should have been at arm's length.¹²⁵ Finally, it must be highlighted that neither the Article itself nor the

¹¹⁹ Article 9(1) of the OECD Model Tax Convention on Income and on Capital, 2017 (OECD Model). It needs to be highlighted that, as stated by the Commentary on the Model, this Article is intended to be applied in complement with the applying state's domestic provisions, where applicable, and cannot be said to bar the application of national laws that may differ from the conditions in the Article.

¹²⁰ *OECD Model Tax Convention on Income and on Capital: 2017(Full Version)*, (2017) OECD Publishing, Paris.

¹²¹ *Ibid.*

¹²² Article 9(2) of the OECD Model.

¹²³ *Ibid.*

¹²⁴ Art. 9(2) of the OECD Model.

¹²⁵ It must be noted that inasmuch as both State A and State B may make adjustments in accordance with Article 9, it might not automatically result in the situation reflecting what should have been at arm's length because in most

Commentary specifies the criteria with which the paragraph 2 adjustment is to be made aside from a requirement of consultation between the relevant authorities nor does it indicate the time period in which an adjustment can be made¹²⁶ hence countries have come up with their own methods to effect the adjustment.¹²⁷

Correlated to art. 9 are Articles 11, 23 (consisting of 23 A and 23 B) and 24 of the OECD Model. Briefly, art. 11 deals with the tax treatment of interest that is paid in one state to a taxpayer in another where there is a treaty in place between the two states and usually involves the limiting of the taxing rights of the state from which the interest is sourced.¹²⁸ However, per sub-art. 11(6) the article is only applicable where the interest payment is at arm's length, effectively leaving art. 9's secondary adjustment to apply in full without any encumbrance. Articles 23 A and 23 B provide the methods for eliminating double taxation and are an important element to art. 9 in that they provide a mechanism in which the non-taxing state will either exempt¹²⁹ or credit¹³⁰ the taxpayer to avoid doubly taxing them for the same amount. Finally, art. 24 is a general non-discrimination provision that prohibits contracting states from applying more burdensome taxation on taxpayers from another contracting state compared to similar taxpayers who are nationals of the taxing state.¹³¹ However, like art. 11 above, art. 24(4) which specifically deals with deductions discrimination expressly limits the art. 24's application from situations where there is an arranged transaction between related parties, one of which is resident of the taxing

cases the profits would be in the hands on the lending enterprise already. The secondary readjustment thus serves to restore the mismatch where the receiving enterprise is taxed on a deemed amount that is not necessarily in its hands.

¹²⁶ An adjustment to the commentary did however provide for states to have a provision limiting the time in which the paragraph 1 adjustment can be made. This provides for some form of clarity for the corresponding state which can then tax their resident enterprise without worrying about the possibility of a secondary adjustment after the stipulated period has expired. This leeway however ought to expressly indicate that there will not be a limitation to adjustments that are effected as a result of fraud, gross negligence or wilful default, an interesting shift by the OECD that parallels the third paragraph in the UN Model as shall be shown below.

¹²⁷ *Commentary* op cit fn106. It must also be emphasised that the secondary adjustment has been a bone of contention amongst developing countries who argue that it could prove very costly and thus states such as Brazil, Thailand, Vietnam and Russia have opted not to include paragraph 2 in their conventions. However, even with the UN alternative of the provision, the wording remains the same with the commentary only providing for flexibility by allowing countries to make the obligation to make a secondary adjustment optional as opposed to strictly preemptory. Furthermore, the UN Model goes further and includes a third paragraph that restricts adjustments to be made if they are initially effected due to a final administrative or other legal ruling under the first paragraph and the enterprise is liable to penalty for fraud, gross negligence or wilful default. See both art. 9(3) and the commentary on Article 9 of the UN Model Taxation Convention, 2017.

¹²⁸ Article 11 of the OECD Model, 2017.

¹²⁹ Article 23 A *ibid*.

¹³⁰ Article 23 B *ibid*.

¹³¹ Article 24 *ibid*.

state, with the purpose of getting a tax benefit, situations that are covered by art. 9. Given the diminished relevance of these articles to the current study, less emphasis will be given to them.

In summary, art. 9 is relevant in determining whether both the interest rate attached to the loan is at arm's length and whether the prima facie loan itself can be regarded as a loan or will be characterised as some other form of payment.¹³² It is thus broad enough to cover instances of hidden capitalisation and even back-to-back/disguised transactions. Furthermore, art. 9's application to thin capitalisation has always been considered as a hand-in-glove affair with domestic rules applicable to thin capitalisation. There is therefore room for the application of specific domestic rules to thin capitalisation, particularly in determining the adjustments to the profits, provided these rules are consistent with the convention and do not unduly raise the profits of the relevant domestic enterprises to more than the arm's length. It is for this reason that the OECD provides guidance as to the approaches to be followed by the member states in assessing thin capitalisation. These are discussed below.

b) Approaches to address Thin Capitalisation

(i) The Arm's length Rule

For years, the arm's length principle has been regarded as the leading approach for both instances of transfer pricing and thin capitalisation. It appears as part of Article 9(1) of the OECD Model Convention dealing with both transfer pricing and thin capitalisation. The principle deals with situations where conditions made or imposed between two connected/related companies in their commercial or financial relations differ from those conditions that would have been imposed by independent enterprises. Should any profits have arisen and or accrued to one of the companies had it not been for those 'special' conditions, the principle demands that these profits be included in the profit calculation of that enterprise to which it would have accrued and effectively require that the enterprise be taxed accordingly. The principle is therefore an adjustment standard under which entities that may be part of a company group are regarded as

¹³² *Commentary* op cit fn106.

separate entities and are therefore subjected to the same treatment that comparable independent entities would have transacted under.

However, because of its comparative approach, the ALR is criticised for its failure to account for economic considerations that may motivate the connected entities to transact outside the arm's length which may not necessarily be unrelated to an intention to seek a tax advantage.¹³³ Moreover, as shall be expanded in Chapter Four, the ALR is also criticised for its complexities which tend to present difficulties for tax administrations which are not as well-resourced and equipped to assess whether the arrangements in question properly fall under its compass.

(ii) Fixed Ratio Approach

The main contender to the ALR approach, the fixed ratio approach is presented as a panacea for the difficulties attached to the use of the ALR. This approach utilises a threshold-based rule to govern the amount of debt to equity a company can maintain for tax purposes. Under it, if a company's total debt happens to be in excess of a certain threshold proportion of its equity then the interest arising from the loan or the excess of the loan amount outside the threshold is automatically disqualified for deductions and instead is treated as a dividend.¹³⁴ Attention must be given, however, to the fact that the debt to equity proportion in question when assessing thin capitalisation under the fixed ratio approach is the debt amount and equity contribution relevant to that particular connected party in question.

To illustrate the above, should the fixed ratio be a 2:1 debt to equity ratio and a company's connected shareholder whose equity value is 100 lends the company an amount of 300, the loan will fail to meet the threshold requirement as this will result in the company having a 3:1 debt-equity ratio with regards to that connected party. A mechanical application of the fixed ratio will establish that the company is thinly capitalised, and the tax authorities will therefore disallow the 100 that exceeds the threshold from an interest deduction regardless of the rationale behind the debt financing. It can thus be ascertained that the fixed ratio approach is a stricter approach to addressing thin capitalisation but is also a more administratively friendly approach.

¹³³ Note that a more expansive engagement with the ALR will be offered in Chapter Four.

¹³⁴ OECD Model op cit fn119.

(iii) Earnings Stripping Rules

In recent years, there have been many variations to the fixed ratio approach, with the earnings stripping EBITDA rule as the leading modification.¹³⁵ Applying to both residents and non-residents, the EBITDA rule uses a threshold rule to curb thin capitalisation that demands that a company's connected debt fall below a certain proportion of the company's earnings before interests, taxes, depreciation and amortisations (hence EBITDA) in order to qualify for interest deductions.¹³⁶ Should the company's debt fall above the debt to EBITDA threshold, the tax authorities disallow deductions for interests arising from the amount of the loan in excess.¹³⁷ A notable feature of this approach is its focus on the entity's earnings as opposed to its equity, a measure which is curious for its concentration on the loan's value to the entity's earnings capacity and its complementary flexibility in allowing for certain debt to equity capitalisation excesses in relevant cases provided the financing falls within the EBITDA threshold.¹³⁸ It is therefore not much of a surprise that the EBITDA rule is regarded as a more effective tool to combat BEPS by the OECD.¹³⁹

c) The BEPS Project

The BEPS Project compiled fifteen action plans in a bid to comprehensively challenge the issue of BEPS by confronting its root causes rather than the symptoms.¹⁴⁰ Of these fifteen, Action 4

¹³⁵ Since the adoption of the Anti-Tax Avoidance Directive (2016/1164), the European Union has been a notable proponent of the EBITDA approach. See further Council Directive (EU) 2016/1164 of 12 July 2016 Laying Down Rules against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market, art. 4 OJ L 193 (2016), EU Law IBFD and R H M J Offermanns Section 7, *European Union - Corporate Taxation* (2019) Country Surveys, IBFD (accessed 9 Jan. 2019).

¹³⁶ OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report* (2015) OECD/G20 Base Erosion and Profit Shifting Project (hereinafter *BEPS Report Action 4*).

¹³⁷ *ibid.*

¹³⁸ Under the EBITDA rule, a loan is to be assessed on its value addition to the lending entity. Should the loan add no value to the lending entity's earnings value and potential, then that loan payment is made for the sole purpose of gaining a tax advantage and will therefore be disallowed from an interest deduction. This thus makes provision for instances where there are high risk factors such that the investment involved is only possibly by way of excessive capitalisation through debt financing, for example in mining ventures, where the loan's value towards the entity's earnings is positive to the entity's operation. In such instances, although thin capitalisation can be established under the fixed ratio, under the EBITDA the interest deductions will possibly be allowed.

¹³⁹ The *BEPS Report Action 4* op cit fn136 regards the earnings stripping approach as more preferable for the following reasons: a) that earnings provide a better indication of an entity's ability to service and carry its debts; b) thin capitalisation rules do not account for prevailing interest rates and, c) thin capitalisation rules can be easily avoided by stuffing the equity of the entity just before the assessment of the debt:equity ratio. See also OECD *Action 4 - 2016 Update* op cit fn110.

¹⁴⁰ OECD 2016 Explanatory Statement op cit fn108.

directly deals with thin capitalisation whilst Action 2 which deals with the issue of hybrid mismatch arrangements indirectly impacts thin capitalisation. Briefly, Action 4 is designed to limit base erosion by interest deductions and other financial payments. It proposes an approach that directly links the entity's net interest deductions to the taxable income generated from the entities economic activities, an approach that is akin to the value approach in thin capitalisation.¹⁴¹ It also encourages increased co-ordination by states in their national rules to safeguard the interest limitations from resulting in double taxation.¹⁴²

Practically, the BEPS Report suggests several approaches to deal with thin capitalisation which include using a *de minimus* threshold, a group-based interest-debt ratio, the ALR and the EBITDA fixed ratio approach. Although the reports engage in lengthy discussions of the above approaches, the most important of these approaches is the interest/EBITDA-based earnings stripping approach which the OECD touts as the best approach, especially when utilized in combination with a group ratio rule. This approach is favored for its appropriateness in measuring economic activity in the given company and company groups¹⁴³ and for its simplicity in administration for both tax administrators and companies.¹⁴⁴ Since the EBITDA ratio restricts interest deductions when they exceed a certain proportion of the EBITDA, the OECD Report recommends that the best practice benchmark should be set within a scale of 10 percent to 30 percent.¹⁴⁵ It must be noted, however, that the Report makes provision for a higher ratio in the event that the ratio is used in isolation; the country does not allow carry-overs of disallowed interests; targeted rules are also used; the country has higher interest rates relative to other countries and or where it is constitutionally required that all entities receive the same treatment, despite posing different risk levels.¹⁴⁶ The BEPS Report thus offers countries leeway to have policy flexibilities when following the best practice approach.

¹⁴¹ OECD Explanatory Statement op cit fn108.

¹⁴² Ibid.

¹⁴³ *BEPS Report Action 4* op cit fn136 at 45.

¹⁴⁴ Ibid at 47.

¹⁴⁵ Ibid at 50.

¹⁴⁶ Ibid.

3.4 THE SOUTH AFRICAN REGIME

a) Section 31 of the ITA

After the 2011 amendments to the Income Tax Act, the provisions applying to thin capitalisation were merged with the rules governing transfer pricing, in essence re-categorising thin capitalisation as a component of transfer pricing.¹⁴⁷ It appears that the merging was necessary since both provisions apply the ALR and thin capitalisation is viewed as ‘merely an extension of transfer pricing’.¹⁴⁸ At present, the provision that applies to thin capitalisation, section 31(2), reads as follows:

‘(2) Where—

(a) any transaction, operation, scheme, agreement or understanding constitutes an *affected transaction*; and

(b) any term or condition of that transaction, operation, scheme, agreement or understanding—

(i) is a term or condition contemplated in paragraph (b) of the definition of “affected transaction”; and

(ii) results or will result in any *tax benefit* being derived by a person that is a party to that transaction, operation, scheme, agreement or understanding,

the taxable income or tax payable by any person contemplated in paragraph (b) (ii) that derives a tax benefit contemplated in that paragraph must be calculated as if that transaction, operation, scheme, agreement or understanding had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm’s length.’

Oguttu summarises the above provision as “where any transaction, operation, scheme, agreement or understanding constitutes an affected transaction; and any term or condition thereof results, or will result, in a tax benefit for a party to that transaction, the taxable income of that person must be calculated as if that transaction had been entered into in an arm’s length dealing.”¹⁴⁹

¹⁴⁷ Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010 at 75.

¹⁴⁸ Explanatory Memo, 2010 op cit fn147.

¹⁴⁹ Oguttu *International Tax law* op cit fn7 at 247.

The above provision is quite complex. It is thus necessary to unpack important concepts used in the provision as these will be key to understanding the workings of South Africa's thin capitalisation regime.

Affected transaction

Section 31(1)(a) outlines the definition of an affected transaction as any transaction, operation, scheme, agreement or understanding which is *directly or indirectly* entered into or effected between or for the benefit of either or both-

- a resident and a non-resident;
- a non-resident and a non-resident who has a permanent establishment within the Republic to which the 'affected transaction' relates;
- a resident and another resident who has a permanent establishment outside the Republic to which the 'affected transaction' relates;
- a resident and a controlled foreign company in relation to any resident

which are connected persons in relation to one another¹⁵⁰ and any term and or condition of the affected transaction differs from that which would arise in an arm's length dealing.¹⁵¹

Directly or indirectly

A phrase that is prominent as a result of the definition of 'affected transaction,' 'directly or indirectly' is interpreted as being extensive enough to include transactions, operations, schemes, agreements and understandings directly or indirectly entered into or effected between or for the benefit of either or both parties specified above.¹⁵² It is not limited to loans between the connected parties but also covers instances of back-to-back transactions with international bank as intermediaries and provision of guarantees by a connected party to a third party lender.

Connected Person

Of concern to this paper is the definition of connected party relating to a company. This is given in section 1 of the ITA as:

¹⁵⁰ Section 31(1)(a) of the ITA.

¹⁵¹ Section 31(1)(b) *ibid*.

¹⁵² Oguttu *International Tax Law* op cit fn7 at 247.

- any other company that is part of the same company group in which at least 50 percent of equity shares in each member company is held by the controlling group company;
- any person other than a company as per the Companies Act, 2008 who individually or jointly with any other connected persons holds directly or indirectly at least 20 percent of the equity shares or voting rights in the company
- any other company which is managed or controlled by any company or person who is a connected person in relation to such a company or person that is in relation with the aforementioned person
- any member or a close corporation; relative of a member or trust connected to such a member or any close corporation or company connected in relation to any member, relative or trust as contemplated above.¹⁵³

Tax Benefit

Section 1 of the ITA defines tax benefit as inclusive of any tax avoidance, postponement or reduction of any tax liability administered within South Africa by the revenue administrator.¹⁵⁴

In a nutshell, s 31 focuses on cross-border affected transactions that have been effected directly or indirectly between, or carried out for the benefit of connected persons and which result in a tax benefit. A relational link is required for transactions to fall under the provision. It is thus crucial to assess whether the conditions in which it is made are similar to conditions and terms under which the transaction, operation or scheme would have attracted had the connected parties been independent persons acting at arm's length.¹⁵⁵ Should the conditions differ from those under an arm's length arrangement and they result in a tax benefit, South African law will charge income tax on the arrangement as if it was carried out at arm's length unless the parties account for the disparities.

This means that the interest, financial charges and other payments that relate to the excessive debt and interest that would not have been made in an arm's length situations are disregarded as

¹⁵³ Section 31(1) read in line with s 1 of the ITA.

¹⁵⁴ Section 1 of the ITA.

¹⁵⁵ SARS 'Draft Note in Determination of Taxable income in International Transaction: Thin Capitalisation' (2013) (hereinafter Draft Note) para 4.

deductions in the computation of a taxpayer's taxable income.¹⁵⁶ Section 31 (3) then adds the element of a secondary adjustment under which the excess interest payments (amount above the arm's length payment) are deemed to have been a dividend *in specie*. The deemed dividend *in specie* is then taxed accordingly for withholding dividends tax.

The ALR is thus the dominant approach in dealing with thin cap italisation under s 31. Nevertheless, as shall be shown below, the fixed ratio approach is not completely discarded but is used by SARS as a risk identifying factor when assessing instances of thin capitalisation.¹⁵⁷

b) Application of the Thin capitalisation Legislation

The application and interpretation of South Africa's thin capitalisation regime is governed by the SARS Draft Interpretation Note on Thin Capitalisation (the Note).¹⁵⁸ Being of a guidance nature and not binding law, the interpretation note is referred to as a draft note due to the absence of its finalisation by SARS but this should not be read as an indication of obsolescence.¹⁵⁹ Instead, this Note remains the leading guide on how s 31 and the accompanying arm's length basis is interpreted and applied in practice. It must be emphasized however that the Note's guidance is not meant to be exhaustive, rather care must be taken to ensure that each instance of thin capitalisation is to be assessed on its merits and specific facts and circumstances.¹⁶⁰

Operationally, the note highlights several tax administration issues that include the taxpayer's notification burden for every affected transaction that is done outside arm's length. This burden includes the requirement for filing a return document prepared under the assumption of an arm's length dealing demonstrating that a tax deduction has not been claimed for portions of the debt not at arm's length. And in the case where a transaction which falls under the definition of an affected transaction being at arm's length, the taxpayer ought to validate that it was in-fact at arm's length. There is therefore a presumption of non-arm's length dealing whenever an interaction falls within the definition of affected transaction.

¹⁵⁶ Draft Note op cit fn155 para 4.

¹⁵⁷ M Stiglingh (ed) *Silke: South African Income Tax*, (2013) vol 1 at 626.

¹⁵⁸ Draft Note op cit fn155.

¹⁵⁹ The reluctance to finalise the Note is apparently due to SARS being confused by the global developments surrounding base erosion such as the UN and BEPS projects and cannot instructively adopt a position as to the approach to follow yet.

¹⁶⁰ Draft Note *ibid* para 1.

In terms of guidance on the application of the arm's length principle, the Note acknowledges the importance of the OECDs guidelines.¹⁶¹ However, it does make important and notable additions in relation to the determination of the arm's length amount of debt, the characterisation of debt and equity for the purposes of testing, the determination of whether the interest rate is at arm's length and the timing at which taxpayers have to consider in determining if they are thinly capitalised. The Note intimates that this process should involve a functional analysis in which the taxpayer looks at the function of the debt and its structure, and a comparability test in which the debt in question is compared with an arm's length debt on both the interest rate and the amount of debt.¹⁶²

Concerning the determination of the arm's length amount of debt, SARS requires both the lender's and borrower's perspective to be considered by the taxpayer. For the lender, the question is whether they would have been prepared to lend that amount at arm's length whilst for the borrower the enquiry is whether acting in the best interest of the business the borrower would have borrowed that amount. Being an inherently factual assessment, this determination requires engagement with a wide range of relevant factors and circumstances. These include, (a) the funding structure in the case; (b) the business the borrower is involved in; (c) their financial strategy; (d) the effect the transaction will have on the company group structure; (e) indicators of the borrowing company's creditworthiness; (f) availability of security; (g) the terms and conditions of the funding arrangement and, (h) the borrowing company's financial projections for an appropriate period. These factors are considered in a comparative assessment which places the party in question against a comparable party at arm's length.¹⁶³ For example, should the borrower have a healthy balance sheet and excess cash flow, the arm's length amount of debt could be regarded as none should a comparable borrower in a similar circumstance not have borrowed the amount.

As for the characterisation of the debt and equity, SARS takes the view that arm's length transacting parties would look at the economic substance when classifying the financing method. Preferring the international Financial Reporting Standards as guidelines for the economic

¹⁶¹ Draft Note op cit fn155 para 5.1.

¹⁶² See Draft Note op cit fn155 para 3.2 for further details on the application of the functional and comparability test.

¹⁶³ As be discussed in Chapter Four, this comparability standard is a bone of contention for the proper implementation of the regime as there is a dearth of comparable data.

substance determination, SARS asserts that the taxpayer's characterisation should regard transactions that would be economically regarded as a debt equivalent such as finance leases as debt whilst some hybrid debt schemes will be treated as equity.

The Note also makes an important proclamation that the assessment of arm's length will also be applied to the interest rate of the affected transactions. This is because circumstances can arise where the debt itself is at arm's length, but the interest attached to that particular debt could not have been charged from a lender's perspective and would not have been accepted from a borrower's perspective. Should the interest rate be determined to not be at arm's length, SARS requires that, like the primary adjustment for excessive debt, the portion which is not at arm's length be disregarded for deduction purposes. In addition, should thin capitalisation be established, a secondary adjustment is made under which the excess interest is treated as a form of dividend *in specie* payment by the borrowing connected company to the lending connected company. This is subsequently subjected to withholding dividends tax.¹⁶⁴

Regarding timing, the Note requires that the taxpayers assess their capitalisation (i) at the time and (ii) after the time of transacting in what falls under the definition of affected transaction. This places a requirement on taxpayers who engage in affected transactions to regularly assess whether they are thinly capitalised.

Finally, having shown the indicators of thin capitalisation such as a greater amount of interest-bearing debt, a longer duration of lending than would be at arm's length and any terms that would not have been entered in at arm's length, the Note outlines the effects of a taxpayer being thinly capitalised when they engaged in the affected transaction. The first effect is that there needs to be a primary adjustment in which all excess debt and interest that would not have been present in an arm's length dealing are disregarded for deductions purposes. This means that should R100 on an interest rate of ten percent be determined to be the excess debt whilst one percent is regarded as the excess interest rate, then all deductions attached to the R100 are disallowed whilst for interest all the extra one percent that attaches to the arm's length debt at ten percent is disallowed. The Note also calls for a secondary adjustment which requires that all excessive interest payments made that attach to the non-arm's length debt and interest rate (ie 10

¹⁶⁴ Note that although the Draft Note in para 6.2 recharacterizes the excess debt into a deemed loan, this has since been changed to a deemed dividend instead since 2015.

percent of R100 and all one percent on the arm's length debt) be re-characterised as dividend payments by the borrowing company and therefore subject to the withholding dividend tax.

c) Interplay with section 23M of the ITA

Following extensive pronouncements by the OECD on the efficacy of domestic thin capitalisation provisions in reducing opportunities for base erosion, the legislature introduced s 23M into the ITA on the 1st of January 2015 to address a deductions/exemptions mismatch loophole and to complete the mechanism for controlling excessive debt.¹⁶⁵ Serving a similar purpose to the thin capitalisation provision in s 31 or as one would call a 'backstop' role to s 31, the provision deals with limitation on the aggregate exempt¹⁶⁶ interest deductions by a taxpayer *not subject to tax* and which arise from a 'controlling relationship'¹⁶⁷ between the resident debtor and a foreign 'taxpaying' creditor. It therefore also seeks to fortify against possible risks of parties who are in the same economic unit arranging their affairs in a way that results in excessive interest deduction claims.¹⁶⁸

Substantively, s 23M applies when there is (a) a controlling relationship between the exempted person in whose hands the interest accrues and the resident debtor claiming the deductions;¹⁶⁹ and, (b) (i) the interest is not subject to tax in the hands of the creditor,¹⁷⁰ whilst (ii) if the foreign creditor is a controlled foreign company, the interest must not be included in the its net income in the company's tax year that commences or ends within the year of assessment in which the debt is being claimed.¹⁷¹ Markedly, analogous to s 31's treatment of back-to-back loans, the limitation in s 23M will also apply even in the absence of a direct controlling relationship provided that the creditor obtained the financing of the debt from or the debt was guaranteed by a person who is in a controlling relationship with the debtor.¹⁷² On the other hand, the provision is inapplicable

¹⁶⁵ Explanatory Memorandum on the taxation Laws Amendment Bill, 2013 para 2.6. See also *Silke* op cit fn157.

¹⁶⁶ This is because the interest deductions covered by the provisions is specifically interest that is received by a party exempt from paying tax within South Africa and is therefore exempt from a withholding interest charge.

¹⁶⁷ Controlling relationship is to be taken in its meaning in s 1 of the ITA that contemplates the holding of 50 percent equity shares or voting rights in a company by the controlling person.

¹⁶⁸ Explanatory Memo 2013 *ibid*.

¹⁶⁹ Section 23M (2)(a) of the ITA.

¹⁷⁰ Section 23M (2)(b)(i)(aa) *ibid*.

¹⁷¹ Section 23M (2)(b)(i)(bb) *ibid*. The provision also goes further to provide for the inapplicability of the limitation should the interest in question be covered by the ambit of s 24N. (See section 23m (2)(b)(ii)).

¹⁷² Section 23M (2)(b) *Ibid*.

when there is no controlling or a back-to-back relationship¹⁷³ and or when the interest that is incurred falls below the repo rate plus 100 basis points.¹⁷⁴

Should the above conditions be satisfied, the consequence is that the amount of interest allowable as a deduction in respect of the total of above-affected¹⁷⁵ debts owed cannot be in excess of a legislatively determined amount. This threshold is provided for in s 23M (3) and consists of the aggregate of the interest income that is accrued or received by the debtor¹⁷⁶ and, a percent of the debtor's adjusted taxable income¹⁷⁷ calculated by multiplying 40 percent with the repo rate divided by 10 but limited to a ceiling of 60 percent of the debtor's adjusted taxable income.¹⁷⁸ In addition, the threshold amount must be reduced by incurred interest amounts from debts falling outside the ambit of the provision.¹⁷⁹

It is thus clear that s 23M offers a parallel function to the thin capitalisation provision by also limiting excessive interest deductions. Likewise, it is also fundamentally influenced by the policy consideration to balance between promoting foreign investment and protecting the tax base.¹⁸⁰ There is, however, a question as to the interplay between the two provisions, particularly the sequence of application. This is relevant when the interest in question has been incurred outside arm's length and yet is also interest that falls under the scope of s 23M. Kruger suggests that given s 23M requires the assessment of taxable income first before it is applied and this can only be established after applying s 31, s 31 must therefore be applied first before the s 23M assessment.¹⁸¹ However, he also counter-proposes that since no 'tax benefit' may have been derived by the taxpayer for s 23M to apply, the provision must predate the thin capitalisation provision.¹⁸² Unfortunately, the legislature is yet to provide clarity on the issue of sequencing.

¹⁷³ Section 23M (6)(a)(i) of the ITA.

¹⁷⁴ Section 23M (6)(a)(ii) *ibid*.

¹⁷⁵ That is, debts arising from a controlling relationship contemplated by s 23M.

¹⁷⁶ Section 23M *ibid*.

¹⁷⁷ Defined in s 23M (1) and summarised in the Explanatory Memo as "the taxable income of the debtor less all interest received or accrued, section 9D controlled foreign company net income and recovered or recouped amounts in respect of capital assets with the addition of interest incurred, all capital allowances and an additional 75 per cent of the debtor's rental income." (See Explanatory Memo, 2013 *op cit* fn129 para 2.6 C)

¹⁷⁸ Section 23M (3)(b) *ibid*.

¹⁷⁹ Section 23M (3) *ibid*.

¹⁸⁰ See Explanatory Memo 2013 para 2.6 A.

¹⁸¹ D Kruger 'Interest-Deduction Limitation Section 23M,' (2015) vol 6:1 *Business Tax & Company law Quarterly* at 20.

¹⁸² *Ibid*.

3.5 THE CANADIAN CONTRAST

a) *The policy concerns*

Like most nations concerned with the protection of their domestic tax base, Canada is greatly concerned with curbing the aggressive tax evasion, avoidance and base erosion strategies implemented by MNEs to reduce their tax obligations. Thin capitalisation as one of the ways in which MNEs carry out these schemes, is thus of major policy interest to the Canadian government. Not only has the government taken strides over the years in setting up regulatory frameworks that address the phenomenon, it has also streamlined and constantly updated their effectiveness to keep up with the ever-evolving BEPS measures taken by corporations. Some of these sharpening measures include the inclusion of trusts and even partnerships in the ambit of thin capitalisation rules as these entities had become gateway vehicles for corporations to skirt the provisions.¹⁸³ Also noted as a critical measure is the inclusion of back-to-back debt transactions within the compass of thin capitalisation rules.¹⁸⁴

Underlying the commitment to make Canada an attractive investment destination, the policy considerations behind the Canadian regime also include concerns of integrity and fairness of the application of the rules.¹⁸⁵ These concerns have been the motivations behind the reduction of the fixed debt to equity ratio to a ratio that is in keeping with the international standard. However, it is also noted that due to the need to balance the investment interests, Canada's policy, although touting the concerns of fairness, appears to imply that it accepts for certain levels of deductions provided they attract foreign investment.¹⁸⁶

b) *Legal provisions*

Unlike South Africa, Canada utilises a fixed ratio approach in its thin capitalisation regime that is found in sections 18(4) to 18(8) of the Income Tax Act of Canada.¹⁸⁷ This difference reflects the policy divergence between the two countries, with Canada viewing thin capitalisation as a

¹⁸³ Canada, *Jobs Growth and Long-term Prosperity Economic Action Plan 2012* (2012) Canada at 419. See also Canada, *Jobs Growth and Long-term Prosperity Economic Action Plan 2013* (2013).

¹⁸⁴ Canada, *The Road to Balance: Creating Jobs and Opportunities Economic Action Plan 2014* (2014) at 345.

¹⁸⁵ *The Road to Balance* op cit fn184 at 259.

¹⁸⁶ N Boidman, H Gagne & M Kandev 'Interest Deductibility in Canada: What's the Fuss?' (2015), vol 79 no. 2, *Tax Notes International*.

¹⁸⁷ Income Tax Act of Canada, Chapter 148 of the Revised Statutes of Canada, 1952.

problem of shareholder equity disguised as debt¹⁸⁸ whereas South Africa understands it as a transfer pricing issue that targets the problem of excessive interest deductions.¹⁸⁹ In overview, the rules state that in computing the taxable income of a corporation or a trust or a partnership in which a Canadian-resident corporation or trust are partners, the authorities ought to disregard the granting of a deduction in respect of an otherwise deductible interest paid or payable to specified non-resident shareholder if the amount of the debt to specified non-residents exceeds a 1.5 to 1 debt to equity ratio.¹⁹⁰ A specified non-resident shareholder (SNRS) is defined in the rules as a non-resident person or non-resident owned investment corporation who at the time of engaging in the debt-granting transaction either alone or together with persons with whom they were not dealing at arm's length owned shares that had 25 percent or more voting rights or 25 percent of the fair market value of all the company's issued and outstanding shares. In the case of a trust, a specified non-resident beneficiary means a non-resident whom alone or together with other person on a non-arm's-length basis owns 25 percent or more of the fair market value of all interest beneficiaries of the trust.¹⁹¹ The Canadian regime is therefore similar to the South African system in how it defines connected parties to the transactions that fall under the ambit of the regime.

Another notable feature of the Canadian regime is its definition of equity when calculating the debt excess. Unlike the position followed by SA prior to its shift to an arm's length approach, the definition of equity is much more expansive and includes amounts such as retained earnings of the corporation at the beginning of the year, the contributed surplus by the SNRS during that year and all paid-up capital contributions from the SNRS of the company.¹⁹²

In application, the rules cover instances of classic thin capitalisation, 'hidden capitalisation' and back-to-back arrangements that fall above the 1.5:1 threshold. Should it be established that an arrangement triggers the application of the thin capitalisation rules and in-effect results in the

¹⁸⁸ Brian J Arnold 'Restrictions on Interest Deductions and Tax Treaties,' (2019) vol 73 no. 4 *Bulletin for International Taxation* at 172.

¹⁸⁹ Ibid at 171.

¹⁹⁰ Arnold (2019) op cit fn188. Take note that debt under Canada's thin capitalisation also includes trade debts as per *Uddelholm v. The Queen*, 87 DTC 5431 (FCTD).

¹⁹¹ Brian J Arnold & James J Wilson 'Aggressive International Tax Planning by Multinational Corporations: The Canadian Context and Possible Responses' (2014) vol 7 Issue 29 *University of Calgary School of Public Policy Research Papers* at 31.

¹⁹² Section 18(5) of the ITA of Canada. Take note that the Act has a slightly different definition with regards to the equity amount of a trust.

refusal of the excessive portion, the provisions call for an adjustment with regards to the tax treatment of the interest paid. Similar to the South African position, this adjustment requires that the interest paid or payable be re-characterised to be dividend distributions by the resident entity to its SNRS.¹⁹³ Consequently, there is a deemed charge of dividends tax that attaches to the interest on the excess which is chargeable in accordance with the applicable tax convention.¹⁹⁴ Should the convention allow Canada to charge a withholding dividends tax, then the tax is chargeable to the interest-paying corporation, whilst if it charged by the SNRS' resident country the convention's agreed rate will apply. This consequence is key in ensuring that MNEs do not get away with BEPS strategies as they will be subject to taxation under the application of the thin capitalisation rules.

¹⁹³ Note that for a partnership, the portion that is found to be excessive is not deemed a dividend but an amount equal to the excess is deemed to be included in the partnership's taxable income. See Arnold & Wilson op cit fn191.

¹⁹⁴ Jeffrey Shafer 'Canada Expands Thin Capitalisation Rules,' (2014) vol 24 *International Tax Review* at 69.

CHAPTER FOUR

4.1 OVERVIEW

This chapter presents an analysis of the South African thin capitalisation regime and considers its effectiveness in addressing BEPS by way of excessive interest deductions. It achieves this by first presenting a detailed critique of the OECD and its approach to dealing with BEPS in general, and thin capitalisation in particular. It then delves into an assessment of the South African regime that shall be framed by the assessment norms laid out in Chapter Two. Although the aim of the critique is to present an overall evaluation, the arm's length approach and the issue of absence of a safe harbour or concrete administrative rules shall be discussed in detail. Finally, after contrasting the South African regime's relationship to the OECD's guidelines against Canada's regime, the chapter shall proffer an evaluation of the framework's efficacy in curbing BEPS by way of excess interest deductions.

4.2 CRITIQUES OF THE OECD/ BEPS APPROACH

a) Political Critique of OECD

The distinctive feature of international law is that, unlike domestic law, the subject of such law are states and not individuals. As a result, for international law to be properly implemented, there is need for an inter-governmental organisation, such as the UN, whose task is to ensure that the subjects of international law – the states – adhere to the tenets of the binding rules. Interestingly, international tax law¹⁹⁵ as a field of international law lacks such a body to enforce the implementation of the rules. Instead, since the end of the Second World War, the task of establishing international tax law norms has been shouldered by the OECD and recently a fair share has been shouldered by the UN Tax Committee,¹⁹⁶ organisations that both lack the mandate at international law to enforce international tax law rules and norms. This is further exacerbated by the fact that the OECD is a closed organisation that furthers the interests of its

¹⁹⁵ In this case, international tax law is to be taken as the customary practices of sovereign states and, principles and standards propounded by international bodies such as the OECD and or the UN and tax treaties.

¹⁹⁶ The case of the UN Tax Committee is even more precarious as the committee consists only of experts in their individual capacities and no de jure national representatives are involved in its processes. See Durst (2018) op cit fn69 at 1158.

members and does not necessarily allow all other states to have the same level of say as its members in its decision-making processes. Therefore, despite its role as an international tax law norm setter, the OECD is still not a legitimate international tax organisation in the international law sense. It is therefore not surprising that one of the major criticisms of the OECD's work in international tax, and more specifically the fight against BEPS, is that it lacks the legal standing to lead the process.¹⁹⁷

Related to the above critique is the question of inclusivity in the OECD's decisions in general and the BEPS Project specifically. Dubbed a 'rich man's club,' the key decisions of the OECD are made by member states with the observer countries having no sway. Even with the BEPS Project which was a joint project by the OECD and the G20, the responsibility of compiling the report was shouldered by the OECD which arguably took in minimal contributions by non-member states in the decision-making process.¹⁹⁸ Linked to the legitimacy and inclusivity critique of the OECD is the argument that there is also lack of transparency in the BEPS Project. This stems from the criticism that there have not been sufficient involvements of civil societies, developing countries and other stakeholders whose input would have been valuable in fashioning an inclusive approach to curbing BEPS.¹⁹⁹ To make matters worse, the Project was carried out in such haste that there was no space for the developing countries and civil societies not represented in the process to adequately deliberate and formulate input to somewhat 'influence' the BEPS Project's framework.²⁰⁰ Consequently, the lack of transparency and inclusivity in the OECD processes makes it an uneasy choice to adopt the OECD norms and guidelines to curbing BEPS.

Further, considering the role the OECD framework plays internationally and the reality that BEPS has a universal impact on both OECD and developing countries, the Project's closed-group nature opens it up to inquiry on whether it serves international interests or merely those of the OECD. Not only are there questions about the legality of the project, but there is also

¹⁹⁷ Durst (2018) op cit fn99 at 1158.

¹⁹⁸ It is also argued that even within the member states themselves, the imbalances in power and influence means that the contributions of the more powerful member nations such as the US are given more prominence. One only needs to look at the EU's own initiative in dealing with BEPS to see that there is less consensus within the OECD itself but rather it is used to push for the agenda of certain economic superpowers within both the OECD and the G20.

¹⁹⁹ Yariv Brauner 'BEPS: An Interim Evaluation' (2014) February *Issue World Tax Journal* at 11. It must be emphasised, however, that as the Project developed there was a marked involvement of developing countries and other civil society groupings in the discussions and output.

²⁰⁰ S Fung 'The Questionable Legitimacy of the OECD/G20 BEPS project,' (2017) 10 *Erasmus Law Review* at 82.

disgruntlement by the developing world which feels the Project pushes for a Western-dominant ideology and decidedly granted only cursory attentions to issues facing developing countries.²⁰¹ An example of the disillusionment by developing countries is noted by Fung who highlights how India felt that the project was superficial in its approach and swept real issues under the carpet.²⁰² Eventually, the disgruntlement at the lack of transparency and inclusion led to the push for the UN to spearhead a project that would ensure that the international taxation rules would not disregard the interests of developing countries by being unjustly skewed towards the developed countries.²⁰³ One is therefore left with an impression that the OECD's framework is fraught with an ideological bias towards the OECD countries. Hence it is not necessarily a desirable standard from which a state like South Africa should emulate its anti-BEPS framework.

b) Policy Critique

Brauner contends that the BEPS Project is an opportunistic and political project that is led with unclear goals, a hasty schedule and equally unclear targets.²⁰⁴ He criticises the work of the OECD as a populist gimmick that is backed by political interests instead of real policy concerns.²⁰⁵ For a project of such magnitude to lack proper policy foundations means any proposals that it makes will always suffer due to its weak roots. As shall be shown below, the OECD's work has been hamstrung with weaknesses due to the failure to reconsider some fundamental policy concepts, the most notable of which is the benefits principle which grounds the source-residence taxing debate and the concept of tax competitiveness, which have been shown to only serve the interests of a few states.

(i) Source versus Residence Debate

As mentioned in the preceding chapter, prior to the OECD's assumption of international tax treaty work, the conceptualisation of model tax treaties and policies to combat double taxation was the responsibility of the League of Nations (LON) since the early 1920s. Yet even before the

²⁰¹ Fung op cit fn200. See also Richard S Collier 'The Impact of the OECD/G20 Base Erosion and Profit Shifting Project on the Task for Developing Countries of Applying the Arm's Length Principle in Practice,' (2018) vol 72 no. 4/5 *Bulletin for International Taxation*, Journal IBFB (accessed 26 March 2018).

²⁰² Ibid at 78.

²⁰³ Brauner op cit fn199 at 13.

²⁰⁴ Ibid at 12.

²⁰⁵ Ibid.

LON began its work, the International Chamber of Commerce had already compiled a model treaty which is noteworthy for its different approach to the issue of taxing rights between states.²⁰⁶ Instead of determining the rights on a binary source versus residence basis as the LON and OECD were inclined to do in the future, the ICC's version utilised a profit split methodology in which states would tax the contributed profits derived from the different states on a pro-rata basis.²⁰⁷

The LON, on the other hand, rejected this approach and, although it initially championed source over residence, residence rose to supremacy after the 1920s as the default taxing basis in international taxation.²⁰⁸ Thus, began the reign of the residence over source concept – particularly with regards to taxation of capital returns – that is still prevalent in the OECD policies and underlies the current international tax law system. Effectively, this means that it is the country in which the taxpayer is based that has primary taxing rights, even if the passive income is derived from a foreign state. But as the UN and developing countries have highlighted over the years, the residence concept is fundamentally tilted against developing countries which are primarily capital importers and are thus robbed of the right to tax MNEs operating in their jurisdictions. The question then is why the OECD, considering its role in the BEPS Project and its international impact, continues to perpetuate the residence concept.

The answer to the above question lies in what is called the benefits principle. Under this principle, it is argued that taxing rights hinge upon where the taxpayer derives the most benefits of the public service system. Correspondingly, it is also argued that taxing rights should be tied to where the taxpayer has a more effective political representation and accountability.²⁰⁹ The rationale for the residence preference is therefore that a taxpayer utilises the services and has more effective political representation in their residence state more than in the source country and should henceforth be taxed there. However, this argument overlooks the reality that it is in-

²⁰⁶ Brett Wells & Cym H Lowell 'Income Tax Treaty Policy in the 21st Century: Residence vs. Source,' (2013) vol 5:1 *Columbia Journal of Tax Law* at 6.

²⁰⁷ Ibid.

²⁰⁸ Ibid. Note that although the treaties utilised a split method in which a certain threshold source taxing was allowed, the default position that pervaded the model conventions was that the residence country had the taxing right.

²⁰⁹ Dale Pinto 'Exclusive Source or Residence-Based Taxation – Is a New and Simpler World Tax Order Possible?' (2007) July 2007, *Bulletin for international Taxation* at 281.

fact the source country that provides more benefits to the taxpayer during the production of the income at dispute in international taxation matters.²¹⁰

There is also an economic efficiency argument tied to the residence concept which asserts that a residence-based taxation promotes more economic efficiency as investment decisions will no longer be affected by the issue of tax rates in the investment destination.²¹¹ As this promotes both capital export and import²¹² neutrality, an MNE then becomes free to invest in foreign states based on other economic considerations as opposed to the destination's tax rates. Further, as it is more difficult to accurately trace the source of the income as opposed to determining the residence of the taxpayer, especially when factoring in the impact of globalisation and the technological revolution, it is apparently more efficient for the income to be taxed at residence than at source.²¹³

However noble the arguments for the supremacy of the residence concept may seem, it cannot be disregarded that most residence companies remain developed countries whilst source countries are predominantly developing countries. One can thus raise a political argument that the OECDs approach is exploitative to developing countries as it allows for MNEs whose residence lies in developed countries to funnel the profits from its resources, be they natural resources, human capital resources or an economic market, whilst not contributing to the revenue of the countries they are 'milking.' One can also proffer a developmental justice and equity argument that the OECDs approach perpetuates underdevelopment in developing countries since the allocation of rights to residence means that the developing source country can no longer utilise the revenue it would have collected to further development. It is therefore unfortunate that given the arguments above and the known impact BEPS has on developing countries, the policies underpinning the OECD's BEPS Project continues to uphold the residence concept.

(ii) Harmful Tax Competitiveness

Although the OECD BEPS Project calls for the harmonisation of tax legislation and cooperation amongst states, there is a marked reluctance to ruffle the policy of tax competitiveness, both

²¹⁰ Pinto op cit fn209 at 288-289.

²¹¹ Ibid at 280.

²¹² Only as far as the foreign sourced income of the residents is exempted from taxation.

²¹³ Ibid.

acceptable tax competition and the more nefarious concept of unfair tax competition which has been blamed for the continued flourishing of tax havens.²¹⁴ It is the observation of this study that while the OECD BEPS framework does deal with harmful tax practices in Action 5,²¹⁵ it does not comprehensively reject the concept of unfair tax competition. Yet it is now commonly acknowledged that this concept is a key ingredient to BEPS as MNEs take advantage of the resultant distortions amongst states to minimise their tax liabilities.²¹⁶ The silence has in a way been interpreted as tacit acceptance of the concept and as some commentators have noted, there is a reluctance to counter BEPS by some states as this would impact their tax competitiveness.²¹⁷ But what is tax competition and why does its implicit acceptance by the OECD pose problems for the efficacy of the fight against BEPS?

Tax competition refers to the practice in which states design their tax policies and legislation in a way that makes their jurisdiction a more attractive destination for investors who induce economic activity. Like a game of chess but with multiple players at the same time, national tax policymakers are in a constant battle against their foreign counterparts and are always crafting methods to make their tax systems more desirable to investors. Typical tax competition activities include how some states like Mauritius and the Virgin Islands charge very little or have no corporate tax at all, whilst those like South Africa offer tax breaks for a certain period if an investor decides to set-up its headquarter operations in the jurisdiction. Ideally, this policy should not ruffle much feathers. However, when excessively implemented without any economic basis but to present a more attractive regime, its impacts are far-reaching and have led to several civil societies, inter-governmental organisations and scholars condemning the practice.²¹⁸

²¹⁴ Oxfam, 'Tax Battles The dangerous global Race to the Bottom on Corporate Tax' (2016) Oxfam Policy Paper December 2016 at 9.

²¹⁵ See OECD 'Harmful Tax Practices - 2018 Progress Report on Preferential Regimes: Inclusive Framework on BEPS: Action 5' (2019) OECD/G20 Base Erosion and Profit Shifting Project.

²¹⁶ Ibid. See also Oxfam, 'Turn the Tide: The G20 must act on rising inequality, starting with fairer global tax reform,' (2014) November 2014 Oxfam Media Briefing.

²¹⁷ Brauner Ibid.

²¹⁸ John Christensen, Pete Coleman & Sony Kapoor 'Tax Avoidance, Tax Competition and Globalisation: making tax justice a focus for global activism' (2004) vol 3 No. 2 *Accountancy Business and the Public Interest* at 6. See also Oxfam 2014 at 7.

One of the biggest criticisms of unfair tax competition is that it leads to developmental damage to the losers who cannot sustain the ‘race to the bottom’ effect of the concept.²¹⁹ This is mainly due to the reality that some states are less dependent on tax revenues, in particular corporate taxes, and can therefore make more sacrifices to attract investments. Most of the losers are developing countries who heavily rely on revenues for their developmental agendas and thus cannot sustainably compete against the former. The effect of this dilemma is that investors will either shun the developing country as an investment destination²²⁰ and consequently it loses out on much-needed investment injections, or the investor will still invest in the destination but will engage in BEPS activities to minimise their tax liabilities. It is for this reason that the policy of tax competition is such an anathema to the efficacious fight against BEPS. One therefore wonders why the OECD is not more vigilant on such a policy that undermines the whole objective of the BEPS Project. It thus begs the question whether the OECD framework is truly a model framework for South Africa to adopt.

c) Substantive Critique

Aside from the institutional and policy critiques above, substantively the OECD’s proposed tools for dealing with thin capitalisation exhibits a lack of contextual sensitivity to developing country challenges such as limited administrative capacity, lower resources to implement the proposed guidelines and distorted economies.

Article 9 of the OECD Model is the anchor of the OECDs transfer pricing and thin capitalisation framework. Effectively, the arm’s length rule is the OECD’s default guideline for dealing with thin capitalisation. However, as pointed out in the UN Manual on Transfer Pricing²²¹ and even concurred to by the OECD, the ALR approach is not quite appropriate for developing countries as it requires greater administrative capacity and resources to administer the complex rules that accompany its implementation.²²² Unlike advanced economies in the OECD, most developing

²¹⁹ Ibid. See also Liesegang Caterina & Runkel Marco ‘Tax competition and fiscal equalization under corporate income taxation,’ (2018) vol 25:2 *International Tax and Public Finance* at 312.

²²⁰ It must be mentioned that tax considerations are usually not the sole considerations when making investment decisions but are weighed together with other considerations such as labour costs, ease of doing business, political stability, corruption and stringency of the legal protection of property rights, etc.

²²¹ Department of Economic & Social Affairs *United Nations Practical Manual on Transfer Pricing for Developing Countries* (2017) 2 ed.

²²² Ibid at 566.

country administrations lack the technical expertise nor the administrative resources to implement the regime. This is particularly prominent when one considers that it requires a case by case facts and circumstances assessment that must be carried out by expert officials which are lacking in developing countries. In addition, the approach relies on comparability information which makes it a rather costly system given how expensive it is to gain access to comparable information which, in most cases, is not available locally.²²³ Furthermore, the case-by-case manner in which the arm's length approach operates creates uncertainty which could deter potential investment, a scenario that could prove fatal for a developing country like South Africa which heavily relies on foreign investment. Additionally, in view of the weak governance institutions in developing countries, the discretion the ALR requires could fuel corruption and bribery in the tax administration and hamper the effectiveness of fighting BEPS.²²⁴ The OECD's ALR approach is thus not a very ideal guide for developing countries should one consider its potential uncertainty for the taxpayer, the resource strain that its complexity creates and the overall administrative difficulty.

It cannot be discounted that the capping of interest deductions is a major tool for developing countries especially when one considers the key role the one-way flowing foreign investment plays in their economies and the heavy reliance their narrow corporate tax bases have on corporate tax. However, due to the western-bias and tainted conceptual basis of the OECD's guidelines, there is a need for a set of rules that are sensitive to their contexts and still effective in dealing with thin capitalisation. Hence why as an alternative for developing countries the Platform for Collaboration on Tax²²⁵ and the UN have suggested that they make use of the fixed debt to equity ratio approach, even as a safe harbour, as it is more certain and easier to implement given their limited resources and capacities.²²⁶ It is argued that this approach provides better ease of administration for developing countries whom can better implement the framework to combat excessive interest deductions without having to overstretch their resource and budgetary capacities. Another advantage is that their simplicity and certainty promote predictability, a very important feature for the taxpayer and potential investors as they will be

²²³ *UN Manual* op cit fn221 at 567.

²²⁴ Richard Collier & Nadine Riedel 'The OECD/G20 Base Erosion and Profit Shifting Initiative and Developing Countries' (2018) vol 72 *Bulletin for International Taxation* at 707.

²²⁵ This is a consortium comprising of the UN, OECD, the World Bank and the IMF.

²²⁶ Collier *ibid* at 715.

able to make more informed investment decisions plus the predictability will help reduce taxpayer compliance costs.²²⁷

The BEPS Project on the other hand dissuades the use of fixed debt to equity ratio caps for interest deductions, arguing that the approach is inflexible if indiscriminately applied in all sectors.²²⁸ Rather, as pointed out in Chapter Three, it proposes the use of the EBITDA approach as its preferred best practice alternative to the arm's length and fixed ratio. However, even this suggestion, just like the ALR approach above involves what has been termed an 'explosion of complexity' which again fails to account for developing countries' resource constraints.²²⁹ Additionally, it is also argued that the EBITDA approach might be a politically challenging suggestion as some developing country might not be sure of the effect it might have on inward investment flow.²³⁰ There is no doubt that despite its good intentions, the BEPS Project also substantively fails to offer measures that cater to the special needs and circumstances of developing countries.

Consequently, given all the critiques outlined above, it is submitted that for a developing country, completely adopting and basing the anti-BEPS framework to combat excessive interest deductions on the OECD will result in an ineffective and context-averse transplant, and should be discouraged. Unfortunately, South Africa has already adopted the OECD's ALP approach hence, as is shown below, it is plagued with an uncertain and contextually alien framework.

4.3 ASSESSMENT OF SA FRAMEWORK

This section resumes the assessment of the efficacy of South Africa's OECD-inspired framework by first evaluating if overall it qualifies as a good tax framework when evaluated against the norms laid out in Chapter Two. I shall carry out this assessment by way of posing a series of norm-based questions whose response will be evaluated to assess the strength of the framework. The section also engages in depth with the key issues in the framework such as the arm's length

²²⁷ Collier op cit fn224 at 715.

²²⁸ Annet Wanyana Oguttu 'OECD' s Action Plan on Tax Base Erosion and Profit Shifting: Part 2 – A Critique of Some Priority OECD Actions from an African Perspective – Addressing Excessive Interest Deductions, Treaty Abuse and the Avoidance of the Status of a Permanent Establishment' (2016) vol 70 *Bulletin for International Taxation* at 332.

²²⁹ Collier op cit fn224 at 717.

²³⁰ Ibid at 711.

principle and the framework's administrative hurdles stemming from the lack of a safe harbour ratio and legally certain regulatory rules.

a) Policy Critique

(i) Is the Thin capitalisation Framework neutral?

Thin capitalisation measures are a response to the distortion to neutrality that arises from the different tax treatment of corporate capitalisation methods. In the South African context, it may be contended that given the fact that the regime only applies to foreign-sourced investments to a South African-based company, there appears to be a discriminatory effect in the application of the thin capitalisation regime. This can be taken as detrimental to the principle of capital import neutrality. However, given the veracity of BEPS and the drive to combat it, this is an accepted form of discrimination that is in-fact neutrality-promoting as it deters the making of investment decisions both foreign and domestic,²³¹ solely based on the tax advantages of debt capitalisation. Given that the policy behind the framework assumes compliance with international best practices and standards, the framework is arguably neutral in both its conception and implementation.

(ii) Is the framework simple?

In a complex field, it is a difficult task to achieve perfect simplicity. This is a fate that befalls the South African thin capitalisation regime as it struggles to provide the average taxpayer with simplicity of understanding. This is worsened by the fact that the document that is meant to offer more clarity to the framework, the Draft Note is also not in itself a paragon of simplicity. Rather, it is peppered with complex rules detailing the application of the regime. Some concepts and rules such as the ALR, the functional analysis required to arrive at the arm's length amount, the inter-play of s 31 with its supposedly covalent provision s 23M, are highly elusive to both the average taxpayer and experts. It is therefore not surprising that the Davis Committee also

²³¹ Take note that capitalisation distortions that occur domestically are addressed by the corresponding effect of taxing the interest income that has been deducted by the debtor at the point it reaches the pocket of the lender. This is not necessarily the case when it comes to foreign-sourced debt capital as the interest payments may not be regarded in the same form by the tax policy of the foreign state and may potentially go untaxed or they will be subjected to a lower tax rate than at the source state.

acknowledged the complexity of the regime and advised the National Treasury to revisit and simplify the rules in the draft guide.²³²

It is also the observation of this research that the thin capitalisation regime is a jungle of complexity. Unfortunately, this is a fatal weakness that may affect compliance, particularly when one considers that the framework places too much a burden of compliance on the taxpayer without providing sufficient guidance. Further, it is also posited that understanding the implications and practical effects of the regime will be important to investors. Hence, the inability to simply grasp the framework can negatively influence potential investors to be more reluctant to invest in South Africa, an effect that ruins the objective of making South Africa more investment attractive.

(iii) Is it certain?

The framework is also laden with uncertainties. Although s 31 already is a jungle of complexity, one of the more enduring sources of uncertainty is the fact that the Draft Note which should provide guidance as to the application of the provision remains in a draft state.²³³ This poses a problem as it cannot confidently be relied upon by taxpayers and potential foreign investors.²³⁴ The Note's content is another source of uncertainty, particularly in how it does not clarify the type of taxpayer who needs to apply the arm's length assessment. Rather it imposes a compulsory burden on all taxpayers to assess that their transactions are at arm's length, in effect shifting the burden of proving arm's length transacting to the taxpayer.²³⁵

While this compulsory self-assessment is favourable for the tax authorities, it remains a source of uncertainty and difficulty for the taxpayer since there is a dearth of proper guidance in the application of the rules in the Note, particularly the determination of the level of interest deductibility a potential investor is entitled to annually.²³⁶ More remarkably, it does not shed any light as to how the taxpayer can carry out the required functionality or comparability assessment

²³² Davis Tax Committee, *Davis Tax Committee: Second Interim Report on Base Erosion and Profit Shifting (BEPS) In South Africa* 'Annexure 4 BEPS Final Report- Action 4' (2018) at 2.

²³³ Davis Committee BEPS Final Report- Action 4 op cit fn232 at 2.

²³⁴ *Ibid.*

²³⁵ A W Oguttu 'Curbing Thin Capitalisation: A Comparative Overview with Reference to South Africa's Approach – Challenges Posed by the Amended Section 31 of the Income Tax Act 1962,' (2013) June 2013 *Bulletin for International Tax* at 323.

²³⁶ Oguttu *International Tax Law* op cit fn7 at 266.

when determining arm's length. This is further exacerbated by the fact that there is no available database available to taxpayers from which to access information to carry out the comparability analysis.²³⁷ Effectively, this creates uncertainty for the taxpayer and business community who are then left in the dark as to the accepted method or the tools to carry out their arm's length assessment.²³⁸

Uncertainty in the framework is also prominent with regards to the interplay between s 31 and what National Treasury regards as its 'twin' provision s 23M. Of major concern is the lack of clarity as to the practical nature of the relationship between the two provisions. It is not clear if both must be applied in a case of thin capitalisation and the order in which these provisions are to be applied. It is also not clear if s 23M is effectively the fixed ratio 'backstop' to the s 31 general arm's length standard. Instead, there is a worrying opacity in both the legislation and the explanatory notes, a situation that is not optimum for potential investors looking to understand the tax rules that their investments will be subjected to.

(iv) Is the framework sufficiently transparent?

However uncertain and complex the thin capitalisation framework is, it would be an injustice to not acknowledge that it is a highly transparent regime. It is clear on the consequences of a taxpayer falling under the ambit of the regime and it openly lays out the conduct that leads up to these consequences. No taxpayer can therefore claim that the thin capitalisation provision and interest deduction disallowance is a surprise provision. However, the only issue that taints the transparency of the framework is the lack of proper guidance on the taxpayer as to the determination of whether their transaction is covered by the provision. There is also a transparency challenge that arises from the uncertainty in the working of the secondary adjustment.²³⁹ Uncertainty thus continues to be one of the framework's pervasive weakness.

(v) Does it promote effective administration?

Transfer pricing, and in this instance thin capitalisation, is a very administratively straining area for the tax administrators because it involves some very sophisticated processes necessary in

²³⁷G Baum & J Simoes "Thin Capitalisation: Introduction and practical considerations to the new draft interpretation note," *TaxTalk* at 49.

²³⁸ *Ibid.*

²³⁹ Oguttu *International Tax Law* op cit fn7 at 265.

carrying out assessments. It is also very demanding on entities who are the subject of these complex regimes. It is thus fortunate that, given the regime's demand on expertise and financial resources, South Africa as an emerging developing economy with a sustained knowledge-diffusion relationship with advanced economies is fairly equipped, though not as sufficiently as the complex regime requires, to handle the demand.²⁴⁰ Unfortunately, this is complicated by the lack of comparability information that is key to carrying out the comparability assessment. Additionally, for the taxpayer this administrative inefficiency is further worsened by the regime's complexity and lack of guidance in assessing whether their transactions fall within the required arm's length basis and thus are not thinly capitalised. No doubt the underlying uncertainties that haunt the regime also contribute towards making it administratively ineffective.

(vi) Is the framework sensitive to economic growth and efficiency?

The contextual reality of South Africa requires a growth and efficiency enhancing regime. It is for this reason that it is crucial for the thin capitalisation regime to avoid posing competitive disadvantages to certain sectors or economic players. Fortunately, given the prominent role of MNEs in the South African economy, the regime is sufficiently sensitive to the necessity of debt in the capital structures of some economic players. This acknowledgment is possibly the motivation behind the Note's use of more flexible functional analytical tools and risk identifying factors to deal with excessive interest deductions without placing a competitive disadvantage on entities whose operational viability is dependent on high levels of debt.²⁴¹ Moreover, a more general outlook also shows that by safeguarding the scourge of BEPS and ensuring that profits sourced from the jurisdiction are reinvested here, the regime reflects South Africa's broader economic objectives and enhances growth. However, this conclusion is highly theoretical as there has not been ample research done so far on the economic effect of the thin capitalisation regime on economic growth and efficiency.

²⁴⁰ South Africa, just like other developing countries but to a slightly lesser degree, remains inadequately capacitated in both the public and private sector with regards the expertise necessary to properly execute a complex transfer pricing and thin capitalisation regime as recommended by the OECD.

²⁴¹ Draft Note op cit fn116 para 5.2.

(vii) *Summation: Is the regime a good tax system?*

The above assessment highlights that SA's thin capitalisation regime is noble in its intentions. However, its strength as a good system is marred by the over-complexity and uncertainty in which it is peppered with. Moreover, nothing seems to suggest that the design conditions and processes behind the regime were inclusive as the regime's weaknesses indicate a failure to account for SA's contextual issues. Given the veracity of these weaknesses, it is very difficult to conclude that the framework makes for a good and efficacious system to curb BEPS by way of excessive interest deductions. More work needs to be done to improve the regime and make it more workable and reflective of SAs realities.

b) *Implementation Critique*

(i) *Arm's length rule*

Recommended for its flexibility in allowing tax administrations an opportunity to examine the specific facts and circumstances of each case,²⁴² the ALR continues to be the most enduring approach to dealing with transfer pricing and thin capitalisation both nationally and internationally. Even as the OECD has come to find the use of arm's length rules as less effective and proposed other methods to address BEPS by thin capitalisation,²⁴³ the ALR continues to be the baseline from which national rules are constructed. South Africa is therefore not peculiar in its shift to the exclusive use of the rule as this is reflective of the international standard.

However, the ALR does not come without its own challenges. In the SA context, these include but are not limited to the issues of over-complexity and uncertainty. Generally, uncertainties arise since the rule's application is largely dependent on the comparison of the conditions in the controlled transaction with those of an arm's length transaction. This process requires consideration of multiple objective factors such as the prices, terms and margins achieved by connected persons in their dealings with those of independent entities that are often multi-faceted which makes the determination more difficult.²⁴⁴ It is thus a fact-intensive process that leaves a

²⁴² Oguttu (2013) op cit fn235 at 314.

²⁴³ Oguttu (2016) op cit fn228 at 334.

²⁴⁴ Oguttu (2013) op cit fn235 at 322.

very high margin of discretion to the administrators in the assessments and creates uncertainty for the taxpayers in ensuring that their transactions will qualify to be at arm's length.²⁴⁵

As mentioned above, the SA regime does not sufficiently provide guidance as to how a taxpayer can carry out the comparability test upon which the arm's length rule relies. Furthermore, the process of carrying out the comparability assessment itself is a difficult endeavour. This is especially for a developing country where the necessary information for carrying out the comparison, particularly that regarding the amount that could have been obtained from an unrelated third party and the economically relevant characteristics between the compared transactions, and the requisite expertise, is less available to both the taxpayer and the administration.²⁴⁶ The result is that the regime is unworkable in practice, effectively costing more for the administration to administer it and offering less of an incentive for compliance for the taxpayer who has to invest more resources in first decoding and then complying with the rule.

Accordingly, it can even be argued that the current state of the arm's length rule is unduly burdensome on taxpayers who may be transacting outside the arm's length for reasons other than a tax benefit purpose.²⁴⁷ Given the resources and expertise required to navigate the highly complex and uncertain thin capitalisation regime and the complementary meticulous documentation requirements, the placing of the onus of proving arm's length transacting on all taxpayers by the framework poses a great strain on MNEs. This can dissuade investment in the jurisdiction. Consequently, it has been proposed that to reduce the unnecessary stringency in the rules, a purpose to avoid taxes should be introduced into the thin capitalisation assessment.²⁴⁸ However practical this seems, a tax avoidance purpose is a controversial notion on its own. This is because not only may it strain the tax administration with a more difficult task of objectively assessing such a subjective matter, it might also prove more detrimental to the taxpayers who might find most of their conduct being regarded as purposefully tax avoiding.

²⁴⁵ Luc De Broe *International Tax Planning and Prevention of Abuse*, (2010) Volume 14, IBFD Doctoral Series, IBFD at 509.

²⁴⁶ Martin Ruf & Dirk Schindler 'Debt Shifting and the Thin-Capitalisation Rules- German Experience and Alternative Approaches,' (2015) vol 1 *Nordic Tax Journal* at 28.

²⁴⁷ Oguttu *International Tax Law* op cit fn7 at 258.

²⁴⁸ Davis Committee BEPS Final Report- Action 4 op cit fn232 at 4.

(ii) Importance of a safe harbour ratio and thin capitalisation administrative regulations

Oguttu posits that after the removal of the debt-to-equity ratio from the SA framework, there is a vacuum with regards to the functioning of the thin capitalisation framework.²⁴⁹ Although it is not advised for countries to merely utilise a fixed ratio rule as this makes the framework insensitive to the fact that different sectors in which MNEs operate may require different amounts of debt leveraging,²⁵⁰ it is crucial that there is clarity as to the rate at which a group falls at risk of falling under the ambit of the thin capitalisation provisions. And as the Davis Committee recommends, this is best done by way of a certain and effective safe harbour ratio to support the arm's length rule to which taxpayers can refer to assess their risk when engaging in debt capitalisation arrangements.²⁵¹

Remarkably, prior to the overhaul of the old thin capitalisation regime, South Africa employed a legislative safe harbour debt to equity ratio with which the revenue administration could assess indicators of thin capitalisation. However, the current framework does not include a safe harbour ratio²⁵² but instead its risk-based approach provides for what it calls risk indicators. These include a debt to EBITDA ratio of 3:1, an interest rate that is two percentage points above the reserve bank's rate and in cases where the debt is in foreign currency, a rate that is two percentage points above that of the foreign state's central bank rate.²⁵³

Nonetheless, SARS emphasises that the above are mere factors to be considered and it can carry out a thin capitalisation assessment even when the entity-in-issue's rate falls below any of the rates above. This thus creates a heavier burden on the taxpayer who must apply a level of judgment to their circumstances to form a position as to whether their intended arrangement will qualify as arm's length.²⁵⁴ This lack of consistency and certainty can impede on their ability to properly comply with the framework as they only have an opaque level of guidance. It is therefore crucial that given the importance of certainty in making a tax system effective and investment friendly, the framework should rather provide for some safe harbour threshold to

²⁴⁹ Oguttu *International Tax Law* at 267.

²⁵⁰ *Ibid.*

²⁵¹ Davis Committee BEPS Final Report- Action 4 op cit fn232 para 7.1.

²⁵² See Draft Note op cit fn116 para 7.1.

²⁵³ *Ibid.*

²⁵⁴ Baum and Simoes op cit fn237 at 50.

guide the taxpayer in their capital strategy decisions and regulatory compliance. It is proposed that given its touted welfare enhancing effect for both the taxpayers and the fiscus, a sector-specific EBITDA ratio should be more preferable for this safe harbour unlike a debt-to-equity ratio which is less accommodating to the non-tax reasons for debt capitalisation.²⁵⁵ It thus lies upon the legislature to come up with a set of flexible and practical ratios, in the style of Brazil's fixed-margin method for transfer pricing,²⁵⁶ that will avoid the shortcomings of the fixed ratio approach laid out above.

The second administrative deficiency is that due to the ambitious nature of the thin capitalisation legislation, it is not necessarily drafted to be understood and certain for the average taxpayer.²⁵⁷ Instead, this is left to the SARS interpretation notes to provide more clarity and guidance. But then given the non-binding nature of SARS's guidance notes, what assurances are there that the taxpayer's compliance with their guidance will be sufficient in keeping them outside the ambit of the thin capitalisation framework? An honest response to the above will be none – for there is no assurances that carrying out all the regulatory requirements within the Note will safeguard the taxpayer from being subjected to the wrath of the thin capitalisation provision.

As mentioned above, the current framework's use of a non-binding note that is unclear creates uncertainties and effectively impedes upon the transparency of the thin capitalisation regime. It also results in more compliance costs for the taxpayer and the administration as they have to comply with a complex framework but with very limited guidance. Unfortunately, this detrimentally impacts upon the framework's policy objective as the lack of clarity can pose a deterrent in compliance since MNEs may find it easier to avoid compliance altogether than attempt to navigate the opaque complexity of the regime. Furthermore, the relative unattractiveness the uncertainty poses could potentially lead to investors avoiding the jurisdiction altogether because of the risk a non-transparent tax regime presents. It is therefore observed that there is need to discard with the use of guidance notes by SARS. Instead, the legislature should

²⁵⁵ Mohammed Mardan 'Why Countries differ in thin capitalisation rules: The role of financial development,' (2017) vol 91 *European Economic Review* at 3.

²⁵⁶ For further details on the Brazilian transfer pricing approach see *UN Manual* op cit at fn184 at 527ff.

²⁵⁷ Ross Robertson (2013) "Thin Capitalisation an Abyss of Uncertainty" 2013 *Tax Professional* at 15.

offer more certainty by promulgating binding legislative regulations to support the proper implementation of the thin capitalisation framework.²⁵⁸

4.4 OBSERVED CONTRASTS WITH CANADA'S FRAMEWORK

At the onset of this research, the impression was that Canada, as an OECD member state, would be more inclined to follow the OECD's proposed frameworks in dealing with BEPS by way of thin capitalisation. It was this assumption that grounded the choice to use Canada to contrast South Africa's regime. However, a close reading of Chapter Three shows that Canada differs in some ways in how it approaches the issue of thin capitalisation. The most noteworthy of these differences is its sole reliance on a debt to equity fixed ratio rule instead of the OECD-endorsed arm's length or EBITDA/earnings stripping rules. Arnold & Wilson posit that Canada's thin capitalisation rules are generally congruent with international standards.²⁵⁹ This is a rather interesting assertion given that South Africa's justification for combining its thin capitalisation rules with the ALR used for transfer pricing was premised on the desire to concur with international standards promoted by the OECD. Nonetheless, it is curious why Canada would opt to maintain the fixed ratio rule despite the OECD discouraging it as a less effective approach.

The justification for this difference may be found in above-highlighted problem of the OECD being dominated by certain western ideologies pushed by more economically powerful nations such as the US. Perhaps Canada is not completely in agreement with the dominant ideology shaping the OECD's position towards dealing with BEPS by thin capitalisation and instead, being a confident developed country opted to follow its own approach that focuses less on excessive interest expenses and instead on disguised equity in the form of debt. This would not be surprising especially if one considers that the EU is also working on its own framework for dealing with BEPS outside that of the G20/OECD.²⁶⁰ But still this ideological 'rebellion' does not justify the use of the fixed ratio approach.

²⁵⁸ This is the position in the US tax regime.

²⁵⁹ Arnold & Wilson op cit fn191 at 31.

²⁶⁰ See a discussion of the EU framework in Ginevra Guglielmo 'The EU Anti-Tax Avoidance Directive and the Base Erosion and Profit Shifting (BEPS) Action Plan: Necessity and Adequacy of the Measures at EU level' (2017) 45 Issue 2 *Intertax*, 120–137.

One is tempted to suppose that this divergence may be premised on the reality that the fixed ratio rule is easier to administer for the tax administration and even the taxpayer to self-evaluate whether their transactions would attract the application of thin capitalisation rules. Undoubtedly, unlike South Africa's dilemma with the arms-length rule, Canada's regime is less dependent on comparable information when making the thin capitalisation assessment. Another possible justification is that since Canada was the originator of the thin capitalisation rules and has greater experience with the fixed ratio, it is less worried about the possible inefficiency that its use could lead to. This is arguably because its administration is now more adept at executing the ratio rule effectively and at a lower administrative strain for both the taxpayer and the administrator that the continued use of the rule is perfectly logical. It is therefore evident that Canada chose to implement a regime that is reflective of its context.

Accordingly, Canada's divergence from the OECD can be taken as vindication for the critique of South Africa's adoption of the OECD's framework, a framework that is not only ideologically skewed but does not reflect solutions that factor in the contextual issues of developing countries. Had South Africa chosen instead to develop a more organic and context-sensitive regime which still upholds the regime's policy objectives, there is a chance the issues such as uncertainty and lack of adequate skills and resources plaguing the framework would be uncommon.

4.5 OVERALL EVALUATION OF THE SA FRAMEWORK

This chapter set out to analyse and evaluate the efficacy of South Africa's thin capitalisation regime in combating BEPS by way of excessive interest deductions. The assessment began by offering a critique of the OECD as an international tax norm-setting organisation, and the OECD framework to dealing with BEPS by way of thin capitalisation. It highlighted that the lack of legitimacy by the OECD in leading the international tax system, the absence of sufficient input from developing countries that plague the framework, and its weak policy basis make it a very disconcerting decision to indiscriminately adopt the framework. The paper also noted that, substantively, the OECD's proposed measures for dealing with thin capitalisation, the ALR approach and the EBITDA approach fail to account for developing countries' unique contexts such as weaker tax administrative institutions, lack of resources to effectively implement the complex measures and the lack of finances to support the costly implementation of the BEPS

Project's proposed framework. It is thus this paper's contention that given the above shortcomings, a more context-sensitive framework, possibly that of the UN – although it does not differ much from the OECD²⁶¹ – coupled with several context-specific adjustments should have been adopted.

Nonetheless, the chapter goes on to observe that a consequence of the wholesale adoption of the OECD framework was that the SA's thin capitalisation framework when assessed against good-tax policy norms fell short due to a dearth of uncertainty, overcomplexity and, to a smaller degree, inefficiency of administration. The regime's weakness is most prominent when it comes to the implementation of its chosen method of dealing with thin capitalisation – the arm's length rule – whose application is marred by uncertainty due to a lack of guidance in its practical application. The rule also suffers from an absence of the requisite resources, be it the skilled officials and or the necessary comparability information which are crucial to its optimal application. Moreover, the paper notes that by placing the onus of proving the nature of potentially 'affected transactions' indiscriminately on the taxpayers, the regime fails to inspire compliance because of its lack of corresponding concrete guiding rules.

It would be disingenuous for this evaluation to not conclude that the preceding legal doctrinal assessment shows that SA's thin capitalisation regime fails to positively satisfy this study's research questions. For the regime is overcomplex and too uncertain to effectively safeguard the jurisdiction's tax base. Instead, it is bound to inspire against compliance as there is no incentive upon the taxpayer to grapple with such a jungle of regulatory difficulty at their own cost too. Moreover, the regime's lack of simple, clear, certain and concrete rules and guidelines makes the jurisdiction less attractive for investors who cannot simply risk ploughing their investment without a full understanding of the possible tax implications. Clearly, contrary to the example of Canada above, SA's regime was not designed to take into consideration the jurisdiction's context, particularly with regards the importance of simpler and less administratively straining yet effective rules nor the need to attract investment to boost employment and address inequality by having more attractive rules. It is therefore justifiable to conclude that the current framework is doctrinally ineffective in addressing BEPS by way of excess interest deductions.

²⁶¹See Veronika Daurer *Tax Treaties and Developing Countries* (2014) at 103-104 for a summary of the differences between the UN and OECD Models.

CHAPTER FIVE

5.1 CONCLUSIONS AND RECOMMENDATIONS

Upon the arrival of Jan Van Riebeeck of the VOC at the Cape of Good Hope in 1652 it would have been unimaginable the impact globalisation, then a mere colonial extractive tool, would have on South Africa's development. Marking the country's first encounter with an MNE, over the centuries this event culminated in the development of the modern-day state of South Africa, which despite being a vastly unequal developing nation with high levels of poverty, possesses a vibrant legal system whose ambit also encompasses the regulation and taxation of the corporation, including MNEs. Arguably the most advanced legal system on the African continent and rivalling even those of some economically advanced states, South Africa's western-inspired system also casts its nets wide enough to regulate globalisation and its effects.

However, given MNEs' propensity to shaping the path of globalisation, even an advanced legal system like South Africa faces great challenges in sufficiently addressing the negative – and to some extent predatory – effects of globalisation upon developing nations. In the present study, the most prominent of these impacts is the scourge of BEPS which MNEs utilize to minimise their tax obligations, effectively robbing the state of much-needed revenue. It is within this background that this study set out to assess the effectiveness of South Africa's thin capitalisation regime in addressing BEPS by way of excessive interest deductions.

There has never been any other time that South Africa has needed to contend with globalisation and its effects than now. Currently mired in recurrent economic recession and threatened by a grave loss of investor faith, the country desperately needs to attract investment to sustain economic development. Hence why the theme of an investor-friendly tax system has been a running thread across the study. Contiguous to the above is the goal of safeguarding the country's tax base to cater for the country's welfare needs. It is therefore a consequence of the above reasons that the study's assessment was guided by three questions central to the evaluation: (a) whether the framework is effective in safeguarding the tax base from BEPS; (b) whether it is cognisant of the need to attract investors; and (c) whether the framework is sensitive to the South African context. Below I detail the resultant key findings from the study's assessment.

a) Key Findings and Recommendations

One of the lasting legacies of globalisation has been the internationalisation of laws, norms and standards. Inter-governmental institutions like the UN and the OECD have arisen as a result. Remarkably, the OECD, although not an international tax law governing body in the strict sense, has harnessed this and emerged as the leading international tax standards and norm setter. As shown in this study, it plays a leading role in developing harmonised mechanisms and approaches to dealing with BEPS, approaches which countries – be they member countries, non-member countries or non-members with OECD observer status – adopt into their own strategies in dealing with BEPS. Regarding thin capitalisation, the study has shown that the OECD in its BEPS framework offers several approaches such as the arm's length principle to which South Africa subscribes, the fixed ratio approach utilised by Canada and the EBITDA approach favoured by the EU. Contrary to the UN alternative framework solely conceptualised for developing countries, the OECD framework gives more prominence to the arm's length principle compared to the fixed ratio approach which it regards as being too inflexible.

However, as shown in the study, the OECD's framework is not without its own criticisms. These stem from the organisation's lack of legal standing to lead international tax legislation, its apparent lack of transparency and inclusivity and western-bias in conceptualising the BEPS framework. Furthermore, it is also observed that the lack of policy clarity and political will to address the root concepts that trigger BEPS by way of thin capitalisation severely weaken the potency of utilizing the OECD framework in addressing BEPS. Most disappointing is the continued endurance of the residence-over-source doctrine which results in the OECD framework being skewed in favour of the developed states and the silence on tax competition which is the undercurrent to BEPS. More substantively, the proposed measures by the BEPS Project are overly-complex and resource-straining which showcases a lack an understanding of the unique challenges developing countries like South Africa face. Thus, one of the most scathing criticisms of South Africa's OECD-inspired thin capitalisation framework is that it follows a framework that is not designed to cater for the contextual realities of a developing country.

The study also makes noteworthy findings against the South African regime in its own stead. Utilising a legal doctrinal evaluative approach, the study found that overall the regime is marred

with uncertainties, over-complexities and context insensitivities. The thin capitalisation rules are supposedly intended to be complex to sufficiently deal with the issue but end up falling short of the objective as the uncertainty they create militate against compliance by MNEs. Further, there is marked uncertainty due to the rules that purport to guide the application of the thin capitalisation legislation still being in draft form which conflicts with investors' need for clarity in the application of laws that affect their investment.

Emphasis on the regime's ALR approach shows that the framework is unworkable as it lacks the necessary tools to carry out the comparability assessment crucial to assessing arm's length transacting. Furthermore, the rules place the burden of assessing the state of thin capitalisation on the taxpayer which is unduly burdensome on the taxpayer especially when one notes the lack of clarity in the application of the rules. Concomitantly, the study rues the lack of appropriate guidelines to the taxpayer in assessing their state of capitalisation such as the absence of a safe harbour ratio to accompany the use of the ALR. The result is that the framework is generally unworkable for the taxpayer who must endure the threat of having their interest deductions disallowed if they unknowingly fall within what the tax administrator will regard as thin capitalisation. The complex framework is also burdensome for SARS which is not sufficiently resourced, both financially and human-resource wise, to properly implement the regime.

Looking at the Canadian contrast, this study finds that its deviation from the OECD guidelines was to ensure their framework caters for their contextual and practical realities. Clearly, the South African regime, unlike what is concluded in the contrast with Canada, is an unworkable and overcomplex transplant that does not reflect the contextual realities of South Africa. There is also no doubt that the confluence of uncertainty and lack of clarity is a recipe against investors whom will not be attracted to invest in a jurisdiction whose thin capitalisation laws are surfeit with glaring problems which can put their investments at risk. Even for those who do invest in the jurisdiction, there is no assurance that the framework will safeguard the tax base as the issues above do not inspire compliance. Therefore, the study's conclusion is that South Africa's thin capitalisation regime is insufficiently equipped to deal with BEPS by way of excessive interest deductions.

Nonetheless, for a framework that is still ripe for further reinforcement, the study proposes the following recommendations that aim at improving context, simplicity and clarity as possible remedies:

(i) Reduced reliance on the OECD BEPS framework

It is proposed that since the OECD framework was created within a more western-context and arguably in favour of the developed states, it cannot be used as the baseline for South Africa's thin capitalisation regime. Instead, the UN guidelines which are fashioned for developing countries and which South Africa was a leading force in their formulation provide a more context appropriate guide, particularly their preference for fixed ratios over the ALR.

(ii) Use of the ALR in conjunction with a safe harbour ratio

It is also proposed that given the weaknesses in applying the ALR as the only approach to assessing thin capitalisation, especially when one considers the lack of comparability information, South Africa should rather take note of the Davis Committee's recommendation to use the rule in conjunction with a sector-specific safe harbour rule. Not only will this make it easier for the administration of the regime, it will also be beneficial in providing some form of certainty for the taxpayer who will have better guidance in assessing the effects of their transactions. The study recommends the use of an EBITDA safe harbour ratio that is particular to each sector as it is more flexible than the fixed debt-equity ratio and has been shown above to incentivise compliance.

(iii) Introduction of finalised guidelines or regulations

Finally, it is recommended that the Draft Note be revised and finalised to provide more clarity in the application of the rules. More finalised guidelines will be helpful in improving the regime's investment-friendliness as investors will have more certainty as to the applicable rules. A more far-reaching alternative would be to do away with the use of guidance notes which are not binding law and instead adopt the use of regulations. These will still provide the legislature with the same flexibility whilst providing taxpayers and investors with much-needed certainty.

b) Areas of further research

Noting the observations and recommendations made above, it will be crucial to have further research in the following:

- (i) The best framework for South Africa to adopt that is sensitive to its contextual realities such as the need to promote socio-economic development in the country through the optimum use of the fiscal benefits and the equally important duty to encourage investment.
- (ii) The optimum sector-specific safe harbour EBITDA ratios which can be utilised to support the framework and accommodate the differences in the way different corporate sectors operate from a financing point of view. This must include research into the potential difficulties that this sector-specific approach might have to address.
- (iii) Lastly, clarification of the relationship between s 23M and s 31 of the ITA and s 23M's role in the thin capitalisation regime.

c) Closing Remarks

In an increasingly globalised world, BEPS is too notorious of an issue to be combatted using a half-backed and ineffective framework. This study therefore calls upon the legislature to revisit the thin capitalisation regime and fortify it appropriately into an effective, context sensitive and investment-friendly regime that can be a useful tool in the country's economic development quest.

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