ARE SOUTH AFRICA'S SECTION 23M INTEREST LIMITATION RULES SUFFICIENTLY TARGETED AND EFFECTIVE IN COMBATTING BASE EROSION AND PROFIT SHIFTING THROUGH EARNINGS STRIPPING SCHEMES BY ASSOCIATED ENTERPRISES?

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I hereby declare that I have read and understood the regulations governing the submission of a Master of Laws (LLM) Specialising in Tax Law minor research dissertation, including those relating to length and plagiarism, as contained in the rules of this University, and that this minor research dissertation conforms to those regulations.

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DEDICATION AND ACKNOWLEDGMENTS

To Liesbeek River – Gazing into you, I found new questions and answers.

To my family – I give to you your blood, sweat and tears. The grub of struggle has metamorphosed to tax jargon and heavy boulders of words. This is what you fought for.

To MRF – You were the wings.

To my supervisor – You made it easy.

To me – For I have now lost all reason to be humble. Poor world.

ABSTRACT

Earnings stripping is a simple structure whereby one affiliate company resident in a low or no tax jurisdiction advances an intra-group loan to another affiliate member company resident in a high tax jurisdiction so that the latter makes excessive deductible interest payments. The overall effect of the structure is to move profits from a high tax jurisdiction through the interest payments to a low tax jurisdiction and thus reduce the multinational group's effective tax rate. This study focuses on how such a structure can arise in the South African tax system and if the measures in section 23M are sufficiently targeted and effective to address the problem without affecting legitimate corporate financing decisions. Considering that South Africa is a medium to high tax jurisdiction, the study focuses on those structures in which the borrower is resident in South Africa and the lender is resident in a low or no tax jurisdiction.

To achieve these objectives, the study outlines how earnings stripping schemes arise in the South African context, finding that two conditions should simultaneously exist: a deduction/exemption mismatch in South Africa and low or no foreign taxation on interest in the lender's jurisdiction of residence. The study also finds that on an analysis of the normal and withholding tax systems in South Africa, a deduction/exemption mismatch can only arise from the operation of treaty law limits on South African taxing rights. This means problematic, tax motivated earnings stripping schemes which take advantage of the deduction/exemption mismatch arise from treaty abuse. This reformulation of the problem as being treaty-based informs this study's analysis of whether section 23M is sufficiently effective and targeted. The study finds that because of its domestic focus, section 23M is neither sufficiently effective nor specific in addressing earnings stripping schemes. The author, therefore, proposes a radical shift in how South Africa deals with earnings stripping schemes: amending section 23M to account for the foreign tax treatment of interest and reframing the rule as a provisional measure while South Africa focuses its long-term efforts on treaty-based reforms.

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CHAPTER 1

INTRODUCTION

Corporations can generally be financed by debt, equity, or a combination of both. In debt funding, a lender establishes contractual rights against the borrower for repayment of the principal and in some cases, obtains a contractual reward for postponing consumption of capital.[1] The lender does not, however, obtain an ownership interest in the borrowing entity. The holder of equity, on the other hand, becomes a co-owner participating in the corporation's risks and in its profits.[2] It has, however, been said that where the provider of the capital is a related party, 'there is little economic significance in the distinction between debt and equity'.[3] As a result, the choice between debt and equity for related parties is usually motivated by tax and other regulatory considerations.[4]

The South African tax system generally allows the deduction of interest payments and other costs incurred in issuing debt on the condition that they are incurred in the production of income. The gain that companies get from the deductibility of interest is sometimes referred to as the interest or debt tax shield.[5] On the other hand, returns on equity (dividends) are not considered deductible expenditure and consequently there is no dividend or equity tax shield. According to a 2014 European Commission Working Paper, this asymmetry in the tax treatment of debt and equity creates a tax induced debt bias.[6] The bias heightens profit shifting risks through excessive interest deductions in high tax jurisdictions by multinational enterprises and results in 'too-high leverage' which increases systemic risk.[7] This study is concerned with the first risk: increasing profit shifting through excessive interest deductions by associated enterprises.

Associated enterprises, multinational enterprises, and affiliate companies, for purposes of this study, are used interchangeably to mean at least two companies which are either parent

[1] Henk Vording Chapter 2 'The Debt/Equity Distinction in Corporate Taxation: Does It Work, Does It Matter?' in Otto CR Marres & D (Dennis) Weber (ed) *Tax Treatment of Interest for Corporations* (2013) 5.
[2] M Stiglingh *Silke: South African Income Tax* 2020 (2019) 526.
[3] D Southern 'UK Report: The Debt-Equity Conundrum' (2012) 97b *Cahiers de Droit Fiscal International* 749 at 764.
[4] National Treasury *Explanatory Memorandum on the Taxation Amendment Bill*, 2013 (2013) § 2.6.
[5] Jonathan Berk & Peter DeMarzo *Corporate Finance* 4 ed (2011) 553.
[6] Serena Fatica, Thomas Hemmelgarn & Gaetan Nicodeme 'The Debt-Equity Bias: consequences and solutions' (2012) 33 *Taxation Papers* at 2.
[7] E Zangari 'Addressing the Debt Bias: A Comparison between the Belgian and the Italian ACE Systems' (2014) 44 *Taxation Papers* at 2.

and subsidiary or are subsidiaries of a common parent company and are resident in different states.[8] For a parent subsidiary relationship to arise, this study takes the position that control in capital, voting powers or management are decisive. Any company which holds sufficient equity, voting power or management power to independently determine the financial or operational activities of another is taken to be a parent company for purposes of this research. Further, the phrase 'intra-group loan' will sometimes be used as shorthand for a loan between associated enterprises.[9] The focus of this research is an earnings stripping scheme: a simple structure where, as a consequence of an intra-group loan, an enterprise in a high tax jurisdiction makes excessive deductible interest payments to an associated enterprise resident in a low or zero tax jurisdiction in order to reduce a multinational's group-wide effective tax rate.[10]

THE SOUTH AFRICAN LEGAL CONTEXT

The Income Tax Act does not define debt and equity financing. However, in the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012, it was stated,

> *'In commercial terms, debt represents a claim on a specified stream of cash flows. In its purest form, this claim comes in the form of interest that is payable despite the financial performance of the debtor. Shares on the other hand, represent a contingent claim by shareholders on dividends that are directly or indirectly based on company profits.'*[11]

Several defining legal characteristics for debt can be identified. These include the creditor's right to repayment at the end of a fixed period and the priority of a creditor's claim over an equity holder's claim upon liquidation. Further, the creditor's return is not connected to the entity's profits, the creditor has no legal control over company affairs and the relationship between the creditor and the company is determined by the loan contract rather than statute.[12] For equity funding, returns are bound to the company's commercial performance, shareholders

[8] Chloe Burnett 'Intra-Group Debt at the Crossroads: Stand-Alone versus Worldwide Approach' (2014) 6 *World Tax Journal* 46, also adopted from the meaning of Associated Enterprises as used in Article 9 of the Model Tax Convention.
[9] Ibid.
[10] Clifton J Fleming Jr., Robert J Peroni & Stephen E Shay 'Getting Serious about Cross-Border Earnings Stripping: Establishing an Analytical Framework' (2015) 93 *North Carolina Law Review* 673 at 675.
[11] National Treasury *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012* (2012) at 21.
[12] Moritz Scherleitner Chapter 2: Financial Instruments from a Multidisciplinary Perspective in M. Scherleitner *Addressing Tax Arbitrage with Hybrid Financial Instruments: A Multidisciplinary Study and Proposal for Developed and Developing Countrie*s (2020) and in Wolfgang Schön, Andreas Bakrozis & Johannes Becker et al 'Debt and Equity in Domestic and International Tax Law – a Comparative Policy Analysis' (2014) 59 *Brit. Tax Rev*. 146-217 where the authors then explore exceptions to these general rules. Generally, equity can be modified to incorporate features traditionally associated with debt and vice versa.

control the company, there is no entitlement to repay the capital after a fixed time during the lifetime of a company and the relationship is largely governed by statute law.[13]

The focus of this study is the specific debt instrument called a loan. Under the common law, provision of funding to a debtor for a fixed period is a type of loan for consumption. In *Mogudi v Fezi*[14], the court stated the common law position that,

> *'A contract of loan for consumption comes into existence when the parties agree that the lender will deliver to the borrower a quantity of consumable or fungible things for consumption by use, subject thereto that the borrower will return the same quantity thereof at some future time.'*

For purposes of the Income Tax Act, it has been decided that borrowed funds (the principal amounts) are not 'received by' a taxpayer for purposes of gross income as defined in the Income Tax Act since both the right to the borrowed money and the obligation to repay an equivalent amount to the lender arise simultaneously.[15] Therefore, the principal amount delivered to a borrower is not included in gross income.

However, interest charged by the lender as a stipulated return for the borrower's use of the principal amount has income tax implications.[16] Generally, interest may be included in gross income if it satisfies the requirements of section 24J(3). Interest paid to a non-resident lender is, however, exempt from normal tax and is not included in income as defined in the Income Tax Act.[17] Where the interest is, in terms of section 9(2)(*b*), found to be from a source within South Africa and it is paid to a foreign person, the foreign person is liable for withholding tax on interest in terms of section 50C. This is charged at 15 per cent in terms of section 50B of the Income Tax Act. However, as will be discussed in detail in this research, this withholding tax can be lowered by the provisions of South Africa's Double Tax Treaties.[18] An analysis of these treaties carried out for purposes of this research shows that 19 of them

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[13] Ibid.
[14] *Mogudi v Fezi* [2007] JOL 20679 (C) at para 19.
[15] *CIR v Genn & Co (Pty) Ltd* 1955 (3) SA 293.
[16] In *Cactus Investments (Pty) Ltd v CIR* 61 SATC 43 at 46, the court defined interest as a stipulated return for advancing a debt rather than merely consideration for a deprivation.
[17] Income Tax Act 58 of 1962 section 10(1)*(h)*. The interest should be in respect of a debt not effectively connected to a permanent establishment in South Africa.
[18] South Africa has 79 DTAs as of 11 May 2022 and these are available on https://www.sars.gov.za/legal-counsel/international-treaties-agreements/double-taxation-agreements-protocols/dtas-and-protocols-africa/ and https://www.sars.gov.za/legal-counsel/international-treaties-agreements/double-taxation-agreements-protocols/dtas-and-protocols-rest-of-the-world/ accessed on 11 May 2022.

reduce the rate of withholding tax on interest to 0 per cent[19], 6 reduce the rate to 5 per cent[20] and 38 reduce the rate to 10 per cent[21]. Therefore, there remains a possibility of very low or non-taxation of interest in South Africa where the lender is a non-resident.

In the hands of the resident borrower, interest is generally deductible if it falls within the terms of the Income Tax Act's specific interest deduction rules in section 24J(2). It should be noted that the definition of interest in section 24J is wide and encompasses not only interest as it is known under the common law but similar finance charges as well as amounts from sale and leaseback transactions. The actual ambit of 'similar finance charges' is not clear but in *CSARS v South African Custodial Services (Pty) Ltd*[22] the court considered the meaning of 'related finance charges', a phrase used in the now repealed section 11(*bA*). The court held that amounts closely connected to obtaining the loan were deductible 'related finance charges'. This included guarantee fees, financial advisory fees, administration fees, legal fees, commitment fees and facility fees. The change from 'related' to 'similar', however, means the applicability of the decision to section 24J is limited.[23] It is submitted that the phrase 'similar charges' means the amounts so charged should also constitute a stipulated return for the advancement of credit rather than merely be connected to the debt. This means administrative charges and legal fees would not be included within the ambit of interest as defined in section 24J.

The interest deduction limitation rules in the Income Tax Act arise after application of section 24J. They include the transfer pricing and thin capitalisation rules in section 31. Transfer pricing rules in section 31 limit interest deductions to comparable arm's length pricing between independent parties.[24] Since 1 April 2012, South Africa no longer has separate thin capitalisation rules but the general transfer pricing rules in section 31 can be applied to adjust

[19] Refer to Appendix 1 for list of treaty partners in respect of which South Africa's taxing rights on interest are reduced to 0 per cent.
[20] Refer to Appendix 2 for list of treaty partners in respect of which South Africa's taxing rights on interest are reduced to 5 per cent.
[21] Refer to Appendix 3 for list of treaty partners in respect of which South Africa's taxing rights on interest are reduced to 10 per cent.
[22] *CSARS v South African Custodial Services (Pty) Ltd* 74 SATC 61 at 74.
[23] Tracy Gutuza *Legal Aspects of Financing Corporates* (2019) at 79 argues 'similar finance charges' means finance charges must be similar rather than just related to interest.
[24] Section 31 provides for the primary (section 31(2)) and secondary (section 31(3)) adjustments where it is found that a taxpayer entered an 'affected transaction' which results in a tax benefit. The primary adjustment is such that the affected transaction is disregarded in its present form for tax purposes and treated as it would have had the parties entered the transaction under the usual terms and conditions independent parties would agree to. The secondary adjustment treats the difference between the affected transaction and the arm's length transaction as either a donation subject to donations tax or a dividend in specie subject to dividends tax in the hands of the resident taxpayer.

the principal debt incurred to an arm's length amount.[25] The Income Tax Act also contains limitation rules for reorganisation and acquisition transactions in section 23N and the general interest limitation rules in section 23M. Other rules that may limit deductions are the hybrid debt instrument rules in sections 8F and 8FA as well as the general anti-avoidance rule in sections 80A to 80L. It should also be noted that within section 24J itself, the requirements that interest have been incurred in the production of income and in the carrying on of a trade can be used to limit the deductible interest. This was the basis of the decisions in *ITC 1530*[26] and *ITC 1762*[27] which will be discussed in Chapter 2.

From the above, it can be observed that in South Africa, a multinational enterprise can arrange its affairs such that the lending affiliate is a non-resident, and the borrowing affiliate is a South African tax resident company. This means if all requirements of section 24J(3) are met, the interest charged by the non-resident lending affiliate is included in the non-resident affiliate's gross income but exempt from normal tax in terms of section 10(1)(*h*). The non-resident affiliate will, however, still be liable for Withholding tax on interest in terms of section 50C. Notably, this can be reduced by an applicable double tax treaty. On the borrower's side, the interest is deductible if it falls within the requirements of section 24J(2). This allowable interest deduction can, however, be limited by the transfer pricing rules and the interest limitation rules in section 23M.

MOTIVATION FOR STUDY

South Africa is a vulnerable, high tax jurisdiction

Earnings stripping should be a concern to South Africa because the country has a corporate income tax rate of 27 per cent for companies with years of assessment commencing on or after April 1, 2022.[28] This tax rate is above the global average of 23.54 per cent.[29] South Africa, like

[25] In a loan, transfer pricing focuses on the interest charged while thin capitalisation focuses on the principal, underlying debt.
[26] *ITC 1530* 54 SATC 261.
[27] *ITC 1762* 66 SATC 41.
[28] Revised by the 2022/23 Budget Speech by the Minister of Finance Enoch Gondongwana available at https://www.parliament.gov.za/storage/app/media/Pages/2022/2-february/23-02-2022_budget_speech/speech.pdf at page 14 accessed on 17 June 2022. Ministerial announcements can alter the tax rate in terms of section 5(2)(*a*) of the Income Tax Act. The 27 per cent rate has now been tabled before National Assembly in the Draft Rates and Monetary Amounts and Amendment of Revenue Laws Bill, Schedule 1 at paragraph 4(*a*). For years of assessment ending before 31 March 2023, the rate remains at 28 per cent.
[29] Tax Foundation '*Corporate Rates Around the World*' https://taxfoundation.org/publications/corporate-tax-rates-around-the-world/ accessed on 03 March 2022. When weighted against Gross Domestic Product, the average is 25.44 per cent.

many other developing nations, is, therefore, a medium to high-tax jurisdiction. A meta-analysis of different empirical studies found strong evidence that higher corporate income tax rates exert a bias on company leverage decisions.[30] In the South African context, Van der Zwan, Reynolds and Wier concluded that the available data on resident multinational subsidiaries with controlling companies in low-tax jurisdictions suggests profit-shifting behaviour through excessive interest deductions.[31] The South African tax base is, therefore, vulnerable to base erosion through excessive interest deductions in earnings stripping schemes.

Earnings stripping is a simple and internationally prevalent strategy

The use of excessive interest deductions has been identified by the African Tax Administration Forum as 'one of the most prevalent and simple base erosion and profit shifting techniques in Africa'.[32] Base erosion and profit shifting refer to instances where interaction of different tax rules results in double non-taxation or transfer of profits from source jurisdictions to low tax jurisdictions with no clear economic connection with the profits.[33] In the G20 and Organisation for Economic Co-operation and Development (OECD) Action Plan to address various base erosion and profit shifting concerns, limiting interest and other financial payments is included under Action 4.[34] The OECD Report for the G20 Development Working Group Domestic Resource Mobilisation for Developing Countries also includes Action 4 in its subset of high priority actions for developing countries to combat base erosion and profit shifting.[35] South Africa is a developing country, therefore, limiting excessive interest deductions is a high priority in combatting base erosion and profit shifting.

South Africa already has several provisions addressing earnings stripping and these should be appraised

As stated above, South Africa has several provisions in the Income Tax Act which govern the taxation and deduction of interest paid to non-residents. These provisions can result in a debt bias due to the interest tax shield and the deduction/exemption mismatch. However, the Income

[30] Ruud A de Mooij 'The Tax Elasticity of Corporate Debt: A Synthesis of Size and Variations' *International Monetary Fund Working Paper 11/95* (2011).
[31] Pieter Van der Zwan, Danie Schutte & Waldo Kruggel et al 'An evaluation of interest deduction limitations to counter base erosion in South Africa' (2018) 21 *South African Journal of Economics and Management* 1 at 8
[32] ATAF *Suggested Approach to Drafting Interest Deductibility Legislation (Excluding the Banking and Insurance Sector)* (2018) ATAF Secretariat, Pretoria.
[33] OECD *Action Plan on Base Erosion and Profit Shifting* (2013) at 10.
[34] Ibid. Also addressed extensively in OECD *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update: Inclusive Framework on BEPS* (2016).
[35] OECD *Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries - Part 1* (2014) at 33.

Tax Act has several provisions that can be applied to limit base erosion through earnings stripping structures. As listed above, there are also several provisions in the Income Tax Act which directly limit allowable interest deductions for the resident borrower. Further, the Income Tax Act's recharacterization rules for debt instruments with equity features in sections 8F and 8FA specifically disallow interest deductions where debt instruments are hybrid debt instruments and hybrid interest for purposes of those provisions. In addition, while withholding tax on interest is not a limitation rule per se, it reduces the advantage obtained from the interest deduction/exemption mismatch and consequently disincentivises earnings stripping schemes.

Considering all these inter-related rules and other provisions like the general anti-avoidance rule which might affect allowable deductions, it has been rightfully argued that South Africa's interest limitation provisions are 'numerous and complex'.[36] This study is a qualitative appraisal of the limitation rules in section 23M, but section 23M must be evaluated in its rightful context as part of a broader system of intricate, interrelated provisions. Thus, in analysing section 23M, a consideration of the contribution of other rules is unavoidable as the rules are interrelated and interdependent.

RESEARCH LIMITATIONS

This study is limited to the targeted rules in section 23M adopted to address the specific problem of excessive interest deductions. It discusses other rules that can be applied to limit interest deductions only to the extent that they are relevant to outline the context in which section 23M operates. These rules form what is, for the purposes of this research, called the interest deduction limitation framework.

Further, it is accepted that beyond tax law, the financing of corporations by foreign loans has exchange control implications. It should be noted that exchange control regulations may limit the amount of foreign debt a South African company can take, and this has an impact on earnings stripping schemes.[37] However, exchange control regulations fall beyond the scope of this study.

[36] 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) 70 *Bulletin of International Taxation* 6 at 13.
[37] Section 9(1) of Currency and Exchanges Act 9 of 1933 and section 10(1)(c) of the Exchange Control Regulations, 1961.

It is also acknowledged that structuring intra-group financing instruments is a highly flexible exercise and some instruments will have both equity and debt characteristics. Such instruments are called hybrid instruments and as already pointed out, they are dealt with under section 8E, 8EA, 8F and 8FA of the Income Tax Act. These rules will also not be discussed in detail in this study but their place in the interest limitation framework is recognised.

Furthermore, the general anti-avoidance rules might also apply to some earnings stripping schemes if the schemes meet the requirements of sections 80A to 80L of the Income Tax Act. However, the rules also fall beyond the scope of the current research.

RESEARCH PROBLEM

This research seeks to answer the question: Are the provisions in section 23M sufficiently specific and effective to combat base erosion and profit shifting through the earnings stripping strategy?

CRITERIA FOR EVALUATION OF SECTION 23M

As stated above, this study focuses on establishing if section 23M is sufficiently designed to effectively counter earnings stripping schemes without unduly affecting legitimate corporate financing decisions. While this is the core issue, the study is, nevertheless, guided by the basic premise that good tax laws adhere to the canons of taxation set out by Adam Smith.[38] These canons have been widely accepted as key elements of good tax law design, and, therefore, serve as the underlying benchmark against which the efficacy and specificity of section 23M is evaluated. In summary, the canons of taxation are equity, certainty, convenience, and efficiency.[39] It has been argued that while it is unrealistic to expect every tax provision to comply with the canons, non-adherence may have a negative impact on tax morality.[40] While this study is generally informed by these canons of taxation, it does not explicitly test for each one. Instead, the research proceeds by evaluating section 23M against internationally accepted approaches to earnings stripping. In doing so, the study assumes that these internationally accepted approaches generally adhere to the Adam Smith canons of taxation. However, where

[38] Adam Smith *An Inquiry into the Nature and Causes of the Wealth of Nations* (2007).
[39] These are summarised in L van Zyl 'The Lategan Case: The Accrual Principle – then and now' (2015) 19 *Southern African Business Review* 97 at 99 and discussed in greater detail ibid at 535.
[40] Ibid.

it is apparent that the internationally accepted benchmarks do not comply with the Adam Smith canons of taxation, this will be highlighted in the study.

RESEARCH QUESTIONS

To address the research problem, the following questions will be considered:

1. What are the rules governing the taxability and deductibility of interest payments made to non-resident associated enterprises?
    a. What rules apply to the non-resident affiliate recipient of interest payments?
    b. What rules apply to the resident affiliate borrower who makes interest payments?
    c. How does the deduction/exemption mismatch arise?
    d. Are there policy reasons for allowing the exemptions?

2. What are the provisions in section 23M?

    a. What is the purpose of section 23M in the Income Tax Act?
    b. How do the rules in section 23M interact with other interest limitation rules in the Income Tax Act?
    c. What are the substantive requirements of section 23M?
    d. What are the consequences of applying section 23M in a transaction?

3. Do the provisions in section 23M address the challenges presented by multinational earnings stripping schemes effectively and with sufficient specificity?
    a. What internationally recommended approaches can be used as benchmarks to assess section 23M?
    b. Do the provisions in section 23M accord with the chosen benchmark recommended approaches?
    c. Beyond the comparative analysis, what other issues are identifiable in section 23M?
    d. Are the rules specific enough to only target earnings stripping schemes while sparing legitimate commercial enterprise?

4. Is there a need to reframe the rules in section 23M?
    a. If the provisions do not align with the internationally recommended approaches, how can they be aligned?
    b. If the criticism by the Davis Committee is valid, how can section 23M be amended to incorporate the raised issues?
    c. Are there more effective and specific approaches to dealing with earnings stripping that South Africa can adopt?

RESEARCH METHOD

This is a doctrinal and comparative study carried out through desk-based research. The main source for this study is primary legislation, particularly the Income Tax Act. South African and international case law is also considered to establish the judicial interpretation of the law. The study also makes extensive use of textbooks and journals providing scholarly analyses of the law and suggested interpretations. The OECD reports, African Tax Administration Forum (ATAF) reports and other relevant international guidelines are also consulted to establish international best practices that can be used as benchmarks against which South African provisions can be measured for efficacy and specificity.

CHAPTER SYNOPSIS

Chapter 1 provides a background and introduction of the equity-debt asymmetry, the interest tax shield, the interest deduction/exemption mismatch, and the resultant tax induced debt bias. The chapter further discusses how, in the absence of effective interest limitation rules, the South African tax system is exposed to base erosion and profit shifting through excessive interest deductions and earnings stripping schemes by multinational enterprises. The research problem and the research questions are clearly outlined as well as the research limitations and methods to be used to achieve the objectives of the study. A synopsis of other chapters is also provided.

Chapter 2 discusses the provisions governing exemption of interest payments to non-resident lenders as well as the provisions allowing interest deductions for the resident borrower. This entails a discussion of section 24J, section 9(2)(*b*), section 10(1)(*h*) of the Income Tax Act to determine the normal tax position of the lender. The policy objectives of the current tax rules are also considered as there are legitimate policy reasons for providing for the exemption of

interest paid to non-resident lenders from normal tax. The withholding tax on interest provisions are then discussed and their position in the system is analysed. On the borrower's side, sections 24J(2) is considered and case law on deductibility of interest is discussed to determine judicial interpretations of these provisions. Ultimately, the chapter illustrates how the Income Tax Act as read with Double Tax Treaty provisions can give rise to earnings stripping schemes which arise from the interaction of the deduction/exemption mismatch with favourable foreign tax treatment of South African interest in affiliated lenders' jurisdictions. The chapter establishes the necessity of measures to protect the tax base by limiting interest deductions in the hands of borrowers.

Chapter 3 deals with the interest limitation rules in section 23M. Firstly, the chapter discusses the purpose of the provisions in section 23M. Further, it considers where section 23M fits within the interest deduction limitation framework. Especially critical is a discussion of whether section 23M should be applied before or after the transfer pricing and thin capitalisation rules in section 31. In addition, section 23M's requirements and substantive scope are extensively discussed to establish who the rules apply to, what sort of transactions are affected and how the rule operates to limit interest deductions.

Chapter 4 analyses section 23M using the OECD based African Tax Administration Forum's model legislation. The chapter briefly justifies why this benchmark has been used in this study before delving into the comparative analysis of section 23M against the model legislation. The core criteria for the analysis are effectiveness and specificity and thus the chapter questions whether the current framing of section 23M, on comparison with the African Tax Administration Forum, is specific and effective. Beyond the comparative analysis, the chapter also considers the views of the Davis Tax Committee before going further to establish if there are other issues that are not addressed by the ATAF approach and the Davis Tax Committee.

In chapter 5, the concluding chapter, a clear outline is provided summarising and synthesising the findings of the research. A summary of the identified issues is provided to ascertain if section 23M is sufficiently specific and effective to deal with earnings stripping structures. Where necessary, recommendations to strengthen the system are provided. In addition, the chapter highlights specific areas for further dedicated research.

CHAPTER 2

INTRODUCTION

This chapter considers the tax treatment of interest in the hands of a non-resident lender and a resident borrower in South Africa. On the lender's side, this entails a consideration of the specific interest income rule in section 24J(3) as well as its interaction with the foreign interest normal tax exemption rule in section 10(1)*(h)* and the withholding tax on interest clause in section 50C. The chapter also considers the policy objectives of the prevailing taxation regime. On the resident borrower's side, the chapter considers the tax rules governing the deduction of interest incurred by a South African resident. This will primarily be carried out through a study of section 24J(2) and a consideration of how the requirements that interest be incurred in the production of income and in the carrying of a trade can be used to limit the extent of interest deductions. This discussion will illustrate how the deduction/exemption mismatch, as well as the interest deduction shield arise in the South African context. In effect, the chapter will establish the relevance of interest deduction limitation rules in the South African legal landscape.

TAXATION OF INTEREST EARNED BY A NON-RESIDENT LENDER UNDER NORMAL TAX

The starting point in determining how interest earned by a non-resident affiliate company should be taxed is the definition of interest itself. In the common law, interest is understood as a 'compensation for deprivation' of a certain amount of money.[41] This understanding was, however, questioned in *Cactus Investments (Pty) Ltd v CIR*[42] where the court gave a more expansive definition of interest as something more than a consideration for deprivation but a stipulated return for the advancement of credit. In the current context of corporate debt financing, interest arises from a loan for consumption (*mutuum*) rather than a loan for use (*commodatum*).[43] A loan for consumption requires an agreement in terms of which one party, the lender, undertakes to transfer a consumable or fungible to another, the borrower for a period of time or to achieve an object, and the borrower is obliged to return a thing of the same kind,

[41] *Riches v Westminster Bank Ltd* [1947] 1 All ER 469 at 472 and in the South African case of *Genn & Co (Pty) Ltd* supra note 15 at 119.
[42] *Cactus* supra note 16 at 46.
[43] Gutuza op cit note 23 at 47.

quality and quantity as that received.[44] Interest is not an essential element of a *mutuum* contract but is instead a supplementary term that parties can agree to. However, in *CSARS v Brummeria*,[45] the court held that interest is a normal term in commercial transactions such that where an interest-free loan is provided as a quid pro quo for a service, it has a commercial value which constitutes an amount for purposes of the gross income definition.[46] While contractual interest arises from the parties' agreement, the Income Tax Act has specific provisions in section 24J which provide for the timing of interest accruals for tax purposes and deem such accruals a part of gross income. Further, section 24J provides a statutory definition of interest which considerably widens the ambit beyond common law interest as defined in the *Cactus Investments* case.

In section 24J(1) of the Income Tax Act, interest is defined in the following terms:

'interest includes the

(a) gross amount of any interest or similar finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement;
(b) the amount payable by a borrower to lender in terms of any lending arrangement as represents compensation for any amount to which the lender would, but for the lending arrangement been entitled; or
(c) the absolute value of the difference between all amounts receivable and payable by a person in terms of a sale and leaseback arrangement.'

Of particular interest to this study is paragraph (*a*) which defines interest as the 'gross amount of any interest or similar finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement'. Gutuza opines this paragraph comprises two elements which are: the definition of interest as a gross amount of any interest or similar finance charges and the second element that defines interest as a discount or premium payable or receivable in terms of a financial arrangement.[47] According to this construction, the first element is 'self-standing and is defined without reference to financial arrangements'. [48]

[44] J Moorcroft in DJ Joubert (founding ed) *The Law of South Africa* vol 26(1) 3 ed (2020) at § 347
[45] *CSARS v Brummeria Renaissance (Pty) Ltd* (2007) 69 SATC 205
[46] The court does not go so far as calling this amount an imputed or notional interest amount. It should simply be considered a general receipt.
[47] Gutuza op cit note 23 at 79.
[48] Ibid.

The first element of paragraph (*a*) refers to a gross amount of any interest which suggests a reference to the common law meaning of interest which has been discussed above. The definition, however, goes further to include 'similar finance charges'. There is no statutory definition of similar finance charges and neither have the courts defined the phrase. However, the closest case is *CSARS v South African Custodial Services (Pty) Ltd*[49] where the court considered the meaning of 'related finance charges' in the context of the now repealed section 11(*bA*) which allowed the deduction of 'interest (including related finance charges)' under certain conditions. The court held that guarantee fees, financial advisory fees, administration fees, legal fees, commitment fees and facility fees were deductible as related finance charges due to their 'close connection to the obtaining of the loans' under consideration in the case.[50] Gutuza argues that the change from 'related finance charges to 'similar finance charges' means the finance charges must be similar rather than just related to interest.[51] It may also be added that while 'related finance charges' were defined as charges with a close connection to the obtaining of a loan, similar finance charges have to go beyond that mere connection and be similar in substance to interest. This means only those charges that can be considered substantively similar to 'stipulated returns on the advancement of credit', or in simpler terms, economically equivalent to interest, qualify as similar finance charges.[52] It is submitted that such an understanding of interest in section 24J(1) excludes charges like administration fees, legal fees, and financial advisory fees.

The actual taxation of interest as defined in section 24J(1) is governed by section 24J(3). The relevant parts state,

> *'Where a person is the holder in relation to an income instrument, there shall be deemed to have accrued to that person and must be included in the gross income (whether or not that amount constitutes a receipt or accrual of a capital nature), an amount of interest which is equal to….'*

A few elements can be identified from the above provision. The first element is there must be a person. Section 1 of the Income Tax Act provides an inexhaustive definition of

[49] *South African Custodial Services (Pty) Ltd* supra note 22 at 74.
[50] Ibid at para 48.
[51] Gutuza op cit note 23 at 79.
[52] Such a reading is not novel as in *Genn & Co (Pty) Ltd* supra note 15, the court held that a raising fee in circumstances where it constitutes a consideration for a loan had to be treated in the same manner as interest. As stated above, however, it should be borne in mind that this study adopts the wider conception of interest as a stipulated return for credit.

'person' but none of the included definitions is relevant to companies. It is, however, trite that companies are juristic persons separate from their shareholders.[53] Section 24J(3) further requires that the person be a holder. This is defined in section 24J(1) as 'any person entitled to interest in terms of an income instrument'. An income instrument, in the case of a company, is defined as 'any instrument'. This means one must refer to the definition of instrument in section 24J(1). An instrument is in relevant part defined as 'any interest-bearing arrangement or debt'. This definition introduces two undefined terms 'interest-bearing arrangement' and 'debt' which should be understood in their ordinary sense. Gutuza suggests that 'interest-bearing arrangement' should be defined with reference to the definition of interest.[54] Therefore, any transaction which produces interest as it is defined in section 24J(1) qualifies as an interest-bearing arrangement. As to debt, according to the Black's Law Dictionary, it is defined as, 'Liability on a claim; a specific sum of money due by agreement or otherwise.'[55] This accords with the meaning of debt adopted by the National Treasury in the Explanatory Memorandum on the Taxation Laws Amendment Bill of 2012 which states, 'In commercial terms, debt represents a claim on a specified stream of cash flows.'[56] Clearly an intra-group loan advanced by a foreign affiliate to a South African resident affiliate fits within the definition of either an interest-bearing arrangement or a debt and is, therefore, an income instrument.

From the above it can be concluded that where there is an inward intra-group loan, the non-resident affiliate lender is a person who is a holder in relation to an income instrument and an amount of interest is deemed to have accrued to such non-resident affiliate lender. The amount of interest is calculated in terms of section 24J(3). It should be noted that while other forms of income that accrue to non-residents should be from a source within South Africa[57], there is no such requirement in section 24J(3). Also, there is no requirement that the interest should not be of a capital nature. However, it is doubtful that any interest can be of a capital nature.[58]

While the interest income is initially included in a non-resident affiliate's gross income as discussed above, it is exempt from taxation if it falls within the provisions of

[53] *Airport Cold Storage (Pty) Ltd v Ebrahim* 2008 (2) SA 303 (C), *Dadoo v Krugersdorp Municipal Council* 1920 AD 530 at 550-1 and *Salomon v A Salomon & Co* [1897] AC 22 (HL).
[54] Gutuza op cit note 23 at 81.
[55] Bryan A Garner *Black's Law Dictionary* 7 ed (1999) at 410.
[56] National Treasury op cit note 11 at 21.
[57] Section 1 definition of gross income at para (ii).
[58] Gutuza op cit note 23 at 82.

section 10(1)(*h*). Section 10(1)(*h*) provides an exemption from normal tax of any amount of interest received by or which accrues to a non-resident unless it arises from a debt that is effectively connected to a permanent establishment situated in South Africa.[59] It should be noted that interest for purposes of section 10(1)(*h*) is currently not defined in the Income Tax Act. Before the promulgation of the Taxation Amendment Act 31 of 2013, interest in section 10(1)(*h*) meant interest as defined in the then section 37I which was the definition section in the previous withholding tax on interest provisions which were in Part IA.[60] However, the reference to section 37I did not achieve the desired clarity considering that at this point, section 37I did not itself have an interest definition (the interest definition[61] in section 37I was removed by the Taxation Laws Amendment Act 22 of 2012). The reference to section 37I was, therefore, meaningless. It is submitted that due to this erroneous reference to section 37I, the inevitable result was that interest for withholding tax purposes in Part IA was interest as per common law and thus, interest for purposes of the exemption was also interest as per common law. Since the enactment of the Taxation Amendment Act 31 of 2013, section 10(1)(*h*) no longer gives a definition of interest.[62] This raises the question of whether interest in section 10(1)(*h*) means interest as construed in the common law, interest as now defined in section 50A for withholding tax purposes or it encompasses interest as defined in section 24J(1).

SARS regards the reference to interest in section 10(1)(*h*) as meaning interest as defined in section 24J.[63] There is no conceivable policy reason for such a definition, and it is submitted that this approach is legally incorrect. Section 24J(1) clearly states that its definitions are for the limited purposes of section 24J. The interest definition provided in section 24J cannot be applied to section 10(1)*(h)* unless it is argued that a purposive reading of section 10(1)*(h)* supports such a definition. It is, however, submitted that the purpose of section 10(1)*(h)* has not been static. Prior to the introduction of a withholding tax on interest, the clear purpose was

[59] Permanent establishment is defined in Article 5 of the OECD Model Tax Convention on Income and on Capital (2017).
[60] This definition had been introduced by section 19(1)(c) of the Taxation Laws Amendment Act, Act No. 22 of 2012.
[61] Prior to the enactment of Act No. 22 of 2012, interest in section 37I was defined as interest as defined in section 24(1) and deemed interest calculated in terms of section 8E(2).
[62] Section 23(1)*(j)* of the Taxation Laws Amendment Act 31 of 2013. It should be noted that the definitions for withholding tax on interest purposes are now in section 50A.
[63] Dennis Davis, Lynette Olivier & Gavin Urquhart (founding eds) *Juta's Income Tax* available on https://jutastat-juta-co-za.ezproxy.uct.ac.za/nxt/gateway.dll?f=templates&fn=default.htm&vid=Publish:10.1048/Enu accessed on 12 July 2021.

to encourage investors from outside the Republic to invest their debt capital in the Republic.[64] Considering that the only applicable tax was normal tax, section 10(1)(*h*) provided an absolute exemption from all taxation in South Africa with respect to the interest which non-residents earned in the Republic. However, after the introduction of withholding tax on interest by section 58(1) of the Taxation Laws Amendment Act 7 of 2010, it is submitted that there emerged a new purpose for section 10(1)*(h).* Since non-residents' interest was now taxable in South Africa under the withholding tax regime, the interest became exempt from normal tax by reason of section 10(1)*(h)* on the one hand, but subject to withholding tax on interest on the other hand. In the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012, it was explained that non-residents would be subject to normal tax where they had strong connections to South Africa but where they only had weak/passive connections, withholding tax would apply[65]. The role of section 10(1)*(h)* became to exempt foreign persons with weak connections to South Africa from normal tax so that they could only be taxed under the withholding tax on interest provisions. Therefore, since the introduction of withholding tax on interest, it can no longer be said that section 10(1)*(h)*'s purpose is to simply encourage investment since it no longer gives an absolute exemption from all taxes charged by South Africa on interest. Instead, section 10(1)*(h)* now serves as a pivot ensuring that where normal tax applies, withholding tax on interest does not apply and vice-versa.

Considering the above, the exemption from normal tax should only be granted to those non-residents who will be subject to the withholding tax on interest provisions. Therefore, it is submitted that interest in section 10(1)(*h*) must be defined with reference to the interest definition in section 50A so as to achieve its purpose as a pivot preventing double taxation of the same interest amount.[66] Since section 50A defines interest as interest as contemplated in paragraph (*a*) or (*b*) of the definition of interest in section 24J(1)[67], interest in section 10(1)*(h)* should also be defined as interest as contemplated in paragraph (*a*) or (*b*) of the definition in section 24J(1). On this purposive reading, interest earned by a non-resident from a sale and

[64] *CIR v Kuttel* [1992] 2 All SA 151 at 156 referring to *Cohen v CIR* 1946 AD 174 at 188, National Treasury of South Africa op cit note 4 at §2.6 and National Treasury of South Africa *Reviewing the Tax Treatment of Excessive Debt Financing, Interest Deductions and Other Financial Payments* (2020) at 28.

[65] National Treasury of South Africa *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010* (2010) at 69 -70 shows that the withholding tax on interest regime was introduced to deal with the problems resulting from the interest exemption in section 10(1)*(h).* The two are, therefore, necessarily connected. The current withholding tax on interest was introduced by section 98 of the Taxation Laws Amendment Act 31 of 2013 but the new regime does not purport to change the rationale behind the withholding tax as it was introduced by section 58 of the Taxation Amendment Act 7 of 2010.

[66] The reasoning is that withholding tax should only apply to interest which is exempt from normal tax.

[67] As per section 50A of the Income Tax Act.

leaseback transaction does not qualify for the exemption in section 10(1)(*h*) since it is not subject to withholding tax on interest.[68] However, it should be noted that interest from an intra-group loan will qualify for the exemption in section 10(1)(*h*) whether one adopts the SARS preferred definition of interest in section 24J(1) or the definition in section 50A.

TAXATION OF INTEREST EARNED BY A NON-RESIDENT LENDER UNDER WITHHOLDING TAX ON INTEREST

The Income Tax Act provides for a withholding tax on interest in section 50C which provides that a foreign recipient of South African interest is liable for the withholding tax on interest to the extent that such interest was received by or accrued to the foreign person from a source within South Africa. As already discussed, withholding tax on interest applies to interest as contemplated in paragraphs (*a*) and (*b*) of the interest definition in section 24J. In terms of section 50B, the withholding tax on interest is charged at 15 per cent of the gross interest amount. However, one must bear in mind the effect of South Africa's Double Tax Treaties on this tax rate. Double Tax Treaties are entered into in terms of section 108(2) of the Income Tax Act and come into force in terms of section 233 of the Constitution. In an intra-group loan, where the lender is a resident in one of the 79 countries[69] which have Double Tax Treaties with South Africa, the taxation of the interest from such a loan will be subject to the provisions of the treaty.

In *CSARS v Van Kets,*[70] the court pointed out that Double Tax Treaty provisions rank equally and should be reconciled with the provisions of the Income Tax Act such that they are read as one coherent whole. Therefore, in the situations where Double Tax Treaties apply and they grant a limited taxing right to South Africa in respect of an amount of interest, the 15 per cent will be reduced such that it accords with the limited taxing right in the treaty. Where the treaties grant exclusive taxing rights to the lender's country of residence, South Africa cannot

[68] The chances of such interest arising at all in the context of affiliate financing are almost inexistent. Section 23G(2) specifies that for the amount earned in a sale and leaseback to be considered interest, the lessee in the arrangement (the resident affiliate in an earnings stripping arrangement) has to be an exempt institution. It is inconceivable that a multinational business entity can own a tax-exempt South African resident.

[69] South Africa has 79 DTAs as at 17 June 2022 and these can be accessed on South African Revenue Service 'DTAs and Protocols (Africa)' available on https://www.sars.gov.za/legal-counsel/international-treaties-agreements/double-taxation-agreements-protocols/dtas-and-protocols-africa/ and South African Revenue Service 'DTAs and Protocols (Rest of the World)' https://www.sars.gov.za/legal-counsel/international-treaties-agreements/double-taxation-agreements-protocols/dtas-and-protocols-rest-of-the-world/ accessed on 17 June 2022.

[70] *CSARS v Van Kets* (2011) 74 SATC 9 at para 25.

charge any withholding tax on interest. An analysis of the Double Tax Treaties entered into by South Africa carried out for purposes of this study shows that 19 of them have the effect of reducing the rate of withholding tax on interest to 0 per cent, 6 reduce the rate to 5 per cent while 38 reduce the rate to 10 per cent.[71] Notably, some of the treaties that reduce the rate of withholding tax on interest to 0 per cent are with countries like the United States of America, the United Kingdom, Netherlands, Ireland, France, and several other capital-exporting nations.

DEDUCTION OF INTEREST INCURRED BY A RESIDENT BORROWER UNDER NORMAL TAX

While the above discussion is about interest in the hands of the non-resident lender, this section focuses on the treatment of interest from the resident borrower's perspective. The deduction of interest incurred by the resident affiliate is dealt with under section 24J(2) which requires:

i) a person;
ii) who is an issuer;
iii) in relation to an instrument (during a year of assessment);
iv) carrying on a trade; and
v) the amount of interest must be incurred in the production of income.

A resident affiliate is clearly a person. To be an issuer in respect of an instrument, the affiliate should have incurred interest or an obligation to repay the amount in terms of such instrument or would be liable to pay such interest had it been due and payable at any time.[72] The resident borrowing affiliate fits in the two requirements and thus qualifies to be an issuer for purposes of section 24J. The meaning of an instrument has already been discussed and an intra-group loan would unquestionably qualify as either an interest-bearing arrangement or debt. Therefore, the remaining requirements are that the affiliate be carrying on a trade and the amount of interest be incurred in the production of income.

The 'carrying on a trade' requirement, means an interest deduction will only be allowed against income the issuer derived from carrying on a trade.[73] Notably, the Act does not define

[71] Refer to Appendices 1, 2 and 3 for lists of counterparties.
[72] Section 24J(1) definition of issuer.
[73] The wording of section 24J(2) suggests that interest is deducted from income from a trade if the interest is incurred in the production of that income. Therefore, the interest must have been expended in the trade that produces the income. This means the test in section 24J(2) is similar to the 'for purposes of trade' test in section 23(g).

the phrase 'carrying on a trade' but provides a definition for 'trade' in section 1. This definition has been criticised for being circular to the extent that it defines a trade as including 'every trade'.[74] However, the definition also includes every profession, business, venture, the letting of property and grant of permission to use intellectual property rights.[75] It has, therefore, been held that this definition should be widely construed and should be understood to cover every profitable activity.[76] Notably, the definition includes the carrying on of a business. In *Smith v Anderson*[77] a business was defined as whatever occupies 'the time and attention of labour of men for the purpose of profit'. To prove a trade, a business does not have to make a profit but the lack of a profit-making motive should be explained to show that the transaction is so tied to the pursuit of a taxpayer's trade that the money expended can be justifiably regarded as for purposes of trade.[78] It should be noted that interest is only deductible to the extent that a trade is actually carried on.[79] Further, carrying on a trade requires a positive act going beyond mere planning for the future.[80] *Estate G v COT*[81] provides a summarised approach to determine if a taxpayer's activities qualify as a trade. Beadle CJ stated, *obiter*, that:

> *'The sensible approach, I think, is to look at the activities concerned as a whole, and then to ask the question: Are these the sort of activities which, in commercial life, would be regarded as carrying on business"? The principal features of the activities which might be examined in order to determine this are their nature, their scope and magnitude, their object (whether to make a profit or not), the continuity of the activities concerned, if the acquisition of property is involved, the intention with which the property was acquired.'*

It is, therefore, clear that the borrower must be engaging in active economic activity which goes beyond mere planning and has a degree of continuity. The borrower should also have an intention to make a profit. This effectively ties interest deductions to actual economic activity. However, it should be noted that a taxpayer does not cease to carry on a trade merely because one of his purposes was to obtain a tax advantage.[82] A taxpayer's tax avoidance motives are irrelevant to the 'carrying on a trade' inquiry. Therefore, unless the borrower's

[74] Afton Titus 'May an investment in interest-bearing securities constitute a trade for the purposes of the Income Tax Act?' (2016) 133 *SALJ* 3, 504 at 505.
[75] Section 1, Income Tax Act 58 of 1962.
[76] *ITC 770* 19 SATC 216.
[77] *Smith v Anderson* 15 Ch D 247 at 258 and Gutuza op cit note 23 at page 87.
[78] *De Beers Holdings (Pty) Ltd v CIR* 47 SATC 229 at 260. This case was dealing with whether a sale of shares at a loss satisfied section 23(g).
[79] Gutuza op cit note 23 at page 87.
[80] *CSARS v Contour Engineering (Pty) Ltd* (1999) 61 SATC 447 (E) and Titus op cit note 74 at 513.
[81] *Estate G v COT* 26 SATC 168 at 173.
[82] *Burgess v CIR* 1993 (4) SA 161 (A) at 179H.

activities have been unjustifiably altered by tax considerations,[83] the mere fact that a borrower is part of an earnings stripping scheme will not result in an interest deduction being disallowed on the basis that it was not incurred in the carrying on of a trade.

The requirement that interest must have been expended in the production of income requires an inquiry into whether the act to which the expenditure is attached is performed in the production of income and then secondly, whether the expenditure is close enough to such act.[84] In the case of interest, the main inquiry is into the purpose for which the loan was obtained.[85] In *CIR v Giuseppe Brollo Properties (Pty) Ltd*[86], the court stated,

> *'Where a taxpayer's purpose in borrowing money upon which it pays interest is to obtain the means of earning income, the interest paid on the money so borrowed is prima facie an expenditure incurred in the production of income…. If on the other hand the purpose of the borrowing was for some other purpose than obtaining the means of earning income (eg to pay a dividend), the interest is not deductible.'*

In the above case, the court held that the taxpayer's capacity to produce income had not been enhanced by the borrowing, but the taxpayer had only been burdened with an obligation to make deductible interest payments and lower its net income. Therefore, a loan should be seen to enhance capacity to produce income. The same reasoning was applied in *ITC 1530*[87] where the court disallowed excessive interest on the ground that the expenditure was not incurred in the production of income or for purposes of trade. Gutuza argues that determining if interest is excessive requires a consideration of factors like the relationship between the lender and the borrower, the terms of the loan and any ulterior motives in the levying of interest at a higher rate, the prime rate, and rates payable by other borrowers in similar circumstances.[88] Another case where interest was disallowed for not being in the production of income is *ITC 1762*[89] where the court disallowed a deduction in its entirety on the basis that the underlying financing transaction was fraudulently designed to create a tax deduction for the taxpayer while the interest was exempt from taxation as it was received by a non-resident.

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[83] Ibid states that a taxpayer is potentially not carrying on a trade if transactions have been so affected or inspired by fiscal considerations.
[84] *Port Elizabeth Electric Tramway Co. Ltd v CIR* 8 SATC 13 at 16.
[85] *Financier v COT* 1950 (3) SA 293 (SR) at 295.
[86] *CIR v G Brollo Properties (Pty) Ltd* [1994] 56 SATC 47 at 54.
[87] *ITC 1530* supra note 26.
[88] Gutuza op cit note 23 at page 86. These considerations suggest the production of income requirement inherently encompasses arm's length considerations.
[89] *ITC 1762* supra note 27.

DELIMITING THE EXTENT OF THE PROBLEM

In the Explanatory Memorandum for the Taxation Laws Amendment Bill for Act 31 of 2013, the National Treasury pointed out that deductible interest paid out to foreign persons or other exempt persons results presented a risk to the tax base due to what it termed the 'deduction/exemption mismatch'.[90] This mismatch can be described as the extent to which a deductible interest amount does not have a corresponding taxable interest amount in the hands of any South African taxpayer. This mismatch is desirable in so far as it attracts foreign debt capital from foreign investors who benefit from the exemption. However, where the foreign lenders form part of the same group as the borrowers, there is a risk that the mismatch may be used as an avenue to shift profits from South Africa to low tax jurisdictions.

Since the introduction of the withholding tax on interest by Act 7 of 2010,[91] the mismatch has been addressed by ensuring foreign lenders who receive interest payments are liable for the tax at 15 per cent of the gross amount of interest. If not for the treaties that reduce the tax rate as discussed above, introducing a withholding tax on interest would be sufficient to eliminate the deduction/exemption mismatch in all cases and thus combat earnings stripping schemes. However, due to the impact of treaties, the consequence is that an absolute deduction/exemption mismatch can still arise where a lender is resident in the 19 countries that do not give South Africa any taxing right on interest paid to foreign creditors. A partial deduction/exemption mismatch also arises where lenders are resident in countries in respect of which South Africa has treaties providing for limited taxing rights on South African earned interest. It should be noted that earnings stripping schemes utilise this mismatch to shift profits from South Africa to another jurisdiction which exempts the interest income or charges a very low rate of tax. Thus, in a multinational group, the enterprise can achieve a lower group-wide tax rate in this way.

On the other hand, it is submitted that where a treaty provides that South Africa may tax interest payable to a foreign resident at 15 per cent or more, there is no resulting deduction/exemption mismatch since South Africa can impose its full withholding tax charge on the interest.[92] Further, where there is no Double Tax Treaty, there is also no deduction/exemption mismatch as South Africa automatically exercises its right to charge the

[90] National Treasury op cit note 4 at §2.6.
[91] Introduced Part IA (sections 37I to 37M) which has now been replaced by Part IVB (sections 50A – 50H).
[92] Countries with such Double Tax Treaties with South Africa include Brazil, Romania, and Israel.

withholding tax on interest at 15 per cent in terms of the Income Tax Act. Therefore, it can be concluded that a deduction/exemption mismatch in South Africa will only arise in either of two circumstances:

i. where the affiliate-lender is resident in one of the countries in respect of which Double Tax Treaties do not allocate any taxing rights to South Africa; or
ii. the lender is resident in the countries where Double Tax Treaties grant limited taxing rights (taxing rights lower than 15 per cent) to South Africa.

It is critical to note that there cannot be an earnings stripping structure without a deduction/exemption mismatch. However, the existence of the mismatch does not in itself prove that an earnings stripping scheme exists. The treatment of the interest in the lender's hands in its jurisdiction of residence is also a key determinant. In South Africa, it can thus be concluded that for an earnings stripping scheme to be set up, two conditions should be satisfied:

i. there should be a deduction/exemption mismatch; and
ii. the foreign jurisdiction should charge no or low tax on the interest earned by the foreign affiliate lender.

The next section discusses the importance of foreign tax treatment of interest and the economic policy underpinnings of decisions foreign countries make regarding the taxation of their residents' foreign earned receipts.

EARNINGS STRIPPING FROM AN INTERNATIONAL TAX POLICY PERSPECTIVE

To fully understand the importance of foreign tax treatment of interest, it is necessary to discuss the economic policy considerations that inform the tax treatment of income in different jurisdictions. The starting point is that there is a consensus in economic theory that taxation should be imposed such that the economy operates as if no taxes have been levied.[93] In other words, there should be no distortions and market forces (rather than taxes) must determine the allocation of resources. In analysing the specific impact of international tax on welfare,

[93] Klaus Vogel 'Worldwide vs. source taxation of income – A review and re-evaluation of arguments (Part II)' (1988) 10 *Intertax* 310 at 313 and Johann Hattingh 'Elimination and Avoidance of International Double Taxation' in Dennis Davis (ed) *Silke on International Tax* (2019) at § 36.11.1 available on https://www-mylexisnexis-co-za.ezproxy.uct.ac.za/Index.aspx?permalink=emIvN2IvNW8zM2IkLTEkNyRMaWJyYXJ5JGRwYXRoJExpYnJhcnk also Gutuza op cit note 23 at 6 and Dale Pinto 'The Theoretical Foundations and continued rationale for source-based taxation in an electronic commerce environment' (2012) *Australian Tax Forum* 443 at 448.

Musgrave introduced the concepts of Capital Export Neutrality (CEN) and Capital Import Neutrality (CIN).[94] CEN focuses on ensuring an investor pays the same total tax regardless of where he invested.[95] Therefore, foreign and domestic returns are similarly taxed such that there is no tax advantage in choosing one over the other. Under CIN, the capital funds from various countries compete at equal terms in the capital market of any country.[96] In such circumstances, it does not matter who invested, both local and foreign investors incur the same tax burden within a country. Vogel, thus, rightly concludes that 'export neutrality implies a system of worldwide taxation plus a foreign tax credit while import neutrality implies an exemption system' (or a source taxation system).[97]

From the above, it becomes apparent that a country that seeks CIN will exempt a taxpayer's income from foreign sources. To obtain the maximum benefit from earnings stripping, an affiliate lender should be resident in such a country which seeks capital import neutrality (in other words, which exempts foreign income). In such instances, interest from the South African affiliate borrower will be exempt from tax in the lender's jurisdiction while the same interest will benefit from the deduction/exemption mismatch in South Africa. This would satisfy the two conditions for an earnings stripping structure. The conditions would also be satisfied where the lender's country of jurisdiction seeks export neutrality but charges very low worldwide tax. It becomes clear that an earnings stripping scheme simultaneously takes advantage of the South African deduction/exemption mismatch and capital import neutrality or low worldwide taxation in foreign systems.

The importance of the foreign jurisdiction's tax treatment of interest cannot be overemphasised. It means a deduction/exemption mismatch in South Africa is by itself not enough to result in an effective earnings stripping scheme if there is no corresponding favourable treatment of the interest in a foreign jurisdiction. The unavoidable conclusion is that to establish if there is an earnings stripping scheme, it is necessary to go beyond the domestic deduction/exemption mismatch and consider the tax treatment of the interest in the lender's jurisdiction. Only where such interest is subject to low or no foreign tax is it reasonable to

[94] Richard Musgrave 'Criteria for Foreign Tax Credit' in Russell Baker (ed) *Taxation and Operations Abroad, Symposium* (1960) at 84-85. Another early text on the concepts is Peggy Brewer Richman *Taxation of Foreign Investment Income - An Economic Analysis* (1963).
[95] Vogel op cit note 93 at 311.
[96] Mitsuo Sato & Richard M Bird 'International Aspects of the Taxation of Corporations and Shareholders' (1975) 22 (2) *IMF Staff papers* 384 at 408.
[97] Vogel op cit note 93 at 311.

assume that there might be an earnings stripping structure in place. The deduction/exemption mismatch only becomes a problem when it is matched with low or no foreign taxation of the interest in question. This understanding of the problem is narrower than that adopted by the National Treasury which views the deduction/exemption mismatch as a distinct tax risk on its own.[98] It is submitted that this is an unjustifiably wide characterisation of the problem which results in the conflation of legitimate interjurisdictional corporate financing decisions with tax avoidance motivated earnings stripping schemes.[99]

CONCLUSION

In this chapter, it has been established that the South African Income Tax Act exempts interest paid to a foreign resident in respect of a debt not connected to a permanent establishment in South Africa from normal tax. However, there is a withholding tax chargeable on the gross amount of such interest. On the deduction side, an interest amount is deductible if it meets the requirements of section 24J(2). It has also been established that the deduction/exemption mismatch which, in certain circumstances, gives rise to profit shifting through earnings stripping schemes only arises where South Africa has a tax treaty with the foreign lender's state of residence. An absolute mismatch arises where a treaty does not give South Africa a taxing right on interest paid by a resident borrower to a foreign resident lender. A partial mismatch arises where treaties limit South Africa's taxing rights on interest to a rate below 15 per cent. From an international perspective, to effectively obtain the benefit of an earnings stripping arrangement, the lender must be resident in a country which seeks capital import neutrality and thus exempts foreign income or in a country with a low worldwide tax rate. This means interest in an earnings stripping scheme should benefit from both the South African deduction/exemption mismatch and the foreign lender's home country exemption or low tax on foreign interest income. This conception of the issue is narrower than that adopted by the National Treasury which considers the deduction/exemption mismatch as necessarily problematic without considering the foreign treatment of interest. To address the 'deduction/exemption mismatch problem', South Africa introduced section 23M which will be discussed in the following chapter.

[98] National Treasury op cit note 4 at §2.6.
[99] This has distortionary effects in the economy.

CHAPTER 3

INTRODUCTION AND BACKGROUND

Section 23M was originally introduced by the Taxation Amendment Act 31 of 2013.[100] The Explanatory Memorandum at 2.6 explained that deductible interest paid to foreign and other exempt persons represented a risk to the South African tax base.[101] This was because of the deduction/exemption mismatch explained in Chapter 2 of this study. The National Treasury, in the 2013 Budget Review, had also explained that the closure of excessive debt had been on the tax policy agenda for more than two years.[102] Section 23M was, therefore, enacted to limit the interest deductions to a percentage of a creditor's earnings where creditors and debtors formed part of the same economic unit and interest was not subject to tax in the hands of the debtor. The original provisions came into effect on the 1st of January 2015.

The general approach adopted in section 23M is reminiscent of the earnings stripping rules in section 163(j) of the Internal Revenue Code introduced by the Omnibus Budget Reconciliation Act of 1989 in the United States of America. These American rules were the first interest deduction limitation rules in the world to benchmark allowable interest expenditure against a taxpayer's earnings.[103] However, the American rules were hybrid in nature as they also incorporated a traditional thin capitalisation safe harbour rule. The limitation only applied where a corporation's debt-to-equity ratio exceeded 1.5 to 1 and the net interest expense was above 50 per cent of the corporation's adjusted taxable income.[104]

The next noteworthy implementation of an earnings-based rule was in 2008 by Germany when the so called '*Zinsschranke*' was introduced.[105] It has been argued that the *Zinsschranke* was the blueprint for the European Union's earnings-based interest deduction limitation rule in article 4 of the Anti-Tax Avoidance Directive of 2016.[106] The *Zinsschranke*

[100] Section 23M has since gone through several amendments, the latest and most expansive of which was through section 19(1)(i) of Taxation Amendment Act 20 of 2021.
[101] National Treasury of South Africa op cit note 4.
[102] National Treasury of South Africa *Budget Review*, 2013 (2013) at 55.
[103] Martin Ruf & Dirk Schindler 'Debt Shifting and Thin Capitalization Rules – German Experience and Alternative Approaches' (2015) 1 *Nordic Tax Journal* 17 at 19.
[104] Section 163(j) of the Internal Revenue Code of 1986 as introduced by the Omnibus Budget Reconciliation Act of 1989 and United States of America Department of the Treasury *Report to the Congress on Earnings Stripping, Transfer Pricing and US Income Tax Treaties* (2007) at 9.
[105] German Income Tax Code (EStG) §4h and German Corporate Tax Code (KStG) §8a.
[106] Daniel Gutmann, Andreas Perdelwitz & Emmanuel Raingeard de la Blétière et al 'The Impact of the ATAD on Domestic Systems: A Comparative Survey' (2017) 57 *European Taxation* 1 at page 4.

treated excessive interest expenses as non-deductible business expenses in a similar fashion to the section 163(j) rule in the United States. The interest received remained taxable in the lender's hands but the interest expenditure on the borrower's side was limited to a percentage of the borrower's taxable earnings. This resulted in a temporary economic double taxation until the paying company was able to deduct the interest in the following tax years.[107] The *Zinsschranke* is important in the global evolution of the earnings stripping rule in that Germany completely abandoned the safe harbour thin capitalisation rules unlike the hybrid approach adopted by the USA which utilized both.

Notably, since 2016, the OECD has formally endorsed an earnings-based interest deduction limitation rule as its recommended approach.[108] It should be noted that South Africa introduced its section 23M rules before the OECD adopted a formal position on the treatment of excessive interest deductions, but the South African provisions have undergone several amendments to align them with the global consensus.

With the above in mind, this chapter discusses the substantive requirements of section 23M, when section 23M is to be applied and what it seeks to achieve. Section 23M was amended by the Taxation Laws Amendment 20 of 2021 and focus will be placed on these newly amended provisions. However, reference may also be made to previous iterations of section 23M for context.

SUBSTANTIVE REQUIREMENTS OF SECTION 23M

The South African earnings-based interest deduction limitation rule is in section 23M(3) which provides that:

> *'The amount of interest allowed to be deducted in respect of all debts owed as contemplated in subsection (2), in respect of any year of assessment must not exceed the sum of—*
>
> *(a) the amount of interest received by or accrued to the debtor; and*
>
> *(b) an amount determined by multiplying the adjusted taxable income of that debtor for that year of assessment by 0,3,*

[107] Richard Resch and Andreas Perdelwitz, 'The German Tax Reform 2008 – Part 2' (2008) *European Taxation* 159 at 159.
[108] OECD op cit note 34 discussed in greater detail in Chapter 4.

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

While section 23M(3) serves as the actual limiting provision, section 23M(2) provides the substantive requirements to trigger section 23M(3). These substantive requirements are:

i. an amount of interest incurred;
ii. by a debtor;
iii. during a year of assessment;
iv. in respect of a debt owed to a creditor;
v. the creditor and debtor are in a qualifying relationship (in the same group, in a controlling relationship or in back-to-back interposition situations);
vi. the interest is not subject to tax or included in the net income of a controlled foreign company in terms of section 9D;
vii. and interest is not disallowed under section 23N.[109]

These requirements will be considered in turn.

i. An amount of interest incurred

To trigger section 23M(1), an amount of interest must be incurred.[110] The interest definition in section 23M(1) was recently changed and now includes interest as defined in section 24J and payments under interest rate swap agreements, finance cost elements of lease arrangements, taxable foreign exchange gains or losses arising in respect of debts and amounts deemed to be interest under Sharia compliant financing arrangements. These are briefly discussed below:

a. Section 24J(1) interest

The definition of interest in section 24J(1) has been extensively discussed in Chapter 2.

b. Section 24K(1) interest

Section 24K generally deals with interest rate swap agreements and operates like section 24J in that it determines the timing of accruals.[111] An interest rate agreement is an agreement

[109] Section 23M of the Income Tax Act 58 of 1962.
[110] An amount of interest is incurred in terms of section 24J(2) Income Tax Act.
[111] Accruals are in terms of section 24K(2).

between two parties in terms of which there are two streams of payments – one based on a variable interest rate by one party to the other and the other on a fixed rate by the other party to the first party.[112] The payments are calculated on a notional amount; there is no real principal amount that exchanges hands.[113] Section 23M applies to all amounts incurred or accrued in terms of section 24K(2) under interest rate agreements.

c. Finance costs in finance leases

Finance leases are defined in IFRS 16 as leases transferring substantially all risks and rewards to use underlying assets during the lease term.[114] They are alternatives to operating leases which do not transfer all risks and rewards. In addition, they can be regarded as an alternative means of financing the acquisition of property or all the benefits obtainable from the property.[115] Some of the criteria used to determine if a lease is a finance lease are: the length of the lease, whether ownership is transferred at the end of the lease and whether the asset is so specialised that only the lessee could use it with limited or no modifications.[116] Under such finance leases, there will be a finance cost component (interest on the lease liability) and non-financial costs (usually depreciation charge for the right-to-use asset).[117] Section 23M ensures that only the finance cost component is considered as interest for purposes of the interest deduction limitation.

d. Taxable foreign exchange gains or losses arising in respect of debts

The interest definition in section 23M also includes foreign exchange differences arising from exchange items in terms of section 24I. Section 24I applies to both realised and unrealised foreign exchange differences arising from exchange fluctuations.[118] An exchange item includes a foreign currency-denominated debt between two related parties as would normally be used in an earnings stripping scheme.[119] Section 24I(10A) specifically deals with debts between

[112] Section 24K(1) of the Income Tax Act 58 of 1962.
[113] Alywn de Koker, RC Williams, *Silke on South African Income Tax '§ 17.72A Interest rate agreements' (2019) LexisNexis Online Library accessed on https://www-mylexisnexis-co-za.ezproxy.uct.ac.za/Index.aspx?permalink=Q2ggMTcgcGFyIDE3LjcyQSQxOTc4MDQ0JDckTGlicmFyeSRKRCRMaWJyYXJ5*
[114] IFRS 'IFRS 16 Leases' available at https://www.ifrs.org/issued-standards/list-of-standards/ifrs-16-leases.html/content/dam/ifrs/publications/html-standards/english/2021/issued/ifrs16/ accessed on 21 February 2022.
[115] Salim Alibhai, Erwin Bakker & TV Balasubramanian et al *Wiley 2020 Interpretation and Application of IFRS ® Standards* (2020) at page 540.
[116] Ibid at 541.
[117] Alibhai, Bakker & Balasubramanian op cit note 115 at 556 and IFRS 16 op cit note 114 at para 49.
[118] De Koker & Williams op cit note 113 at § 24.5.
[119] The definition of exchange item in section 24I(1) includes 'an amount in a foreign currency owing by or to a person in respect of a debt incurred by or payable to such person'.

such related parties. Unrealised gains in a debt between related parties will only be included as exchange gains or losses if the debt has been hedged, a portion of the debt is regarded as a current asset or current liability under IFRS standards, or the debt has been directly or indirectly funded by an unrelated third party. Section 24I(10A) provides for a formula to be used to determine the amount to be included or deducted from a resident taxpayer's income. The amount obtained from this calculation is the amount included in the interest definition under section 23M.

e. Amounts deemed to be interest under Sharia-compliant financing arrangements

A financing arrangement is considered sharia compliant if it is open to the public and presented as compliant with Sharia law.[120] The Income Tax Act recognises the following sharia arrangements: *muradaba, murabaha,* diminishing *murashaka* and the *sukuk*.[121] Under a *muradaba,* any amount received by or that accrues to a client is deemed to be interest in terms of section 24J(1).[122] Under a *murabaha,* the difference between the amount of consideration for the asset by a financier to a seller and the consideration payable to the financier by the client to acquire an asset is deemed to be interest in terms of section 24J(1).[123] Under a diminishing *murashaka,* the amount calculated in terms of the formula given in section 24JA(6)(b) is regarded as interest as defined in section 24J(1).[124] Lastly, under a *sukuk,* any consideration paid by the government, a public entity or a listed company in respect of the use of an asset held by the trust in that sukuk arrangement is deemed to be interest as contemplated in section 24J(1).[125] These deemed interest amounts also constitute interest for purposes of the limitation in section 23M.

ii. A debtor

Section 23M also requires that there be a debtor. A debtor can either be a person that incurs an amount of interest and is resident in South Africa or a non-resident that owes a debt which is effectively connected with the non-resident's permanent establishment in South Africa.[126] 'Effectively connected' is a term widely used in in treaty law and the OECD has explained that

[120] Section 24JA(1) of Income Tax Act.
[121] These are defined in section 24JA(1).
[122] Section 24JA(2). Client in this case refers to a client in the banker-customer relationship.
[123] Section 24JA(3)(d).
[124] Section 24JA(6).
[125] Section 24JA(7)(c).
[126] Section 23M(1).

it refers to economic ownership of debt. [127] The inquiry, therefore, goes beyond the formal records to seek the real owner of the debt.

iii. During a year of assessment.

A year of assessment is defined in section 1 of the Income Tax Act as 'a year or other period in respect of which a tax is chargeable'.[128] In terms of section 5(1)(*d*) of the Income Tax Act, the year of assessment of a company is its financial year. Notably, the new section 23M provisions apply to taxpayers with years of assessment starting on or after the 1st of April 2022.[129]

iv. In respect of a debt owed to a creditor

The new provisions in section 23M introduced a non-exhaustive definition of debt which says it 'includes any amount in respect of which interest is determined or incurred and that amount must be regarded as owed'.[130] Debt, however, excludes a tax debt in terms of the Tax Administration Act. Section 23M does not define 'creditor' and it should be understood to mean 'one to whom any obligation is owed, whether contractual or otherwise'.[131] It should be noted that the Act does not require that the creditor be a non-resident. It is submitted that this may be a result of constitutional[132] and double tax treaty non-discrimination considerations.[133]

v. The required degree of association between creditors and debtors

To trigger section 23M(3), there is a required degree of association between the creditor and the debtor. The first, straightforward qualifying association is a controlling relationship between a debtor and a creditor. Section 23M(1) defines this as a relationship where a person, or a person together with connected persons directly or indirectly hold 50 per cent or more in equity or voting rights in a company. A controlling relationship also arises where only

[127] OECD *Organisation for Economic Cooperation and Development Commentaries on the Articles of the Model Tax Convention* (2019) at 215.
[128] Section 1, Income Tax Act.
[129] Section 19(2) of the Taxation Amendment Act 20 of 2021.
[130] Section 23M(1), Income Tax Act.
[131] This is the ordinary meaning of a creditor as provided in Garner op cit note 55 at 375.
[132] Section 9 of the Constitution of South Africa, 1996 provides for the right to equality before the law.
[133] OECD 'Organisation for Economic Cooperation and Development Articles of the 2017 Model Tax Convention at Article 24(4)' available on https://www.oecd.org/ctp/treaties/articles-model-tax-convention-2017.pdf accessed on 7 June 2021 and Joshua Michael Friedman *South Africa's Restrictions on Interest Deductions and Their Compatibility with the Non Discrimination Provisions of the 2017 Version of the OECD Model* (Unpublished LLM Thesis, University of Cape Town, 2019).

connected persons in relation to a person directly or indirectly hold half of the equity or can exercise 50 per cent of the participation or voting rights in a company. This definition covers situations where a person together with connected persons hold rights in a company in their own name (direct ownership) or when they hold shares in a company that holds shares or voting rights in another (indirect ownership). Direct holding, therefore, means voting rights or shares are held without an intermediary while indirect holding means the voting rights or equity shares are held through an intermediate person.[134]

Another qualifying degree of association arises where a creditor is in a controlling relationship with the debtor and the creditor gets the funding it grants to the debtor from a person in a controlling relationship with the creditor. Thus, one can say in such cases there is a chain of controlling relationships from the original funder which is in a controlling relationship with the creditor which is in turn in a controlling relationship with the ultimate debtor.

In instances where the creditor is not in a controlling relationship with the debtor, section 23M(2) requires that the creditor should have obtained the funding for the debt from a person in a controlling relationship with the debtor. It is submitted that the purpose of this provision is to deal with the interposition of third parties to circumvent the controlling relationship requirement. The key question is who the true funder in such situations is. If it is found that the funds advanced to the debtor came from an unrelated creditor who was, however, funded by an ultimate creditor in a controlling relationship with the debtor, section 23M(3) is triggered. It is submitted that in determining if a creditor 'obtained the funding for the debt' from an ultimate creditor in a controlling relationship with the debtor, it should be remembered that section 23M is an anti-avoidance provision.[135] This means the aim should be 'to give full effect to the remedy advanced by the provisions'.[136]

The fourth and final qualifying association is where the creditor and debtor are a part of the same group of companies. Notably, group of companies is defined in section 1 of the Income Tax Act as requiring common control of over 70 per cent but section 23M reduces that threshold to 50 per cent. This means if more than 50 per cent of the equity or voting rights in

[134] SARS *Interpretation Note: 67 (Issue 4) – 28 January 2020: Connected Persons* at 22, available on https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2020-01-Arc-01-IN67-Issue-3-Connected-Persons-28-01-2020.pdf accessed on 20 May 2021.
[135] National Treasury of South Africa op cit note 4.
[136] *Glen Anil Development Corporation Ltd v SIR* 37 SATC 319 at 334.

the debtor and creditor are held by the same parent, they will be regarded as part of the same group for purposes of section 23M.

vi. The interest is not subject to tax or included in the net income of a controlled foreign company in terms of section 9D

In this requirement, tax is widely understood as 'a tax, or a penalty imposed' in terms of the Income Tax Act.[137] However, there has been a compelling argument made in favour of interpreting 'tax' as including foreign corporate taxes where an applicable double tax treaty exists and has a definition for 'tax'.[138] This would, to some extent, limit the application of section 23M to instances where there is no foreign tax charged on interest. The argument hinges on the fact that the 'tax' definition in section 1 of the Income Tax Act applies 'unless the context otherwise indicates'. It is further argued that the 'context otherwise indicates' where there is an applicable Double Tax Treaty with a 'tax' definition for treaty purposes. In addition, the argument is also based on the change of the heading in section 23M from 'Limitation of interest deductions in respect of debts owed to persons not subject to tax under this Chapter' to 'Limitation of interest deductions in respect of debts owed to persons not subject to tax'.[139] This, so the argument goes, means the focus of section 23M shifted from the taxes covered under Chapter II (normal tax and withholding taxes) to a wider conception of taxes which should include the taxes covered by treaties between South Africa and other countries where applicable. However, it should be noted that the Explanatory Memorandum to the Taxation Laws Amendment Bill 15 of 2016 explains that the change was to ensure every person not subject to tax in South Africa was covered by section 23M regardless of whether the taxpayer was not subject to tax because of the provisions in Chapter II of the Income Tax Act or the provisions of a tax treaty. In other words, the aim of the change was to widen the ambit of 'persons not subject to tax' rather than widen the meaning of 'tax'. Be that as it may, the argument to include foreign taxes under 'tax' for purposes of section 23M is still persuasive in so far as it relies on the legal position that domestic law must be read as a coherent whole with

[137] Section 1, Income Tax Act 58 of 1962, De Koker & Williams op cit note 113 at *§13.39A Limitation of interest deductions — section 23M.*
[138] Otladisa Patrick Leshomo *A proposed interpretation of the phrase 'subject to tax' in section 23M(2)(i)(aa) of the Income Tax Act No. 58 of 1962 when read in context of the South African Tax Treaties* (Unpublished LLM Thesis, University of Cape Town, 2021).
[139] The change was made by section 41, Taxation Laws Amendment Act 15 of 2016.

treaties.[140] However, despite the theoretical cogency of this argument, the current consensus is that tax in 'subject to tax' means a tax or penalty imposed in terms of the Income Tax Act.[141] Considering that the courts are yet to make a decision on this issue, it is, therefore, assumed for current purposes that tax in 'subject to tax' means a tax or penalty imposed under the Income Tax Act.

With this in mind, the next question becomes the meaning of the entire phrase – subject to tax. 'Subject to tax' is not defined in the Income Tax Act and there has not been a judicial decision on its meaning as it is used in section 23M. However, in *Downing v Secretary for Inland Revenue*[142] the court used the phrase 'subject to tax' to refer only to instances where tax is actually levied on an amount of income. Further, in the English case of *Paul Weiser v HMRC*[143], the court stated that 'subject to tax' requires that income 'actually falls within the charge to tax'. The income must be included in the calculation of a taxpayer's taxable income such that, not for deductions, it would be taxed. The *Weiser* case was considering the difference between 'liable to tax' and 'subject to tax' in a double tax treaty but it is submitted that there is no reason the *Weiser* understanding cannot apply to section 23M. De Koker and Williams also opine that the phrase 'subject to tax' requires the recipient to fall within the scope of the taxing rules in South Africa and not be exempt from tax.[144] As stated above, section 23M is an anti-avoidance measure and the above interpretation of 'subject to tax' advances its aim as a counter-base erosion provision.[145]

In view of the above, it can be concluded that if a double tax treaty takes away South African taxing rights in respect of interest, that interest amount is not subject to tax in South Africa.[146] As already stated, if an intra-group loan is not effectively connected to the foreign lender's permanent establishment in South Africa, the interest income from that loan is exempt

[140] *Van Kets* supra note 70 at para 25 but this decision was dealing with the application of administrative provisions which, not for an expansive reading of 'taxpayer' to include foreign taxpayers would have resulted in South Africa failing to meet its treaty obligations. I Du Plessis 'Some Thoughts on the Interpretation of Tax Treaties in South Africa' (2012) 24 *SAMLJ* 31 at 37-38 argues this case was wrongly decided.
[141] Des Kruger 'Interest-Deduction Limitation: Section 23M' (2015) 6 *Business Tax & Company Law Quarterly* 11 at 17, National Treasury of South Africa *Explanatory Memorandum to the Taxation Amendment Bill* 2021 at page 18 and Phillip Haupt *Notes on South African Income Tax* 13 ed (2020) §17.6 are examples of this interpretation.
[142] *Downing v Secretary for Inland Revenue* (Natal Income Tax Special Court) unreported case No. 6737 of 2 August 1972 at 15.
[143] *Paul Weiser v HMRC* (TC 02178).
[144] De Koker & Williams op cit note 113 at *§13.39A.*
[145] *Glen Anil Development Corporation Ltd* supra note 136 at 334 but in *CSARS v Airworld CC & Anor* [2008] 2 All SA 593 (SCA) the Supreme Court held the reading had to be contextualised not simply be as broad as possible.
[146] Exempt residents like pension funds and public benefit organisations are also not subject to tax.

from normal tax in the foreign lender's hands in terms of section 10(1)*(h)*. However, the interest would be liable for withholding tax in terms of section 50C unless a double tax treaty limits South African taxing rights. If the treaty completely limits South Africa's taxing rights, granting exclusive taxing rights to the lender's state of residence, the interest is not subject to tax for purposes of section 23M. However, if the treaty limits the South African taxing right to a rate lower than 15 per cent (the withholding tax on interest rate), such interest is, to some extent subject to tax. Where interest is partially subject to tax, section 23M does not apply to the full interest amount. A new proviso in section 23M provides a formula to calculate the portion of interest that is to be treated as not subject to tax where South African taxing rights are reduced to a rate lower than 15 per cent by double tax treaties.[147]

Section 23M(2) also requires that any interest included in the net income of a controlled foreign company in terms of section 9D be excluded from the interest limitation rule. The rationale is that such interest would have already been included in the notional income of the South African resident taxpayer and consequently taxed. The interest would, therefore, present no base erosion risks as it is included in the South African tax base in terms of section 9D.

vii. Interest is not disallowed under section 23N

Section 23M(5) implies that section 23N, another specific earnings-based limitation rule, should be applied first where an interest amount satisfies the requirements of both sections. Section 23M will not apply to interest that has already been disallowed under section 23N.

APPLICATION OF SECTION 23M

Where section 23M applies, deductible interest must not exceed an amount calculated in terms of section 23M(3). According to section 23M(3), the limit is the sum of interest earned by the debtor less interest incurred, and that amount is added to 30 per cent of adjusted taxable income. The starting point to obtaining adjusted taxable income is taxable income, which is then reduced by interest received or accrued, any CFC imputed income in terms of section 9D(2), and recouped or recovered amounts in respect of a section 19 allowance.[148] Interest expenditure

[147] The formula is in the proviso to section 23M(2). The calculation is interest received or accrued multiplied by the difference between the ideal 15 per cent withholding tax and the effective tax rate applied to the interest, divided by 15. The idea is to isolate the amount of interest benefiting from the lower rate and treating that as 'not subject to tax'.

[148] Section 23M(1), Income Tax Act. Adjusted taxable income is the tax equivalent of Earnings Before Interest, Taxes, Depreciation and Amortisation.

allowed as a deduction is added back to the amount as well as amounts allowed as deductions under section 19, any assessed loss or balance of assessed loss allowed to be set off under section 20, and qualifying distributions deducted in terms of section 25BB(2). The amount of interest not captured by section 23M (in so far as it exceeds amounts disallowed by section 23N[149]) will be deducted from the sum of interest earned and 30 per cent of adjusted taxable income. The section 23M limit is, therefore, made up of an amount approximating net interest earned by a debtor in a year of assessment and a percentage of EBITDA.[150] The disallowed interest is carried over to the following year of assessment in terms of section 23M(4) and the Act does not limit these carry-overs. It is, therefore, clear that section 23M operates less as a hard limit but as a deferral rule allowing the deduction of disallowed interest in future years where it is worth less to the taxpayer due to the time value of money.

INTERACTION OF SECTION 23M WITH SECTION 31 AND SECTION 23N

While the operation of section 23M in isolation has been discussed above, it is critical to note that section 31 and section 23N can potentially apply to the same amounts as those dealt with under section 23M. Different outcomes will be obtained when different provisions are applied first, therefore, it is critical to establish the correct sequence of application of the provisions. The National Treasury has proposed that companies first apply the arm's length rules in section 31 and then the interest limitation rules in sections 23N and 23M.[151] In the Final Response Document on the 2021 Draft Tax Legislation, the National Treasury also stated that an interpretation note is the best mechanism to address the uncertainty.[152] This, of course, is doubtful as such an Interpretation Note would represent the unilateral interpretation of SARS rather than a practice generally prevailing.[153] As at 30 April 2022, SARS had released a Draft Interpretation Note providing for the order of application.[154] In itself, the government's opinion

[149] Section 23N is also an EBITDA-based interest limitation which, however, applies to the subset of interest incurred in acquisitions.
[150] The limit is made up of a net amount of interest obtained by deducting untainted interest (interest not affected by section 23M) from interest received by the debtor and adding this to 30 per cent of adjusted taxable income.
[151] National Treasury of South Africa op cit note 64 at 48 and in the National Treasury of South Africa *Final Response Document on the 2021 Draft Rules and Monetary Amounts and Amendment of Revenue Laws Bill 2021 Draft Taxation Laws Amendment Bill, 2021 Draft Administration Laws Amendment Bill and the Second Batch of the 2021 Draft Taxation Laws Amendment Bill and 2021 Draft Tax Administration Laws Amendment Bill* (2021) at 30.
[152] Ibid.
[153] *Marshall NO and Others v Commissioner for SARS* (CCT208/17) [2018] ZACC 11 (25 April 2018) at page 6.
[154] SARS *Draft Interpretation Note: Determination of the taxable income of certain persons from international transactions: Intra-group Loans* (2022) at 36. The draft was released for public comment.

does not necessarily carry the force of law and it is still necessary to establish the correct legal interpretation of the provisions to determine the hierarchy of application.

The arm's length provisions in section 31 are applied in obtaining the correct taxable income. Section 31(2) clearly states that affected transactions, schemes, arrangements, and understandings that fall within section 31(1) are adjusted such that taxable income is calculated as if such transactions, schemes, and arrangements were entered into by independent parties at arm's length. This means taxable income is only calculated after applying section 31. On the other hand, section 23M is hinged on a mechanical limit obtained by calculating 30 per cent of adjusted taxable income. As already noted, to obtain the adjusted taxable income, the starting point is taxable income. To calculate this taxable income, the taxpayer must apply section 31 first and make all necessary arm's length adjustments.

As to the application of section 23N, it is clear under section 23M(5) that section 23N is to be applied before section 23M is applied. Therefore, as also argued by Kruger, the hierarchy of the three provisions is: section 31 is applied first, section 23N follows, and lastly, section 23M is applied.[155] The application of all these provisions is obviously preceded by the application of section 24J to establish the deductible interest, then section 31 is applied to adjust both the interest to arm's length pricing and the principal debt to an arm's length amount.

CONCLUSION

In this chapter, it has been established that section 23M is South Africa's earnings-based interest limitation rule operating on similar principles to the American section 163(j) of the Internal Revenue Code and the German *Zinsschranke*. In the South African tax system, section 23M applies after section 31 and section 23N have been applied. It has also been established that where the substantive requirements are met, section 23M limits the allowable interest deduction to the sum of an amount approximating the debtor's net interest earned in a year of assessment and 30 per cent of adjusted taxable income. After section 23M has been applied, the disallowed interest amounts are carried over to subsequent years of assessment and this carry-over is unlimited.

[155] Kruger op cit note 141 at page 20.

CHAPTER 4

INTRODUCTION AND BACKGROUND

The amendments to section 23M enacted in February 2022 were the culmination of a process that started in February 2020 when the National Treasury issued its report titled Reviewing the Tax Treatment of Excessive Debt Financing, Interest Deductions, and Other Financial Payments.[156] The review used the OECD BEPS Action 4 best practice approach as the benchmark.[157] This recommended approach has been endorsed for African systems by ATAF which released its Suggested Approach to Drafting Interest Deductibility Legislation to enable African countries to operationalise the OECD recommendations.[158] It should be noted that while South Africa is not an OECD member country, it is an ATAF member state and an associate in the OECD Base Erosion and Profit Shifting (BEPS) Project.[159] Further, ATAF itself participated in the BEPS Project's work on Action 4 and was of the view that the earnings-based limit provided an appropriate limit for drafting interest deductibility rules in Africa.

This chapter analyses the effectiveness and specificity of section 23M using the ATAF Suggested Approach as the key benchmark for an effective and specific earnings-based limit for African countries.[160] Locally, the Davis Committee report[161] will also be considered and finally, issues that are not raised by the Davis Tax Committee or in the ATAF-based analysis are then separately discussed. The aim of the chapter is to ultimately determine if section 23M is designed such that it is effective in combatting earnings stripping schemes in South Africa while having very little effect on legitimate commercial decisions.[162]

THE ATAF SUGGESTED APPROACH

The ATAF approach is based on the OECD Action 4 Recommendation but is more contextualised and adapted to African tax systems. The approach has two main options: a

[156] National Treasury of South Africa op cit note 64.
[157] OECD op cit note 34.
[158] ATAF op cit note 32.
[159] South Africa ratified the Agreement on the Establishment of the African Tax Administration Forum in 2012. South Africa is also an Associate in the Base Erosion and Profit Shifting (BEPS) Project.
[160] Considering that it is based on the OECD Recommended Approach, reference will also be made to the OECD Action 4 Final Report where necessary.
[161] Davis Tax Committee Secretariat *Closing Report: March 2018 – Closing Report on the Work Done by the Davis Tax Committee* (2018)
[162] Specificity ensures that only tax avoidance is targeted and there is limited collateral damage on legitimate commercial enterprises. This reduces tax-based distortions on economic activity.

group-based option and a single company-based limit. Under the single company limit, the approach proposes a 10 per cent to 30 per cent of tax EBITDA interest deduction limit. The standalone company's earnings are considered without considering its group's position (if it is part of a group). In a group-based limit, a company's allowed interest is limited to the greater of the 10 per cent to 30 per cent earnings-based limit or the company's group net interest ratio multiplied by the company's tax EBITDA.[163] The ATAF limit excludes the banking and insurance industry, a position also shared by the OECD which states that earnings-based limits on interest would not be effective for banks and insurance companies due to the nature of their businesses which normally results in net interest income rather than a net interest expense.[164] Notably, the interest definition in the ATAF approach is quite expansive. It goes beyond interest as consideration for funds advanced and covers economically similar payments. It also has a list of inclusions including revenue flows in Islamic financing structures, guarantee fees in loans, and the finance cost element of finance lease payments.[165]

The features discussed above are the core elements of the ATAF approach, but it has the following optional features: a *de minimis* requirement to exclude small to medium enterprises, an optional carry-forward limit, specific recommendations where creditors obtain tax benefits on interest in their countries of residence, and recommendations for group companies in the same country.[166] The OECD also proposed an optional *de minimis* exclusion in its recommended approach, as well as an optional carry-forward which it stated, should only be applied where the interest deduction limit applies to all companies.[167] Where rules are targeted towards dealing with tax avoidance and base erosion like South Africa's rules, the OECD position is that the carry-over should not apply.[168] The ATAF approach, however, does not recommend instances when carry-over rules must be used but only recommends that the carry-over be for a maximum period of five years in all cases.[169]

In the suggested approach, ATAF also deals with the highly specific situations where a lender gets a tax benefit in its country of residence, or the lender is resident in a jurisdiction

[163] The aim is to allow a company to deduct interest up to its group's interest to EBITDA ratio where it is higher than the company's ratio.
[164] OECD op cit note 34 at page 80 and Part III.
[165] ATAF op cit note 32 at page 4.
[166] ATAF op cit note 32 at page 5.
[167] OECD op cit note 34 at page 39.
[168] OECD op cit note 34 at page 72.
[169] ATAF op cit note 32 at page 11.

deemed to be a beneficial tax regime.[170] In such cases, the approach recommends not allowing any deduction on the interest except to the extent to which the lender pays a foreign tax. The foreign tax is, therefore, allowed as a deduction rather than the interest itself. This recommendation is not in the OECD approach, but it can be concluded that it is a direct response to aggressive earnings stripping schemes where the lender is placed in a low to no-tax jurisdiction.

AN ATAF BASED CRITIQUE OF SECTION 23M

To effectively analyse section 23M in reference to the ATAF approach, this section will consider:

a) who is covered by section 23M and the ATAF approach,
b) what the limits in section 23M and the ATAF approach apply to,
c) and how the limits in section 23M and the ATAF approach are structured.

This exercise will ultimately establish if section 23M is, when compared to the ATAF approach, sufficiently effective and specific in dealing with earnings stripping schemes.

Who is covered by the limit?

Section 23M generally applies to debtors by limiting the interest deductions they can claim in their calculation of taxable income. However, it only applies to those debtors who incur debts with creditors with whom they have a controlling relationship, are in the same group with, or where creditors are interposed to deliberately break the chain between an ultimate lender in a controlling relationship with the debtor or creditor. The design of section 23M means it generally does not apply to situations where the debtor is a stand-alone company completely unrelated to the lender whether directly or indirectly. Similarly, the ATAF approach applies to companies that are part of multinational enterprises and not stand-alone companies.[171] Section 23M's scope is, therefore, sufficiently specific as it covers companies that are part of multinational entities. These are the high-risk taxpayers in earnings stripping schemes and thus one can also conclude that in so far as section 23M targets affiliate companies, it is effective and specific in dealing with earnings stripping schemes.

[170] ATAF op cit note 32 at 5 and 10.
[171] ATAF op cit note 32 at 6.

What is limited?

Section 23M limits interest incurred by a debtor from debts with creditors with close associations to the debtor. The section limits the gross amount of interest expenses incurred in such debts. Interest is expansively defined and includes cashflows from Sharia compliant financing arrangements, interest swap rate agreements, finance cost elements from finance lease arrangements and exchange losses.[172]

On the other hand, the ATAF approach has two options that states can adopt – it can limit net interest expenses or the gross interest expense. Interest is also widely conceived, going beyond interest on debts and including amounts under alternative financing arrangements, notional interest amounts under derivative instruments, foreign exchange gains or losses, guarantee fees and arrangement fees.[173] While the ATAF definition has a longer open list of specific inclusions, it is submitted that the section 23M definition which makes reference to section 24J(1) and includes a further list of specific inclusions, generally covers the listed inclusions in the ATAF approach. Interest as conceived in section 23M is, therefore, sufficiently wide to capture most charges that may be used to shift profits in an earnings stripping scheme. To this extent, it effectively targets the problematic schemes.

A notable difference between section 23M and the ATAF approach, however, is that the latter includes third-party interest expenses. Section 23M is, therefore, more targeted in its approach and seeks to limit only the interest deductions regarded as base erosion risks. The focus in section 23M is on earnings stripping schemes while the ATAF general approach applies to all interest since multinationals can also use third-party interest in high tax jurisdictions to lower their tax burden.[174] The use of third-party debt is, however, beyond the scope of this study since the focus is earnings stripping through intra-group debt financing. Regarding earnings stripping, the section 23M scope is, therefore, sufficiently expansive, and effective.

[172] Section 23M(1) definition of interest.
[173] ATAF op cit note 32 at 5.
[174] The ATAF approach has a separate and more specific rule for aggressive earnings stripping schemes which will be discussed below.

How the limits are structured

The section 23M limit is calculated on a sum of interest received or that accrues to a debtor and 30 per cent of tax-EBITDA, reduced by untainted interest expense.[175] This means the limit in section 23M is not simply a percentage of tax-EBITDA, but it is the sum of 30 per cent of tax-EBITDA and an amount approximating the debtor's net interest earned.[176] The ATAF rule, on the other hand, does not add the taxpayer's interest profits to the limit as done in section 23M. The structure of section 23M introduces a risk identified in the OECD Action 4 Report that taxpayers may convert their income to interest to increase their limit.[177] However, in such circumstances, it is submitted the substance over form doctrine might potentially be used to limit the more egregious forms of conversions. The case of *Commissioner for the South African Revenue Service v NWK Ltd*[178] provides a useful illustration of the application of the substance over form doctrine in interest bearing structures. The Supreme Court held that a structured arrangement entered into by NWK and designed to enable the taxpayer to get deductible interest in respect of a greater principal amount than that it required was a simulation. It was also held that the contract was dressed up to create an obligation to pay interest and claim a deduction to which the taxpayer was not entitled. While the case concerned itself with a simulation that inflated the allowable interest deduction, it can be argued that if a company converts general income to interest income through tax structuring, the substance over form doctrine might be used to deny that interest accrual and treat it as general income included in the adjusted taxable income rather than the net interest element of the section 23M limit.

Another key difference is that the limit in section 23M has no group reference. This means the deduction limit is calculated for a debtor without reference to the debtor's overall group ratios. The ATAF approach includes group-wide ratios as an optional limit that states can use but it is not a core element of the rule.[179] Due to the difficulty in administration, this element would only complicate the system without commensurate rewards.[180] The one benefit

[175] Untainted interest expense in this case refers to interest not falling within the scope of section 23M.
[176] Considering that the formula deducts untainted interest expenses from interest received or accrued and 30 per cent of EBITDA, it can be loosely argued that the limit is the sum of 30 per cent of EBITDA and an amount approximating net interest earned by the debtor in a year of assessment.
[177] OECD op cit note 34 at 42 and 76.
[178] *Commissioner for the South African Revenue Service v NWK Ltd* [2010] ZASCA 168 but it should be noted that in this case, the doctrine was used to deny an interest deduction rather than deny an interest accrual or receipt.
[179] Section XX(1) Option 2 to 2B and page 8.
[180] ATAF op cit note 32 at page 10.

of a group ratio system is it more accurately tracks the commercial realities of a taxpayer by referring to the taxpayer's group position on debt and thus determining if a higher interest deduction limit is justifiable on the basis that the taxpayer's group generally operates on high debt for purely commercial reasons. It has been said that such a group ratio rule compensates for the blunt operation of the fixed ratio.[181] The National Treasury in 2020 stated that it would not introduce a group ratio element to the section 23M limit due to the administrative difficulty of enforcing it.[182] It is submitted that the group-wide ratio, while useful in enhancing section 23M's specificity in targeting only tax avoidance situations, would come at the cost of simplicity and would increase compliance costs for taxpayers.[183] Differentiated carry-forward periods for different industries could achieve the same purpose of easing the burden on non-avoidance situations while targeting and disincentivising avoidance structures. Further, non-avoidance situations may be wholly excluded from the rule by other means as will be discussed later in this chapter.

The limit in section 23M does not exclude banking and insurance companies from the rule unlike the ATAF approach which specifically excludes the banking and insurance industries from the earnings-based limit on the basis that the limit would not be an effective measure for them.[184] In 2020, however, the South African National Treasury signalled that it would not seek a finance sector carve out but it did not provide any rationale for adopting this position.[185] In the Final Response Document on the 2021 Draft Taxation Laws Amendment Bill, the National Treasury then clarified that since the South African rule is designed such that net interest[186] is added to the percentage of EBITDA, the banking and insurance industry which get profits from interest income would be accounted for.[187]

This explanation, however, does not recognise that the banking and insurance industries end up with an unfair advantage. While only 30 per cent of general business profits can be included in the section 23M upper ceiling, as already discussed, interest income is not subject to the same 30 per cent calculation. This means a company in the business of lending, and which predominantly makes interest profits, will obtain a higher interest deduction limit than

[181] OECD op cit note 34 at page 61.
[182] National Treasury op cit note 64 at 18.
[183] This would go against the Adam Smith canons of convenience and efficiency.
[184] ATAF op cit note 32 at page 6.
[185] National Treasury op cit note 64 at 23.
[186] Being interest received reduced by untainted interest expense in terms of section 23M.
[187] National Treasury of South Africa op cit note 151 at 30.

a company which predominantly makes its profits from other forms of income like rental income and profits from trade. The more plausible reason for the favourable treatment of banks and insurance companies is that the National Treasury does not consider the finance industry as a base erosion high risk due to the numerous other rules that apply to the industry in South Africa.[188] While the finance industry might be heavily regulated, it is submitted that these financial regulations are not tailored to minimise tax avoidance but focus on maintaining the integrity of the financial sector. Any effects on tax avoidance are merely coincidental thus it is not advisable to rely on financial regulations to resolve base erosion risks in the tax system. With regard to its application to the finance industry, section 23M is, therefore, not sufficiently effective in limiting earnings stripping risks.

Additionally, as partly discussed above, section 23M does not have industrial differentials. It is a blunt rule which does not account for the differences in sizes and operational demands of different companies in different industries. It does not have a *de minimis* rule and does not differentiate the treatment of taxpayers in different industries. The ATAF approach, on the other hand, has an optional *de minimis* rule to exclude small sized companies which do not pose a significant risk to the tax base. Further, the ATAF approach uses carry-over provisions to differentiate between businesses requiring high upfront capital expenditure and delayed revenue streams like mining operations.[189] It should be noted that in the ATAF approach, the carry-over can be used in such a manner because it is ordinarily limited to five years and where a business requires high upfront capital expenditure, this is extended. Section 23M, on the other hand, has an indefinite carry-over for all companies. This is overly lenient for companies actively engaged in earnings stripping; these companies get the benefit of guaranteed future deductions.

The unfortunate result of the above is that companies actively engaged in earnings stripping are treated in a similar manner to companies that genuinely require a lot of debt financing to satisfy operational requirements. Legitimate operational requirements are, therefore, collateral damage in section 23M. On the other hand, the indefinite carry-over is not sufficient to disincentivise earnings stripping since it means the only loss to the borrowing affiliate is the time value of the interest deduction rather than the deduction itself. The operation

[188] Including the Banks Act 94 of 1990, Financial Sector Regulation Act 9 of 2017, Inspection of Financial Institutions Act 80 of 1998, Mutual Banks Act 124 of 1993, Currency and Exchanges Act 9 of 1933, Insurance Act 18 of 2017 and regulations issued in terms of the statues.
[189] ATAF op cit note 32 at 11.

of the carry-over means section 23M operates less an interest deduction limitation rule and more as an interest deduction deferral rule. This, with respect, is not sufficient to combat aggressive earnings stripping. In 2020, the National Treasury proposed a five-year limit to the carry-over, but this was ultimately not introduced by the Taxation Amendment Law of 2022.[190] With regards to the absence of industrial differentials, section 23M is, therefore, less effective, and less specific than the ATAF approach. Section 23M treats companies in different industries similarly which is unduly harsh on capital intensive industries while being overly lenient on companies actually engaging in earnings stripping.

Lastly, a key difference between the provisions in section 23M and the ATAF suggested approach is that the ATAF approach has the option for specific earnings stripping rules in situations where lenders are resident in tax beneficial regimes or obtain tax benefits on the interest they earn from their debts to South African affiliates. This is a highly specific earnings stripping rule and ATAF suggests that in such circumstances, no deduction should be allowed for the local debtor save for the foreign tax actually paid by the non-resident creditor.[191] The disallowed interest in such instances is not carried forward. As has been mentioned in previous chapters, it is a considerable weakness of the South African deduction limit that it does not have any regard for the foreign tax position of non-resident creditors. Considering its regard for the foreign tax treatment of interest in intra-group debt, the ATAF suggestion is the more effective mechanism to directly target only the problematic earnings stripping schemes wherein multinationals advance funds to their affiliates resident in South Africa's relatively high tax system and place affiliate lenders in low or no tax regimes. Identifying the countries that should be regarded as beneficial tax regimes has, however, been said to be a politically sensitive exercise.[192] Further, there is a risk that such a rule may not comply with treaty non-discrimination provisions.[193]

THE DAVIS TAX COMMITTEE CRITIQUE OF SECTION 23M

With the above in mind, this section relies on the Davis Tax Committee's findings in 2016. The Davis Tax Committee (DTC) was an advisory commission set up by the Minister of Finance in 2013, and according to the DTC Secretariat, its mandate was 'to inquire into the

[190] National Treasury op cit note 64 at 47.
[191] ATAF op cit note 32 at 10 and Section XX(1)(k), (l) and (n) of the model legislation.
[192] ATAF op cit note 32 at 10.
[193] OECD op cit note 133.

role of the tax system in the promotion of inclusive economic growth, employment creation, development, and fiscal sustainability'.[194] The committee reported directly to the Minister of Finance. As part of its work, the DTC released a report on base erosion and profit shifting in the South African context in 2016. In this report, the DTC analysed section 23M and other provisions on the tax treatment of interest as at that date. Considering the report was released in 2016, this section will focus on the issues that are still relevant to the present iteration of the interest deduction limitation rules.

One of the issues raised by the DTC is that section 23M is too wide to be regarded a targeted anti-avoidance rule.[195] In fact, the DTC's criticism raises the question of whether section 23M is an anti-avoidance rule at all since the provisions do not consider the tax treatment of interest in the foreign jurisdiction where the creditor is resident.[196] This raises the possibility that a deduction is denied in South Africa in respect of interest for which the creditor obtains no tax benefit in its home jurisdiction. In such circumstances, there is no earnings stripping scheme in the first place but section 23M still applies.[197] This makes the rule imprecise and results in economic double taxation.[198] As already discussed, a specific rule like the ATAF reference to tax beneficial regimes would only apply in situations where the creditor is exempt or subject to low tax in its home jurisdiction. The lack of a reference to the foreign tax treatment of the interest is, therefore, a significant shortcoming of the section 23M. It means that while section 23M might successfully target some companies actively engaging in earnings stripping, it is not specific and thus also targets legitimate commercial practices. However, the effect on legitimate commercial practices is attenuated by section 23M's indefinite carry over provision. The only loss to the borrower, once the carry-over is applied, becomes the time-value of the interest since the deduction is staggered over several tax periods. The inequity of the rule, as discussed above, is in that both companies engaging in abusive earnings stripping and companies raising legitimate financing through inter-jurisdictional intra-group debt are similarly affected.

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[194] Davis Tax Committee Secretariat op cit note 161.
[195] The Davis Tax Committee *Second and Final Report on Base Erosion and Profit Shifting – September 2016 Annexure 4* at 39.
[196] This issue was also raised above in the ATAF based critique.
[197] As already discussed, an earnings stripping scheme only arises in South Africa where there is a deduction/exemption mismatch and the affiliate lender's foreign jurisdiction charges zero or low tax on the interest. Section 23M applies even when the affiliate lender's jurisdiction charges high taxes on the interest.
[198] Annika Soom 'Double Taxation Resulting from the ATAD: Is There Relief?' 2020 *Intertax* 48 (3) 274, OECD op cit note 34 para 159 and Emilio Cencerrado, Millan Soler Roch & Maria Teresa Soler Roch 'Limit Base Erosion via Interest Deduction and Others' (2015) 43 *Intertax* 58 at 67.

In addition to the above, the DTC raised the lack of clarity on the interaction between section 23M and section 31, an issue which has been raised since the promulgation of section 23M.[199] The DTC suggested an Interpretation Note to clarify the matter, a position the Treasury has since adopted.[200] SARS has since released a Draft Interpretation Note for public comment.[201] This issue has been discussed more extensively in Chapter 3 above. In any case, it is not, strictly speaking, a specificity or effectiveness issue. However, it raises concerns around the Adam Smith canon of certainty.

Another issue raised by the DTC was the earnings-based limit's effect that it disproportionately affects borrowers who are less profitable and thus pay less tax yet there is a range of factors that affect the profitability of companies and thus the tax that they pay.[202] It is not always the case that a company which pays low taxes in South Africa is engaging in tax avoidance practices; it may be the nature of the company's operations that it incurs low profits and must borrow large amounts to finance its activities. This is especially the case in capital intensive operations like mining. The DTC, therefore, argued that section 23M should interrogate the reasons behind the low profits rather than simply punish low profit-makers. Notably, this would significantly complicate section 23M but ultimately result in a rule which only targets abusive earnings stripping without punishing taxpayers for making low profits without inquiring into why that is the case. To the extent that section 23M uses low profits as an indicator of a tax avoidance motive, it fails on both the specificity and effectiveness score. It is not specific in that it fails to isolate companies engaging in tax avoidance from those having genuine commercial difficulties. Ironically, by denying interest deductions, section 23M exacerbates the situation for companies facing difficulties. In addition, section 23M is not effective in that companies making high profits may still engage in earnings stripping and in such cases, section 23M does not sufficiently address the problem.

At a policy level, the DTC raised concern with the effect that the complex rules in section 23M would have on the funding of capital-intensive sectors and on the South African drive to 'attract foreign direct investment, encourage development and projects aimed at improving the country's infrastructure'.[203] This is in addition to the DTC's exception to

[199] The Davis Tax Committee op cit note 195 at 39 and Kruger op cit note 141.
[200] National Treasury of South Africa op cit note 151.
[201] SARS op cit note 154.
[202] The Davis Tax Committee op cit note 195 at page 40.
[203] The Davis Tax Committee op cit note 195 at page 40.

targeted anti-avoidance rules, which it said rarely achieve their desired outcomes but only add complexity in the system. The DTC argued that companies intending to raise income would always do it regardless of rules like the section 23M limitation. To illustrate this, the DTC argued that groups could simply reroute financing through companies with high taxable income or use alternative finance structures.[204] This, therefore, means on the DTC analysis, section 23M is not sufficiently targeted in that it could have collateral effects on foreign direct investment and infrastructural projects while also failing to effectively combat earnings stripping since companies still have open options to creatively reroute financing.

OTHER CONCERNS ABOUT SECTION 23M

It should also be noted that section 23M is a part of a set of 'numerous and complex'[205] rules which apply to interest deductions. These rules are labyrinthine, and this potentially discourages foreign investment while adding administrative burdens. Additionally, considering that South Africa has alternative rules which apply to interest, it is questionable if section 23M is necessary in the system. Section 24J(2), similar to section 11(*a*), requires that deductible interest expenditure should be in the carrying on of a trade and in the production of income. The tax court has previously disallowed excessive interest because it was not incurred in the production of income.[206] Further, section 31 thin capitalisation rules can be applied to determine arm's length principal debt and the transfer pricing regime in section 31 also determines arm's length interest that would have been charged had the parties been independent. In addition, the general anti-avoidance rules, common law doctrines like the substance over form doctrine and the withholding tax on interest provisions also apply. The ultimate question, as asked by the Davis Tax Committee, is whether the rules are, in total, an 'overkill'.[207] Considering the totality of all the issues raised above, section 23M does not seem entirely necessary in the system. To compound the issues, section 23M is such a blunt tool in dealing with earnings stripping that it sacrifices legitimate financing transactions to limit a small subset of the truly problematic schemes. The costs of the provisions in section 23M seem to outweigh the benefits.

[204] The Davis Tax Committee op cit note 195 at page 41.
[205] Oguttu op cit note 36.
[206] *ITC 1530* supra note 26 and *ITC 1762* supra note 27.
[207] The Davis Tax Committee op cit note 195 at 44.

CONCLUSION

The limit in section 23M as amended by the Taxation Laws Amendment Act 20 of 2021 is broadly based on tax-EBITDA as recommended by the OECD. Notably, section 23M applies interest which is as expansively defined as interest in the ATAF suggested approach. A key difference, which represents a substantial weakness of the section 23M rule is that the limit is not simply a percentage of tax-EBITDA, but it is the sum of that percentage of tax-EBITDA and interest received by the debtor reduced by allowed interest expenses (referred to in this study as untainted interest). This means a company which earns a lot of interest income has a distinct advantage in calculating its limit as interest income is not reduced to 30 per cent of the initial amount as done to the rest of the taxpayer's income. A company intending to increase its deduction limit can simply increase its interest income. The rule in section 23M has the further disadvantage of having an indefinite carry-over provision which can create a moral hazard as taxpayers are never completely denied their deductions, but these are merely deferred to later years. The ATAF approach, in line with the OECD approach recommend a five-year limit.

In addition, section 23M does not differentiate between banks and insurance companies, and other taxpayers in industries which do not get a lot of interest income. It also does not have a *de minimis* rule to exclude small companies that do not present a huge risk for base erosion purposes. There are also no industry specific rules for capital intensive sectors where companies may borrow large amounts and only turn profits after several years. However, the greatest issue with section 23M as compared to the ATAF approach is section 23M is not specific enough to deal with the actual issue of earnings stripping. It is an imprecise rule which does not inquire into the tax position of a foreign lender and thus the base erosion potential of transactions. It targets both avoidance and legitimate transactions, while achieving less than satisfactory results on the actual avoidance structures. The Davis Tax Committee raised some of these issues in 2016 and further raised the provision's effect on South African economic policy. Another issue is that section 23M is part of a crowded regulatory system and it is arguable that the few benefits it gives do not justify its inclusion in an already complex regulatory system at the cost of simplicity.

In view of this analysis, the next chapter discusses recommendations to ensure the South African system effectively deals with earnings stripping schemes without sacrificing specificity.

CHAPTER 5

INTRODUCTION

This study has looked at the effectiveness of section 23M in combatting the intra-group debt-based tax avoidance structure known as an earnings stripping scheme. This is a structure where, because of an intra-group loan, an enterprise in a high tax jurisdiction makes excessive deductible interest payments to a low or zero tax associated enterprise to reduce a multinational's group-wide effective tax rate.[208] The set-up is simple: an affiliate company in a low tax jurisdiction grants a loan to an affiliate in a high tax jurisdiction. Due to the interest shield (an advantage companies get from the deductibility of interest[209]), companies can move their income from a high tax jurisdiction like South Africa to a low tax jurisdiction like Ireland. Considering that the affiliate companies form part of the same economic unit, the advantages of interest stripping the South African affiliate in this way accrue to the whole group. The aim of this study was to analyse section 23M to determine if it is designed to effectively and with sufficient precision address this avoidance scheme.

SUMMARY OF FINDINGS

From the study, it has been established that an earnings stripping scheme takes advantage of the tax rules of at least two jurisdictions. The scheme is decidedly interjurisdictional in nature. This study has found that an earnings stripping scheme can only be set up in South Africa if there is a deduction/exemption mismatch within South Africa and low or no taxation of the interest in the lender's country of residence. These two conditions are conjunctive in nature. It is not possible to have an earnings stripping scheme without one or the other. In view of this, the National Treasury's conception of the problem as merely 'a deduction/exemption mismatch' gives an incomplete picture since South Africa has historically used this mismatch to attract foreign investment. The mismatch is only problematic when paired with low or no taxation of interest by the foreign jurisdiction as this creates the risk that a multinational can use the system to lower its overall group tax rate.

[208] Clifton J Fleming Jr., Robert J Peroni & Stephen E Shay op cit note 10.
[209] Jonathan Berk & Peter DeMarzo op cit note 5 at 553.

In addition, this study has found that the deduction/exemption mismatch, while domestic in nature, arises from the application of double tax treaties. There can only be a mismatch when a double tax treaty exists between South Africa and the lender's country of residence and if the treaty lowers South Africa's taxing rights to below 15 per cent of the gross interest amount. Therefore, in the South African context, earnings stripping schemes arise from treaty abuse. This reframing of the issue as being treaty-based opens several avenues for addressing the base erosion risks it presents.

Finally, the study analysed section 23M against the ATAF model legislation benchmark and concluded that section 23M was not as specific and effective as the ATAF model. In addition, the study also considered the Davis Tax Committee criticism, and this discussion reinforced the fact that section 23M is not sufficiently specific to target only the problematic transactions and it is also not effective enough to combat these problematic transactions. The Davis Tax Committee also provided context for why specificity matters, arguing that section 23M has adverse effects on investment in capital intensive industries, on foreign investment and on financing of infrastructural projects in South Africa. On the other hand, section 23M is not effective enough to inhibit earnings stripping because multinational companies can still creatively avoid its operation.

This study, therefore, found that section 23M is effective to a very limited extent in that it does introduce an earnings-based limit which generally covers most earnings stripping schemes. However, the limit itself is unduly lenient on aggressive earnings stripping schemes in that it grants unlimited carry-overs and incentivises earning interest income over other types of income to increase the deduction limit. Further, section 23M is also not sufficiently specific. It is a blunt rule which also targets legitimate corporate financing decisions due to its lack of industrial differentials and lack of a rule referencing the foreign tax treatment of interest.

Considering that there are numerous other rules dealing with interest, the interest limit framework is already crowded, and it is the author's view that section 23M's limited benefits do not justify its continued existence in its current form. Instead, section 23M should be reframed as a transitional rule while the National Treasury of South Africa focuses on dealing with earnings stripping through treaty-based mechanisms since it has been established that the problem has treaty-based origins. The next section discusses these recommendations in greater detail.

RECOMMENDATIONS

As stated above, it is the author's considered view that the South African interest deduction limitation system is due for a radical shift in how it approaches earnings stripping schemes and the attendant risks. In summary, this research proposes a treaty focused solution rather than a domestic focused rule as that currently found in section 23M. Section 23M should be reframed as a transitional rule while South Africa pursues treaty-based solutions which will be more targeted and effective. The starting point is amending section 23M to make it more specific and effective in combatting earnings stripping schemes by ensuring that the limit in section 23M is only triggered where lenders enjoy favourable foreign tax treatment of interest. Further, only the foreign tax actually paid by the lender in its foreign jurisdiction of residence should be allowed as a deduction in South Africa. In addition, no carry-overs should be allowed where a transaction falls within this modified section 23M. These measures are derived from the ATAF model law. At treaty level, one simple solution is the ratification of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI) which will allow South Africa to use the principal purpose test to combat earnings stripping schemes where lenders are resident in a jurisdiction in respect of which the MLI applies. Lastly, South Africa should also seek bilateral treaty amendments in respect of treaties which will not be modified by the MLI. These recommendations are discussed below.

The first recommendation is to adopt a rule in section 23M which references the foreign affiliate lender's tax position in its jurisdiction of residence as done by the ATAF model legislation. This ensures that section 23M does not apply to transactions where lenders are resident in high tax jurisdictions which make it impossible to set up earnings stripping schemes. The ATAF based rule would be structured such that the Commissioner for SARS will either list tax beneficial regimes in respect of which the interest deduction limit would apply or consider on a case-by-case basis if the lender obtains a tax benefit in its home jurisdiction. The latter is administratively tedious while the former is simpler but politically sensitive. It is, however, suggested that South Africa can use global lists of tax havens like the EU list of uncooperative jurisdictions as a starting point.[210] The obvious risk in relying on these lists is that they are potentially biased. It has been argued that the lists usually punish smaller and

[210] Council of the European Union 'Council conclusions on the revised EU list of non-cooperative jurisdictions for tax purposes' available at https://data.consilium.europa.eu/doc/document/ST-6437-2022-INIT/en/pdf accessed on 13 March 2022.

countries while sparing wealthier states like Switzerland and Luxembourg.[211] The EU list[212], for example, does not list low tax European jurisdictions like Ireland, Luxembourg, and Netherlands.[213] Beyond the political considerations, is also critical to ensure that the modified section 23M is designed such that it does not fall foul of treaty non-discrimination provisions.[214] It is submitted that this may be achieved by ensuring the modified section 23M rule does not overtly discriminate on the basis of residence. However, it should still be ensured that where section 23M applies to foreign lenders, it is only triggered where they pay no or low taxes in their states of residence.[215]

With the above in mind, where an affiliate lender gets foreign tax benefits in respect of interest from a South African resident affiliate, the Commissioner should be given the power to completely deny the interest deduction for the resident affiliate and only allow the limited deduction of the foreign tax charge actually paid by the foreign affiliate lender. In such circumstances, disallowed interest should not be carried over since it is likely that it arises from an earnings stripping scheme. It is the author's opinion that this modified section 23M would be specific, simple and would reduce the risk of collateral damage. The rule will, therefore, get rid of the reference to tax-EBITDA which may unjustifiably punish low profit-making companies. Further, it will also get rid of the addition of interest earned (reduced by untainted interest) to the deduction limit as currently required by section 23M. As already discussed, this addition of interest earned favours companies which predominantly make their profits from interest. The modified section 23M should, however, only be considered a transitional rule. In South Africa, the earnings stripping problem is more effectively addressed by treaty-based solutions as discussed below.

As mentioned above, earnings stripping schemes in South Africa arise due to treaty abuse. A theoretically simple but practically complex solution is to renegotiate and amend all

[211] Steven A Dean & Attiya Waris 'Ten Truths About Tax Havens: Inclusion and the 'Liberia' Problem'(2021) 70 *Emory Law Journal* 1657 at 1659 – 1660 and 1669 – 1670.
[212] Council of the European Union op cit note 210.
[213] Oxfam 'Once again, the EU lets tax havens off the hook' available on https://www.oxfam.org/en/press-releases/once-again-eu-lets-tax-havens-hook accessed on 13 March 2022 and Oxfam 'EU tax haven blacklist review' available on https://oi-files-d8-prod.s3.eu-west-2.amazonaws.com/s3fs-public/2020-02/2020-02-17%20Oxfam%20background%20briefing%20-%20EU%20tax%20haven%20list.pdf accessed on 13 March 2022.
[214] These provisions are in most South African tax treaties and are modelled on Article 24(4) of the OECD Model Treaty.
[215] One way to achieve this is introducing an explicit definition of 'tax' for purposes of section 23M's 'not subject to tax' requirement which includes foreign corporate taxes as discussed in Chapter 3. With creative drafting, the 'not subject to tax' requirement can be used to build in a consideration of foreign tax treatment in section 23M.

unfavourable tax treaties. This will allow the government of South Africa to eliminate unjustifiable deduction/exemption mismatches which have no policy benefits for the South African economy.[216] A key example of a tax treaty that was amended in recent years is the South Africa and Mauritius Double Tax Treaty which entered into force on the 28th of May 2015. The National Treasury explained that the new treaty reflected the changed policy objectives of the two countries and it curbed abuse of the old treaty.[217] With respect to earnings stripping, the National Treasury should focus on amending tax treaties to increase South Africa's taxing rights on interest and to introduce a principal purpose test. The latter is explained in more detail in the recommendation below. It should be noted that renegotiating tax treaties is a huge administrative undertaking. The renegotiation of the South Africa-Mauritius treaty, for example, took six years.[218] However, South Africa should still consider this a long-term solution to base erosion and profit shifting schemes like earnings stripping. Since the modified section 23M proposed above will apply as a transitional rule, there is no risk of avoidance while the National Treasury renegotiates high-risk treaties.

Even more importantly, South Africa should ratify the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI), to which it is a signatory.[219] Notably, on the 23rd of March 2022, the South African cabinet approved the submission of the MLI to parliament for ratification.[220] It is the author's opinion that ratification of the instrument will do more to combat earnings stripping than the current targeted EBITDA-based interest limit in section 23M. Article 7 of the MLI introduces the principal purpose test (PPT), which operates in a somewhat similar fashion to the domestic general anti-avoidance rule (GAAR) to deny any treaty benefits where in a transaction, one of the taxpayer's principal purposes is to obtain treaty benefits.[221] This effectively deals with earnings stripping schemes where a foreign affiliate lender advances funds to its South Africa affiliate company to specifically take advantage of treaty benefits which reduce South African withholding tax while the resident

[216] Some deduction/exemption mismatches may be maintained to stimulate foreign investment. The current system, unfortunately, bluntly limits interest deductions even where they result from deduction/exemption mismatches which have valid policy justifications.
[217] National Treasury of South Africa *Media Statement: New South Africa Mauritius Tax Treaty Enters into Force* (2015) §1.
[218] Ibid.
[219] South Africa signed the MLI on the 7th of June 2017 as per OECD 'Signatories and Parties to The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting Status as of 1 June 2022' available at https://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf accessed on 17 June 2022.
[220] South African Department of International Relations and Cooperation 'Statement on the Cabinet Meeting of 23 March 2022' available at http://www.dirco.gov.za/docs/2022/cabinet0323.htm accessed on 10 April 2022.
[221] OECD *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS* (2016) Article 7.

borrower benefits from the domestic deduction. In such a case, even if there are other principal purposes like commercial need, the treaty benefit of low withholding tax on interest can be denied since one of the principal purposes of the foreign affiliate lender is to avoid paying the full withholding tax.[222] It is submitted that the PPT can, therefore, effectively deal with treaty shopping whereby a group positions its affiliate lender in a low tax jurisdiction with a favourable tax treaty with South Africa and lends to a South African affiliate borrower. As of 17 June 2022, 49 of South Africa's treaty counterparties had ratified the MLI and if South Africa ratifies and the MLI comes into force in the country, the treaties with the 49 counterparties which have already ratified will be modified by the instrument.[223] In the context of earnings stripping, once the treaty benefits are denied, South Africa can tax the foreign affiliate's interest at 15 per cent of gross amount thus denying the foreign affiliate the benefit of the deduction/exemption mismatch. This approach is more targeted and can deal with base erosion without affecting legitimate commercial enterprise. The only drawback is that not all of South Africa's 79 treaty partners are signatories to the MLI[224], but as stated above, this can be resolved by seeking bilateral amendments.[225] Where the countries resist amendments, the modified, ATAF-based section 23M discussed above can be used as a transitional domestic measure until bilateral solutions can be found.[226]

AREAS FOR FURTHER RESEARCH

While this study has recommended using the MLI as the primary measure to address earnings stripping in the future, it is still necessary to further study the impact of the PPT on earnings stripping schemes in dedicated research. This will establish the full extent to which a modified

[222] For more detailed discussions of the operation of the PPT, see Vikram Chand 'The Principal Purpose Test in the Multilateral Convention' (2018) 46 *Intertax* 18, Błażej Kuźniacki 'OECD/International - The Principal Purpose Test (PPT) in BEPS Action 6 and the MLI: Exploring Challenges Arising from Its Legal Implementation and Practical Application & OECD/G20' (2018) 10 *World Tax Journal* 233 & *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances Action 6 - 2015 Final Report Base Erosion and Profit Shifting Project* (2015) at 55.

[223] Listed in Appendix 4. Compiled from South African Revenue Service 'Summary of all Agreements for the Avoidance of Double Taxation Multilateral Convention to implement tax treaty related measures to prevent base erosion and profit shifting (MLI) Synthesised Texts' available on https://www.sars.gov.za/wp-content/uploads/Legal/Agreements/LAPD-IntA-DTA-2013-01-Status-Overview-of-All-DTAs-and-Protocols.pdf accessed on 17 June 2022 and OECD op cit note 219.

[224] Kenya, Lesotho, Namibia, Nigeria, Tunisia, Bulgaria, Italy, Kuwait, Mexico, and Turkey are signatories, but they are yet to ratify. 20 treaty partners are, therefore, not signatories to the MLI and South Africa will need to seek bilateral amendments in respect of their treaties.

[225] Considering these countries' opposition to the MLI, PPT-based amendments may potentially be contentious.

[226] This approach has its limitations since most tax treaties have anti-discrimination provisions modelled upon Article 24(4) of the OECD Model Tax Convention. This provision bars states from denying interest deductions where the lender is a resident of the other contracting state.

section 23M will still be necessary when the MLI is ratified in South Africa. In line with this, studies should also be carried out on the impact of the domestic GAAR on earnings stripping in South Africa to ascertain if the domestic rules can operate in a similar manner to the PPT to deny treaty benefits in avoidance schemes. The GAAR question, of course, raises a key issue of treaty override and this should be explored further. In addition, if the GAAR applies, it might provide a solution for the treaties with states which have not signed and ratified the MLI. Further, the role of the 'carrying on a trade' and 'in the production of income' requirements in section 24J as interest deduction limitation rules must be fully considered in dedicated research to fully establish their effect on earnings stripping schemes. It is also critical to further research the impact of treaty non-discrimination provisions on a modified, ATAF based section 23M so as to establish how it should be designed to avoid non-compliance. Lastly, the impact of the global minimum corporate tax rate in the OECD Pillar Two[227] and the proposed EU Directive on minimum taxation,[228] while not yet effective should be considered to ascertain if targeted rules will still be necessary in a tax system where states will ensure large multinationals are subject to a minimum effective tax rate. Such a system might potentially affect the low or no foreign tax element of earnings stripping therefore, this should be studied in greater detail.

CONCLUSION

After a consideration of the nature of earnings stripping risks in South Africa, it has been established that they primarily arise from treaty abuse. To benefit from the deduction/exemption mismatch, the affiliate lender must be resident in a foreign jurisdiction which has a double tax treaty which limits South African taxing rights. To complete the scheme, the foreign jurisdiction should charge low or no taxes on foreign interest. It has been argued that focusing on the treaty abuse yields more effective and targeted protections for the local tax base than applying section 23M in its present form. This study has recommended using the treaty law system to resolve earnings stripping concerns while relying on a modified section 23M as a transitional rule. Since South Africa is a signatory to the MLI, the most immediate and effective solution to earnings stripping is ratifying the instrument. This will deal with earnings stripping schemes where the lender is resident in the 49 contracting states which

[227] OECD *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)* (2021).
[228] European Commission, Directorate-General for Taxation and Customs Union *Proposal for a COUNCIL DIRECTIVE on ensuring a global minimum level of taxation for multinational groups in the Union* European Commission, 2021.

have already ratified the instrument. Considering the global consensus around the MLI, more states are expected to sign and ratify. In the meantime, an amended and more specific section 23M can be used as a transitional rule which completely denies deductions in South Africa where the foreign affiliate lenders engage in aggressive earnings stripping schemes. This modified section 23M will apply in respect of countries which are yet to sign and/or ratify the MLI while the South African government seeks bilateral treaty amendments. The transitional section 23M will refer to the foreign lender's tax position and where no or low foreign tax is payable with respect to the interest, South Africa should completely deny the deduction to the extent that it exceeds the actual tax payable in that foreign jurisdiction by the lending affiliate company. This will simplify the system, exclude legitimate commercial transactions from section 23M's scope, and more effectively protect the local tax system from earnings stripping schemes.

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17. *Estate G v COT* 26 SATC 168.
18. *Glen Anil Development Corporation Ltd v SIR* 37 SATC 319.
19. *ITC 1530* 54 SATC 261.
20. *ITC 1762* 66 SATC 41.
21. *ITC 770* 19 SATC 216.
22. *Marshall NO and Others v Commissioner for SARS* (CCT208/17) [2018] ZACC 11 (25 April 2018)
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APPENDIX 1

List of countries with double tax treaties that limit South African taxing rights on interest to 0 per cent as of 17 June 2022

1. Austria
2. Croatia
3. Cyprus
4. Czech Republic
5. Denmark
6. Finland
7. France
8. Hungary
9. Ireland
10. Kuwait
11. Luxembourg
12. Netherlands
13. Norway
14. Oman
15. Slovak Republic
16. Sweden
17. The Seychelles
18. United Kingdom
19. United States of America

APPENDIX 2

List of countries with double tax treaties that limit South African taxing rights on interest to 5 per cent as of 17 June 2022

1. Bulgaria
2. Iran
3. Saudi Arabia
4. Spain
5. Switzerland
6. Zimbabwe

APPENDIX 3

List of countries with double tax treaties that limit South African taxing rights on interest to 10 per cent as of 17 June 2022

1. Algeria
2. Australia
3. Belarus
4. Belgium
5. Botswana
6. Cameroon
7. Canada
8. China
9. Democratic Republic of Congo
10. Eswatini
11. Germany
12. Ghana
13. Hong Kong
14. India
15. Indonesia
16. Italy
17. Japan
18. Kenya
19. Korea
20. Lesotho
21. Malaysia
22. Malta
23. Mauritius
24. Mexico
25. Namibia
26. New Zealand
27. Pakistan
28. Poland
29. Portugal
30. Qatar
31. Russian Federation
32. Rwanda
33. Taiwan
34. Tanzania
35. Turkey
36. Uganda.
37. Ukraine
38. United Arab Emirates

APPENDIX 4

List of South Africa's treaty counterparties that have ratified MLI as of 1 June 2022

1. Australia
2. Austria
3. Belgium
4. Cameroon
5. Canada
6. Chile
7. China (People's Republic of)
8. Croatia
9. Cyprus
10. Czech Republic
11. Denmark
12. Egypt
13. Finland
14. France
15. Germany
16. Greece
17. Hong Kong
18. Hungary
19. India
20. Indonesia
21. Ireland
22. Israel
23. Japan
24. Korea (Republic of Korea)
25. Luxembourg
26. Malaysia
27. Malta
28. Mauritius
29. Netherlands
30. New Zealand
31. Norway
32. Oman
33. Pakistan
34. Poland
35. Portugal
36. Qatar
37. Romania
38. Russian Federation
39. Saudi Arabia
40. Seychelles
41. Singapore
42. Slovak Republic
43. Spain
44. Sweden
45. Switzerland
46. Thailand

47. Ukraine
48. United Arab Emirates
49. United Kingdom