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University of Witwatersrand, Johannesburg

Master of Commerce, Taxation

An analysis of the deductibility of interest expenditure rules in South Africa

A research report submitted to the Faculty of Commerce, Law and Management in partial fulfilment of the requirements for the degree of Master of Commerce specialising in Taxation

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Date:	30 March 2019

DECLARATION

I declare that this research report is my own unaided work. It is submitted for the degree of Master of Commerce at the University of Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination in any other university. Any uses made within the report of the work of authors in any form are properly acknowledged at the point of their use in the report.

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ABSTRACT

Taxpayers are broadly financed in two ways, namely through the use of debt and equity. The returns on capital and debt are treated differently from an income tax perspective (SARS 2013). The interest expense incurred by taxpayers in the production of income by a person carrying on a trade, are deductible in determining taxable income, subject to certain conditions and limitations.

The number of provisions contained in the Income Tax Act of 1962 (the Act) which deal with the tax treatment of interest income and interest expenditure have gradually increased over time. There are numerous aspects to be borne in mind by resident and foreign companies when considering the income tax and withholding tax implications which may arise in respect of transactions giving rise to interest income and interest expenditure (SAICA 2015). This is affirmed by the number of provisions in the income tax act dealing with the deductibility of interest primarily dealt with in section 24J of the Act as well as indicated by the 2014 amendments to section 8F, the introduction of section 8FA, sections 23M and 23N into the legislation.

The purpose of this report is to assess whether the Department of National Treasury (National Treasury) have taken the number of provisions of the deductibility of interest too far.

Key Words

Arm's length principle, base erosion and profit shifting, BEPS Action 4, Interest deductibility, limitation of interest, section 8F, section 8FA, section 23M, section 23N, section 24J, thin capitalisation, Withholding Tax on Interest.

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1. INTRODUCTION

Background – Deductibility of interest expenditure

Domestic tax authorities often introduce rules that place a limit on the amount of interest that a taxpayer may be entitled to deduct in calculating taxable income. From a policy perspective, failure to tackle excessive interest payments allows a taxpayer to gain tax advantages (Davis Tax Committee 2014). The deductibility has been an area of focus for the South African Revenue Service (the SARS) and the National Treasury. This is evidenced by the number of provisions in the Income Tax Act 58 of 1962 (the Act) that regulate not only the whether or not the interest is deductible but also the quantum of the interest to be deducted.

The Organisation for Economic Co-operation and Development (OECD) made a number of recommendations in relation to the deductibility of interest limitation as part of the Base Erosion and Profit Shifting (BEPS) project. This led to an analysis under Action 4: *'Limit base erosion involving interest deductions and other financial payments'* issued during 2015 states that:

> The use of third party and related party interest is perhaps one of the simplest of profit shifting techniques available in international tax planning. The fluidity and fungiblity of money makes it a relatively simple exercise to adjust the mix of debt and equity in a controlled entity (OECD 2015:15).

According to Van der Zwan (2018), the Report contained recommendations for governments to implement proposed measures to address the risk posed to the tax base by interest payments and the resultant deductibility of interest. The suggested approach includes a general interest limitation (core rule) based on an interest-to-profit ratio. This coupled with *de minimis* exclusion rules, exceptions for highly leveraged groups, and specific anti-avoidance rules to target identified instances not addressed by the general interest limitation rule (OECD 2015).

National Treasury released a request for public comment in April 2013 for incorporation into the 2013 Tax Laws Amendment Bill for proposed limitations against excessive interest deductions. Included in the background section to this commentary was the following:

> Over the past several years tax schemes by some corporates have become an increasing concern locally as well as globally. The recent OECD paper notes that 'while there are many ways in which domestic tax bases can be eroded, a significant source of base erosion is profit shifting'. One of the most significant types of base erosion in South Africa is in the form of excessive deductions by some corporates with income effectively shifted to no-tax or low tax jurisdiction or converted to a different

type of income in another jurisdiction. These deductions are typically interest, royalties, service fees and insurance premiums. Of greatest concern is *excessive* deductible interest. In terms of excessive deductible interest, Government has identified four recurring concerns:

1. *Hybrid Debt:* Hybrid debt instruments essentially involve instruments with the label of debt but substantive features being more indicative of shares (equity). These instruments are typically labelled as debt in South Africa so that payments are deductible. However, these instruments are often labelled as equity in the other jurisdiction so as to benefit from cross-border arbitrage. Most of these instruments would otherwise be labelled as shares if tax were not a consideration

2. *Connected person debt:* The relationship between creditor and debtor often becomes blurred once both parties are of the same economic unit. This situation often arises when a parent company lends money to a wholly owned subsidiary. In this situation, the terms of the instrument are somewhat irrelevant because both parties can change the terms at will to serve the overall interests of the group. As a result, the debt label for instruments in these circumstances is often driven by tax and other regulatory factors; whereas, payments often represent substantive capital contributions to be repaid only if the subsidiary is profitable.

3. *Transfer pricing:* In a cross-border context, excessive interest can arise if the interest yield is driven by tax considerations as opposed to arm's length commercial reasons especially if the debtor and creditor are connected persons. Also of concern is 'lending' that would not arise in a commercial context. In these cases, transfer pricing adjustments can be used to eliminate debt with excessive interest or excessive debt.

4. *Acquisition debt:* While the need to obtain debt financing for acquisitions is well understood, excessive debt becomes problematic because excessive debt (or over-gearing) is often anchored on the expectation that the interest will be paid from future profits. If allowed to extremes, the interest on the debt often eliminates taxable profits for years to come. Acquisition debt of greatest concern is mezzanine and subordinated debt (i.e. debt containing an escalating number of equity features). Besides tax concerns, debt gives rise to governance concerns with excessive debt creating excessive risk (as the number of economies have 'painfully' discovered in recent years).

The 2013 Explanatory Memorandum to the Taxation Laws Amendment Bill 2013 highlighted that debt was an important investment tool. It can however create opportunities for base erosion. A balance is required attracting debt capital and the protection of the tax base against base erosion. In line with international concerns the South African tax base could be potentially at risk of allowing excessive interest deductions that is actually incurred overall by a group of companies. This is mitigated to a large extent as set out by the DTC (2014:26), through the following existing measures in place in South Africa:

- **Exchange Control**: The interest rate payable on loan financing obtained from a non-resident is capped and subject to pre-approval by the South African Reserve Bank (SARB). The SARB places an interest rate payable on these loans.
- **Transfer pricing**: Section 31 and the Draft Interpretation Note on Thin Capitalisation requires taxpayers to not only ensure that the interest rate is at arm's length, but also to determine whether it is thinly capitalised on an arm's length basis. Built into the income tax return, SARS have now included ratio

calculations designed to assist SARS in determine whether a potential transfer pricing risk exists in regards to interest.

- **Income Tax**: Sections 8F, 8FA, 23N and 23M are both recently amended between 2014 and 2016 and new sections in the Act that restrict interest deductions.
- **Withholding tax (WHT) on interest**: A 15 per cent WHT is imposed on interest determined to be of a South African source paid to a non-resident.

The South African tax system has changed since the recommendations of the last tax commission being the Katz Commission. The changes saw the establishment of the SARS, the broadening of the tax base and the lowering of marginal tax rates (DTC 2018). The tax system in South Africa has developed significantly and now compares favourably in relation to other developed economies (DTC 2018). Given the challenges and aftermath of the 2008/2009 recession, social challenges that this country faces and slow growth in the economy, there was a need to review the current tax policies as this has a direct impact on the above challenges. BEPS was identified by the OECD and the Group of Twenty (G20) as being high priority for governments to address (DTC 2018).

The DTC tasked with considering South Africa's tax policy and particularly the OECD BEPS for presentation to the Minister of Finance, has noted in its *Second Interim Report on Action 4* that South Africa should seriously consider the costs by both local and foreign investors in complying with the required tax legislation in relation to its benefits and the impact that it has on the ease of doing business in South Africa. (DTC 2014:32)

All references to section numbers, unless otherwise stated, refers to the Income Tax Act.

2. THE RESEARCH PROBLEM

2.1 Research Problem

Are the number of provisions contained in the Act that regulate the deductibility of interest excessive?

The research report will examine the provisions of the Act that regulate the deductibility of interest with a background to the sections as well as looking at the recent amendments to the relevant sections contained in the Act. In addition the

research report will seek to address the ability of the taxpayer to comply with these requirements where no clear guidance exists.

2.2 Sub-problem

The following sub-problems will also be addressed:

- The first sub-problem relates to whether or not the OECD recommendations in relation to BEPS have been applied by SARS and National Treasury in relation to the provisions in the Act which seek to address deductibility of interest. Although South Africa is not a member of the OECD, it participated in the OECD/G20 BEPS Project. The recommendations arising from Action 4 should have were considered by National Treasury and SARS in light of these recommendations. In this regard there are a number of differences exist between the current South African measures to address the risk of erosion of the tax base as a consequence of interest deductions and the recommended approach of the OECD (Van der Zwan 2018). The report will compare the provisions contained in the South African tax legislation to the recommended (*best approach)* as set out by the OECD.

- The second sub-problem relates to the ease of application of the various sections in the Act by taxpayers. Inherent in the provisions contained in the Act are uncertainties which taxpayers need to contend with. These uncertainties will also be considered. Specifically in relation to:
    - Transfer pricing – the transfer pricing interpretation note has not yet been finalised by National Treasury and SARS
    - In relation to a transaction it is not clear as what order to apply the provisions contained section 31, 23M or 23N i.e. which section should take precedence
    - The complexities and definitions contained in section 24J

- The last sub-problem relates to whether or not the number of provisions contained in the Act that seek to limit the deductibility of interest could have an adverse impact on investment in South Africa and whether or not a

different more holistic approach should be applied by National Treasury when putting into place the legislation. (DTC 2014)

3. RESEARCH METHODOLOGY

Research methodology

The research has been undertaken as a literature review. The sources of information included tax legislation, government releases, books, publications, websites and any other publicly available document relevant to the research.

Scope and limitations

The following will fall outside of the scope of this report and will not be examined: Exchange Control Regulations and section 24O of the Act.

4. PROPOSED CHAPTER OUTLINE

4.1 Chapter 1: Introduction

The chapter gives the background to the research, the research problem and sub-problem, research methodology, scope and limitations.

4.2 Chapter 2: Incurral and accrual of interest

This chapter will analyse the basic concepts with regards to the incurral and accrual of interest and the issues a taxpayer may face when applying the principles of section 24J. A brief reference to case law that was used to establish the taxation of interest will also be discussed. The definition of interest in the context of its common law meaning will be assessed as well as the interpretation of *'similar finance charges'*.

4.3 Chapter 3: Section 23M and 23N

As from 1 January 2015 and in respect of interest incurred on or after that date, the deductibility of interest owed by a debtor to a creditor is, in defined circumstances, subject to a statutory ceiling in terms of section 23M (Stiglingh, Koekermoer, Van Zyl, Wilcocks, de Swart 2017). Section 23N applies to limit the interest deduction that

may be claimed when a company incurs interest on debt arising from an acquisition or re-organisation transaction (Haupt 2018:557-558).

This chapter will contain an analysis of the provisions of section 23M and section 23N. A brief history of the sections with reference to the old provisions contained in section 23K will also be considered. The chapter will also seek to compare the provisions of section 23M to that of thin capitalisation rules in South Africa, with a view to conclude that the provisions are similar in that they can apply to the same transaction. Further analysis will show that section 23M is based on a fixed percentage applied to all companies that may fall into this provision and does not treat each transaction separately based on the merits, substance and contractual terms of the transaction.

4.4 Chapter 4: Anti-avoidance provisions – sections 8F and 8FA

This chapter will consider the provisions of the above sections. A consideration into the use of debt versus equity in the context of business will also form the background to this chapter. The anti-avoidance provisions will be assessed in relation to the OECD recommendations with a view to conclude that the scope of the sections are limited.

4.5 Chapter 5: Transfer pricing

This chapter will analyse the provisions contained in section 31 of Act. Historically South Africa followed a simplistic approach to transfer pricing as contained in Practice Note 2 which was then replaced by a Draft Interpretation Note (IN). This draft IN still remains in circulation with no final guidance from SARS in this regard. The result increased uncertainty as to what would constitute arm's length level of debt and interest rates (Chong and Miller 2018). Withholding tax on interest in terms of the Act will also be analysed.

4.6 Chapter 6: Conclusion

In the concluding chapter the analysis contained in the preceding chapters will be used to answer the research question.

CHAPTER 2 – Incurral and accrual of interest

Introduction

The deductibility of interest is dealt with in two sections of the Act:

- Sections 11(*a*) and 23(*g*) – general deduction formula; and
- Section 24J.

Although section 24J deals with both the incurral and accrual of interest, for the purposes of this report focus has been placed in the incurral of interest. The purpose of this chapter is not to analyse in detail the provisions of section 24J or the number of definitions contained in this section but rather to touch on how this impacts the deductibility of interest (Haupt 2018:479).

In the absence of specific provisions, section 11(*a*) provides that:

'For the purposes of determining taxable income by any person carrying on a trade, there shall be allowed as a deduction of income of such person so derived-

(a) Expenditure or losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature…'

This section must be read together with section 23(*g*) which denies the taxpayer a deduction in respect of expenditure to the extent that the amount was not incurred for the purposes of trade. (Haupt 2018)

Section 11(*a*) read with section 23(*g*) of the Act (general deduction formula) set out the deductions allowed to be claimed by taxpayers in the determination of taxable income. The Act also contains sections which apply to the deduction of specific expenditure (ENS 2015). Section 24J is one such section that allows for a taxpayer to claim a deduction in respect of interest expenditure incurred (Haupt 2018:483).

Interest can narrowly be seen as money paid for the use of credit (Haupt 2018). It is included in gross income of the person of the lender and is deductible in the hands of the borrower provided that certain conditions are met i.e. it is incurred in the production of income in the course or furtherance of a trade (Haupt 2018). From a legal perspective the liability to pay the interest and accrual of the interest in the hands of the creditor is determined with reference to the legal agreement (de Koker and Williams 2018: 17.61). From an income tax perspective the incurral and the right to receive interest are

determined with reference to section 24J of the Act. Section 24J provides that (similar and in line with section 11(*a*)):

> *'(2) where any person is the issuer in relation to an instrument during any year of assessment, such person shall for the purposes of this Act be deemed to have incurred an amount of interest during such year of assessment… which must be deducted from the income of that person derived from carrying on any trade, if that amount is incurred in the production of income'*

Where the obligation to pay interest or right to receive interest occurs over a period of more than year or there is a change in the interest rate, such that the interest rate is not constant, section 24J sets out the amount of the interest income and interest expense that must be taken into consideration in the determination of taxable income in any year of assessment (Haupt 2018:479). Where section 24J applies the interest is spread over a yield to maturity (YTM) basis over the period of the instrument for the inclusion in the income of the person to whom it accrues to be deducted in the hands of the borrower (unless the borrower applies an alternative method which has been approved). The yield to maturity is defined as the rate of compound interest per accrual period at which the present value of all amounts payable or receivable in terms of an instrument in relation to a holder of an issuer, as the case may be, of such instrument equals the initial amount in relation to such holder or issuer of such instrument (Haupt 2018:488).

Haupt (2018:479) confirms that the rules contained in section 24J for the deductibility of interest are exactly the same as for the general deduction formula i.e. the expense must be incurred in the production of income in the ordinary course of the taxpayer's trade. Haupt goes on further state that section 24J overrides the principles of the general deduction formula in the following ways:

- It includes premiums and discounts on instruments in the definition of interest (section 24J(1)).
- It deems interest to have accrued or be incurred during the year of assessment even though it may only be receivable or payable at a later stage in that year of assessment.
- It stipulates (generally) that all interest earned is to be included in gross income (section 24J (2)).
- It stipulates (generally) that all interest incurred be deducted from income (section 24J(3)).

Haupt (2018:480) concludes that the deductibility of interest has been contentious on the basis that it was necessary to determine whether interest was incurred in the production of income in the course of a trade. On the basis that the above terms are not specifically defined, reference to case law has been used in order to make this determination.

In *CIR v Standard Bank of South Africa Limited* (1985 AD) where the taxpayer used funds to acquire redeemable preference shares. SARS disallowed the deduction of a portion of the interest incurred in relation to the funding on the basis that the funds were utilised to purchase an investment that produces tax-free dividends and thus the interest was not determined to be in the production of income. The investment was determined to be incidental to the main operations of the taxpayer and the general purpose of the funding needed to be considered. As the funds was generally raised by the bank in the production of income, the interest paid on all funds was held to be deductible. In this instance the court was required to determine the closeness between the expenditure and income earning operations of the bank. (Haupt 2018:480)

The principle above was re-iterated in the *CIR v Drakensburg Garden Hotel (Pty) Ltd* (1960 AD) where a connection between the interest paid on a loan to purchase shares and the income earning operation needed to be assessed. The court was convinced that due to the fact that the purchase of shares would result in an increase in profits other than through the earning of dividends, the interest was deductible. This was despite the possibility that dividends may not be received in respect of the shares or that when receipt the dividends would be exempt from normal tax. (Haupt 2018:480)

In *CIR v Allied Building Society* (1963 AD), the court held that the final use of the borrowed funds was not the decisive factor in the assessment of the deductibility or otherwise of the interest payable on the funds. The dominant question was what was the true nature of the transaction or the purpose of the borrowing? (Haupt 2018:480)

In *Financier v Commissioner of Taxes* (1950 SR), the court said:

> *where a taxpayer has for good and sufficient reasons borrowed money for the use in the business producing his income, despite the fact that he subsequently, in pursuit of a legitimate business purpose, invested such money in an investment which does not produce taxable income, the interest is still deductible for income tax purposes…It would see that the test to be applied is the purpose for which the money is borrowed.*

Haupt (2018:481) concludes that there needs to be a differentiation between where a taxpayer borrows money for both a specific purpose and sum and where the taxpayer

borrows money generally in order to raise floating capital for the business. In the latter case it is easy to determine a link between the sum and purpose in determining the deductibility of the expenditure. In the former case it is not simple to determine whether a causal connection exists between the sum and purpose of the income and therefore the general purpose of the income has to be analysed. Even if some of the borrowing was used to acquire investments that generate exempt income, the general purpose of producing income could very well relay the interest as being deductible.

In *CIR v G Brollo Properties Pty Ltd* (1994 AD), the court held that interest paid on a shareholders loan account which had been created as a consequence of the declaration of a dividend was not deductible (i.e. this was not in the production of income). (Haupt 2018:481)

Practice Note 31 – interpretation of what constitutes trade

In terms of Practice Note 31 where interest is earned on capital or surplus funds invested (other than in a case of a money lender), this does not constitute carrying on a trade however it is the practice of SARS to permit a deduction in respect of the interest incurred to the extent that it does not exceed the income. Should a person borrow money at a specified rate of interest with the intention of advancing the funds at a higher rate of interest, this taxpayer could more than likely be carrying on a trade. The same principle noted above is applied were funds are borrowed at a certain rate of interest and on lent at a rate that does not recover the cost of capital. On strict interpretation of the legislation, this principle is contrary to the Act, however this is the practice of SARS that has come to be acceptable (PN 31).

Definition of interest for the purposes of section 24J

In order to qualify for a deduction in terms of section 24J such interest will need to fall within the definition of interest as contained in section 24J. The costs incurred in relation to the acquisition of finance include interest as well as various other charges in relation the credit received (ENS 2015)

Interest is defined in section 24J as follows:

> **'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) amount (or portion thereof) payable by a borrower to the lender in terms of any lending arrangement as represents compensation for any amount to which the lender would, but for such lending arrangement, have been entitled; and

(c) absolute value of the difference between all amounts receivable and payable by a person in terms of a sale and leaseback arrangement as contemplated in section 23G throughout the full term of such arrangement, to which such person is a party, irrespective of whether such amount is—

(i) calculated with reference to a fixed rate of interest or a variable rate of interest; or

(ii) payable or receivable as a lump sum or in unequal instalments during the term of the financial arrangement

It is irrelevant in all cases whether the amount in question is calculated with reference to a fixed or variable rate of interest, and whether it is payable or receivable as a lump sum or in unequal instalments during the term of the financial arrangement. (de Koker and Williams 2018:24.11)

It is clear that the definition of interest for the circularly includes the word 'interest' and therefore ascribe to the meaning of this word (ENS 2015). The definition of interest is also not contained in any other section of the Act hence uncertainty could arise. ENS (2015) confirm that in the absence of a definition in the Act the general principle of statutory interpretation i.e. the literal approach must be used. The point of reference of the definition will thus be the ordinary meaning of the word provided that the ordinary meaning does not lead to absurdity so glaring that it could not have been intended by legislature (ENS 2015).

The Shorter Oxford English Dictionary defines the word 'interest' as '*money paid for the use of money or for the forbearance of a debt*'. This definition is consistent with the meaning that our courts have generally given to the notion of interest in terms of common law, that is 'compensation for the use of money lent*'* (*Commissioner for Inland Revenue v Cactus Investments (Pty) Ltd* 59 SATC 1 (1998)) (ENS 2015). The above indicates that the amount paid must be for the benefit of the lender and as such the element of compensation creates a link between the borrower and the lender (this link could be direct or indirect).

A direct link is created where the amount is paid directly to the lender and the lender is able to use the compensation as he pleases (ENS 2015). An indirect link is created when the compensation is paid to a third party, acting behalf of the lender and the lender is still able to apply the compensation as he pleases (ENS 2015).

Similar finance charges

The definition of 'interest' under section 24J of the Income Tax Act 58 of 1962 previously referred to 'interest or related finance charges'. This term was also not defined in the Act and thus the ordinary meaning of the word was used. ENS (2015) set out that the Dictionary of Banking Terms defines the term 'related finance charge' as:

> 'the borrower's total **cost of credit**, including loan interest, commitment fees, and prepaid interest, in a consumer loan'

The Supreme Court of Appeal has interpreted the word 'related' widely, including guarantee fees, facility fees, and even legal fees for drafting financing documents.

Under the Taxation Laws Amendment Act 15 of 2016 (promulgated on 19 January 2017), the word 'related' is now to be substituted by the word 'similar', so that the definition of interest will read 'interest or similar finance charges'. The draft Explanatory Memorandum states that this is to clarify 'the policy position that this applies to finance charges of the same kind or nature.' This change is more than likely to narrow the courts' previous interpretations (Kotze 2017). The words 'similar finance charges' have also not been defined in the Act. Kotze states that words such as 'similar' and 'related' are not precise and would depend on the context in which they are used. 'Similar finance charges' and 'related finance charges' would in practice not be materially different, and whether the meaning of 'related finance charges', as ascribed to it in case law, will now be curbed, is debatable. (Kotze 2017)

The application of the above definition could prove to be difficult to interpret. Consider raising fees**:**

> A 'finance charge' is a fee charged for a service or the provision of a facility, namely, making credit available in order to enable the acquisition of an asset (de Koker and Williams 2018:8.53). In order to establish if the fee would be deductible in terms of section 24J it is necessary to consider if it is 'similar' to interest. Even where the finance charge is calculated and expressed in terms of a rate of interest, it is distinct from interest, which is a payment for the use of borrowed moneys in the same way as rent is a payment for the use of an asset. (de Koker and Williams 2018:8.53)

SARS's Income Tax Practice Manual (Practice Manual) at page A:D 10 states that:

- Raising fees are a cost of raising capital, while interest is a cost for the use of capital
- Raising fee is once off while interest is recurring
- Interest is calculated with reference to time whilst a raising fee is usually unrelated to time
- SARS's view is that raising fee is not related/similar to interest.

In light of recent amendment to s24J, together with view expressed in the SARS Practice Manual, it is likely that SARS will challenge a raising fee being 'interest' as defined. One would then need to establish if the fees are in fact deductible in terms of the general deduction formula in terms of section 11(*a*). Additional consideration is whether short term or long term funding. The view here is that a long term loan creates a so-called 'enduring benefit' and that the raising fee may be held to be capital in nature due to the duration of the loan. There may however be an argument if you paying this fee to the same paying bank providing the finance i.e. the Bank where the loan agreement is concluded, that this fee could be seen as a cost associated with the funding itself and thus 24J should apply. In addition there is a risk that if this is then considered to be interest in terms of section 24J then section 8FA could deem this to be hybrid interest as the 'fee' is not calculated with reference to a specified rate of interest. One could however argue that on the basis that section 24J calculates a YTM that this is an interest rate and thus falls outside the provisions of section 8FA.

Conclusion

Section 24J can be seen as one of the most complex sections in the Act (ENS 2015). It contains numerous definitions and there is a lack of clarity of what the definition of interest constitutes. Reference will need to be made to case law and the recent amendment to the definition of interest, which now refers to 'similar finance charges' as oppose to related finance charges has narrowed the scope of this section. In the absence of case law in this regard and the complexities contained in this section makes the ease of application difficult

particularly in the case of smaller sized entities with limited access to a large skilled set of tax resources that is able to ensure compliance. (ENS 2015)

Chapter 3 – Section 23M and 23N

Introduction - Section 23M

Non-residents are exempt from normal income tax on interest income received from a South African source in terms of section 10(1)(*h*) of the Act (Haupt 2018:85). This makes the use of debt financing more attractive, however, it poses a risk to the protection of the South African tax base.

The Explanatory Memorandum on the Taxation Laws Amendment Bill, 2014 sets out debt funding whilst an important investment tool was used as a mechanism for base erosion. It was highlighted that taxation should follow a matching principle where every deduction there should see a corresponding inclusion in taxable income (National Treasury 2014). Of particular concern was in the instance where a deduction for interest was claimed by a South African resident and there was no corresponding inclusion in income. This was the case where income was paid to a foreigner and this was exempt from tax in South Africa. This mismatch could lead certain taxpayers to over-leverage because of the deduction/exemption mismatch. (National Treasury 2013)

With effect from 1 January 2015, section 23M was introduced into the Act. The main aim of this section was to limit the deductibility of interest payable by a resident taxpayer to a non-resident creditor or lender who was in a controlling relationship with the South African taxpayer (National Treasury 2013). At the time of its introduction sections 31 and 50 of the Act contained two provisions in order to combat excessive debt:

- A Debt: Equity ratio of 3:1 applied to cross border debt which applied as an adjunct to transfer pricing (National Treasury 2013). Section 23M was intended to be a more accurate transfer pricing tool (Haupt 2018:513). Previously the thin capitalisation rule of 3:1 was relied on but this changed in light of the change to section 31 which moved away from a fixed ratio rule to the consideration of the fact and circumstances of the transaction. Section 31 was then aligned to the OECD recommendations on transfer pricing rules. National Treasury was of the view that the 3:1 rule was too lenient leading to an excess of foreign debt levels (Haupt 2018:587); and
- A 15 per cent withholding tax that applied to cross border interest.

The need for the introduction of section 23M was substantiated in the Explanatory Memorandum (2014:20) to combat financing arrangements where the debtor and creditor formed part of the same economic unit (group of companies). The terms of the financing arrangement could easily be altered in order to support the overall interest of the group (SARS 2014:20). Related party loans were not subject to market conditions. In this way the categorisation of the debt (by altering the terms and conditions and quantum of the loan) could be easily manipulated in order to achieve a desired tax outcome. In addition, by application of the double tax agreements in most instances, this had the effect of reducing the 15 per cent withholding tax on interest to zero per cent. (OECD 2014:22)

Provisions of section 23M

Section 23M(1) sets out the following definitions:

'Adjusted taxable income' means taxable income

(a) reduced by

(i) any interest received by or accrued that forms part of taxable income;

(ii) any amount included in income of a person under section 9D(2);

(iii) any amount recovered or recouped in respect of an allowance in respect of a 'capital asset' as defined in section 19 and

(b) with the addition of –

(i) any amount of interest incurred that has been allowed as a deduction from income;

(ii) any amount allowed as a deduction in terms of this Act in respect of a capital asset as defined in section 19 for purposes other than the determination of any capital gain or capital loss; and

(iii) any assessed loss or balance of assessed loss allowed to be set off against income in terms of section 20.

'Average repo rate' in relation to any year of assessment means the average of all ruling repo rates determined by using the daily repo rates during that year of assessment

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

'**Debtor'** means a debtor who is a person that is resident or any other person who is not a resident that has a permanent establishment in the Republic in respect of any debt claim that is effectively connected with a permanent establishment

'Lending institution' means a foreign bank which is comparable to a bank contemplated in the Banks Act.

'Interest': means interest as defined in section 24J

'Repo rate' means the interest rate at which the South African Reserve Bank enters into a repurchase agreement contemplated in s 10(1)(*j*) of the South African Reserve Bank Act.

The statutory provisions as set out in section 23M(2) are as follows:

Where interest is incurred by a debtor, who is a resident, during a year of assessment in respect of a debt owed to-

(a) a creditor with whom the debtor is in a controlling relationship, as defined (see s 23M(1)) or

(b) a creditor that is not in such a controlling relationship with that debtor, if the creditor obtained the funding for the debt advanced from a person who is in a controlling relationship with the debtor,

and the amount of interest so incurred is not during that year of assessment –

(i) (aa) subject to tax in the hands of the person to which the interest accrues; or

(bb) included in the net income of a controlled foreign company as contemplated in section 9D in the foreign tax year of the controlled foreign company commencing or ending within that year of assessment; and

(ii) disallowed under section 23N

the amount of interest allowed to be deducted may not exceed the amount determined in accordance with subsection (3).

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

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

(b) a percentage of taxable income of that debtor to be determined in accordance with the formula –

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

In which formula

(a) 'A' represents the amount to be determined
(b) 'B' represents the number 40
(c) 'C' represents the average repo rate plus 400 basis points
(d) 'D' represents the number 10

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

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

(4) So much of any amount of interest as exceeds the amount determined in terms of subsection (3) may be carried forward to the immediately succeeding year of assessment and subject to subsection (2), must be deemed to be an amount of interest incurred in the succeeding year of assessment.

(5) Where an amount of interest is to be taken into account in terms of this section and in terms of section 23N, that amount of interest shall only be taken into account in terms of this section after section 23N has been applied.

(6) This section does not apply-

(a) to so much of the interest as incurred by a debtor in respect of a debt owed to a creditor as contemplated in subsection (2) where –

(i) the creditor funded that debt amount advanced to that debtor with funding granted by a lending institution that is not in a controlling relationship with that debtor; and

(ii) that interest is determined with reference to a rate of interest that does not exceed the official rate of interest as defined in paragraph 1 of the Seventh schedule plus 100 basis points.

(b)to any interest incurred by a debtor in respect of any linked unit that is held by a creditor as contemplated in subsection (2) where that creditor is a long-term insurer as defined in the Long-Term Insurance Act, a pension fund, a provident fund if –
(i) the long-term insurer, pension fund or provident fund holds at least 20 per cent of the linked units in that debtor
(ii) the long term-insurer pension fund or provident fund acquired those linked units before 1 January 2013 and
(iii) and at the end of the previous year of assessment 80 per cent or more of the value of assets of the debtor, reflected in the annual financial statements prepared in accordance with the Companies Act for the previous year of assessment, is directly or indirectly attributable to immovable property.

The word ‘tax’ is as set out in section 1 of the Tax Administration Act where it is defined as including a tax, duty, levy, royalty, fee, contribution, penalty, interest and any other moneys imposed under a tax Act. The Income Tax Act has its own definition of ‘tax’ in section 1 as a tax or penalty imposed in terms of the Act (de Koker and Williams 2018). The tax implications regardless of which definition of tax was applied if the interest is subject to either the normal (income) tax or the withholding tax on interest, the interest deduction will not be subject to the limitation contained in section 23M in the hands of the debtor. (de Koker and Williams 2018:7.39)

Interpretation of 'subject to tax'

The words 'subject to tax' have not been defined in the Act. Generally speaking, it requires the recipient to fall within the scope of the taxing rules of the relevant country and not to be exempt from tax (de Koker and Williams 2017:13.39A). The OECD Commentary on Article 4 (2014:77) concludes that the concept of 'liable to tax' (a requirement that a taxpayer to benefit from a treaty is accepted that he is liable to tax in the treaty country) can be interpreted differently in different countries. The OECD concludes in line with the principle that applies to income where an amount may constitute gross income will not be regarded as having been subject to tax if it is exempted. Similarly an amount of interest would not be regarded as being subject to tax if it exempted from withholding tax by application of the provisions of the double tax treaties or the exemptions from withholding tax on interest that may apply. If an amount of interest is not subject to tax as a result of this being reduced by deductible amounts where no tax liability arises, this would still be considered 'subject to tax'.

Other schools of thought in relation to the above are as follows:

- Where the recipient of the interest is subject to withholding tax and this rate has been reduced by application of the double tax agreement, the provisions of section 23M would not find application (ENS 2015). Where the interest is exempt or subject to no withholding tax by application of the DTA, the provisions of section 23M will apply.
- Mandy (2014) also supports this view, and states that an amount will not be regarded as being subject to withholding tax on interest if it is exempted from that tax.

From the above it can be seen that the view is that if interest is exempt from tax section 23M will find application.

Interaction of section 23M and other provisions in the Act

Section 23M and sections 50A to 50H of the Act

ENS (2015) states that section 23M applies to the payer of the interest whilst the interest withholding tax (contained in sections 50A to 50H of the Act) is levied on the person that receives the interest. One of the main concerns was how the introduction of the two sections would impact the level of foreign debt that was brought into South Africa. This was a serious concern as the South African market was already less desirable from a political and an

economical perspective (ENS 2015). Although both sections contain exclusions the sections are not mutually exclusive and ENS questioned whether this was an unintentional omission by National Treasury or whether it was specifically intended that both sections would apply in all circumstances (ENS 2015).

Section 23M and section 31 of the Act

Section 31 of the Act as well as section 23M are two sections of the Act that are similar in purpose as both sections target base erosion and profit shifting through excessive interest deductions. SAIT (2014) have set out that there is some uncertainty regarding the application of both these sections. It remains unclear how these two sections interact.

In the 2014 Explanatory Memorandum National Treasury set out that the provisions of section 31 will first apply to cross border loans (National Treasury 2013). National Treasury (2014), argues that section 31 targets the non-arm's length nature of the interest rate whereas section 23M has a broader objective of regulating excessive leveraging in South Africa thereby resulting in excessive deductions in respect of interest. Where however the quantum of the loan is not at arm's length but the interest is, section 31 will apply and adjust the loan amount. The interest although at arm's length would then be subject to section 23M and there is no guidance as to whether this is the actual interest incurred or the adjusted interest. (SAIT 2014b)

There seem to be a few parallels between the sections and the sections do not appear to be mutually exclusive:

- Section 23M applies where there is a South African resident debtor or where the debtor has a permanent establishment in South Africa and the debt amount is attributable to the permanent establishment. The creditor in this instance is a non-resident and the interest earned will must not be subject to tax in South Africa. The provisions of section 31 similarly apply where there a resident and a non-resident that enter into an affected transaction as defined. (SAIT 2014b)
- Both sections require that the debtor and the creditor be 'connected' in relation to one another and should a controlling relationship exist in terms of section 23M, section 31 will also find application. (SAIT 2014b)
- Both sections apply to financing transactions (financial assistance as it is referred to in section 31) and there is no clear guidance on which section should be applied first in order to determine the acceptable level of interest that will qualify as a deduction. (SAIT 2014b)

From the above it is apparent that section 23M and section 31 could apply to the same transaction with no clear guidance as to which section should be applied first. SAIT (2014) argued that section 31 already addressed the mischief that section 23M was introduced to combat. SAIT (2014) further commented that having numerous anti-avoidance provisions that seek to limit the deductibility of interest increases the burden of compliance and could make South Africa less attractive from an investment perspective. It is yet another example of sections in the Act designed to target a specific transaction rather than being a principle-based approach to regulating BEPS.

Section 23M falls short of the recommendations of the OECD Guidelines

The OECD Action 4 sets out the recommendations to be applied to target excessive interest deductions and other financial payments in order to protect the tax base (OECD 2015b). The OECD proposes a 'group ratio rule' approach under which third party debt, related party and intra-group debt are used to obtain excessive interest deductions (OECD 2015b:18). The group ratio rules are designed to ensure that deductible interest would be allocated to related parties based on where the underlying economic activity is being undertaken i.e. where profit is being generated thereby ensuring that only loans with external parties would generate deductible interest. Section 23M however only addressed the use of intra-group debt to fund exempt income and focusses only on interest paid to a creditor who is in controlling relationship with the debtor. (OECD 2015b)

The limit on the deductibility of interest is dependent upon the repo rate and has a limitation of 60 per cent. Where a fixed ratio is used, which allows an entity to deduct net interest expense up to a benchmark net interest/EBITDA ratio, a 10 per cent to 30 per cent corridor is recommended (OECD 2015b:26). The current benchmark ratio as contained in the Act of approximately 40 per cent is higher than this recommended guideline.

Conclusion

The above analysis indicates that section 23M is similar to the provisions of section 31 in that both sections deal with financing transactions between a resident and a non-resident. The provisions of the Act are not entirely in line with the recommendations of the OECD. The DTC recommended that in order to bring clarity on the details and application of section 23M

it was important an interpretation note be issued by SARS in order to confirm the interaction between section 23M and section 31. The DTC further recommended that the limitation of interest deductions needs to be extended to incorporate other finance charges and payments for example derivative and finance lease charges (DTC 2015:39). It was also undesirable for the interest income to be subject to both withholding taxes as well as section 23M.

SAIT (2014b) in its commentary on the Taxation Laws Amendment Bill, 2015 called for the re-consideration of the section 23M and the delay by a year of its enactment in order for the provisions and concerns to be reconsidered and addressed. There were also strong arguments that section 31 had already addressed the concerns of section 23M so the need for another section in this regard was potentially not required. (SAIT 2014b)

Section 23N

Background

In June 2011 the provisions of section 45 (dealing with corporate relief in relation to intra-group transactions) of the Act were suspended in order to allow for National Treasury to reassess the then current provisions of the Act and put into place measures that protected the South African tax base in the case of debt funded private equity transactions (Grant Thornton 2014). The suspension would last for a period of 18 months and the purposes as set out by Keep and Makola (2015) was to close a loophole in the section that allowed for a tax-free mechanism to obtain deduction that were linked to excessive levels of debt. At the time of its introduction is was made public that the provisions of this section was a short-term solution to address the levels of debt being used and in addition the section was still servicing the needs of the business community. (Keep and Makola 2015)

After the suspension of section 45 was removed National Treasury then introduced section 23K. Section 23K denied a deduction in respect of debt used to fund re-organisation transactions in terms of:

- Section 45 intra-group transaction and
- Liquidation distribution in terms of section 47 of the Act.(Grant Thornton 2014)

The purpose of the section was to limit the deduction of interest in relation to debt that was issued, assumed or used either directly or indirectly for the following purposes:

- Financing the acquisition of an asset in terms of a reorganisation transaction where debt was utilised
- Finance the acquisition of a share in terms of an acquisition transaction or
- Debt which re-financed or substituted debt which financed and acquisition in terms of a re-organisation or acquisition transaction. (Grant Thornton 2014)

The provisions of section 23K allowed the Commissioner of SARS to exercise his discretion, upon application of the acquiring company, and allow for the deduction of interest to the extent that he was satisfied that this did not pose a risk of erosion of the South African tax base (Grant Thornton 2014). SARS could only issue this directive and permit the deduction of interest if it was satisfied that this would not lead to a material deduction in taxable income of all parties that incurred or accrued the interest. This section was only an interim measure and was intended to apply only until 31 December 2013. The section fell away with effect from 1 April 2014. (Keep and Makola 2015)

De Koker and Williams (2018) set out that companies make use of debt push down structures for which they obtain a deduction in respect of debt used to acquire shares (normally when funding is used the acquire shares, the interest is not deductible as the purpose of the funding is to earn exempt dividends and thus the interest expense has not been incurred in the production of income). The example given by de Koker and Williams (2018: 13.39B) is as follows:

> *An acquiring company would purchase the shares of a target company and fund the acquisition with temporary debt, the interest incurred not qualifying for deduction as it is not incurred in the production of income. The target company then disposes of all its assets to a newly-incorporated subsidiary pursuant to a section 45 intra-group transaction, the consideration for the acquisition met by external funding. Interest incurred on the external will be deductible in the hands of the new-incorporated subsidiary as it is incurred in the production of income. The target company then distributes the cash received on disposal of the assets as an 'exempt' dividend to the acquiring company*.

Two new sets of rules were then introduced into the Act to replace the above discretionary system. The proposals to introduce these provisions were announced by the Minister of Finance in the 2013 Budget Speech which was held on 27 February 2013 (Keep and Makola 2015):

- Section 23N came into effect from 1 April 2014 and
- Section 23M came into effect from 1 January 2015.

Section 23N was then introduced as an objective test (no longer at the discretion of the Commissioner) which provides that when debt funding is used to acquire assets through a re-

organisation transaction, the interest allowed as a deduction in respect of the transaction will be subject to a limitation calculation. (Grant Thornton 2014)

Provisions of section 23N

Section 23N(1) sets out the definitions as they apply to the section:

The definitions are as follows:

'**Acquired company'** means

(a) a transferor company or a liquidating company that disposes of assets pursuant to a reorganisation transaction; or
(b) a company in which equity shares are acquired by another company in terms of an acquisition transaction.

'Acquiring company' means

(a) a transferee company contemplated in the definition of intra-group transaction in section 45(1);
(b) a holding company contemplated in the definition of 'liquidation distribution' in section 47(1); or
(c) a company that acquires an equity share in another company in terms of an acquisition transaction;

'Acquisition transaction' means any transaction –

(a) in terms of which an acquiring company acquires and equity share in an acquired company that is a company as contemplated in paragraph (a) or (b) of the definition of an 'acquisition transaction' in section 24O (1); and
(b) as a result of which that company, as at the end of the day of the transaction, becomes a controlling group company in relation to that acquired company;

'Adjusted taxable income' means taxable income

(a) reduced by

(i) any interest received by or accrued that forms part of taxable income;

(ii) amount included in income of a person under section 9D(2);

(iii) any amount recovered or recouped in respect of an allowance in respect of a 'capital asset' as defined in section 19; and

(b) with the addition of –

(i) any amount of interest incurred that has been allowed as a deduction from income;

(ii) any amount allowed as a deduction in terms of this Act in respect of a capital asset as defined in section 19 for purposes other than the determination of any capital gain or capital loss; and

(iii) 75 per cent of the receipts and accruals derived from the letting of immovable property

(iv) any assessed loss or balance of assessed loss allowed to be set off against income in terms of section 20;

The inclusion of the assessed loss provision was brought into the Act with effect from 1 January 2015. Webber Wentzel (2014) notes that the starting point of taxable income is that adjusted taxable income will more closely resemble EBITDA of the transferee company which acquires

the assets and will not impact the tax deductibility of interest incurred by a company which has an assessed loss available to be carried forward from the previous year. The amendments were however not retrospective preventing a company that entered into an acquisition transaction before this date from adding back the assessed loss in the calculation of adjusted taxable income for the years of assessment before 1 January 2015. (Webber Wentzel 2014)

'Average Repo Rate' in relation to a year of assessment means the average of all ruling repo rates determined by using the daily repo rates during that year of assessment;

'Interest' means interest as defined in section 24J**;**

'Issue' in relation to a debt, means the creation of a liability to pay or of a right to receive an amount in terms of that debt;

'Reorganisation transaction' means –

(a) an intra-group transaction as defined in section 45(1) to which section 45 applies; or
(b) a liquidation distribution as defined in section 47(1) to which section 47 applies

'Repo Rate' means the interest rate at which the South African Reserve Bank enters into a repurchase agreement contemplated in section 10(1)(j) of the South African Reserve Bank Act.

(2) Where an amount of interest is incurred by an acquiring company in terms of a debt

(a) directly or indirectly assumed or applied for the purpose of procuring, enabling, facilitating or funding the acquisition by the acquiring company of any asset in terms of a reorganisation transaction;

(b) used directly or indirectly for the purpose of redeeming, refinancing or settling the debt contemplated in paragraph (a);

(c) issued, assumed or used in terms of an acquisition transaction; or

(d) used directly or indirectly for the purpose of redeeming, refinancing or settling the debt contemplated in paragraph (c)

the amount of interest allowed to be deducted is limited must not exceed the amount determined in terms of subsection (3).

(3) The amount of interest allowed to be deducted in terms of all debts owed as contemplated in subsection (2), in respect of any year of assessment in which the acquisition transaction or reorganisation transaction is entered into and in respect of five years of assessment immediately following that year of assessment, must not exceed the sum of –

(a) the interest received by or accrued to the acquiring company; and

(b) the highest of the amounts determined by multiplying the percentage determined under subsection 4 by the adjusted taxable income of the acquiring company for each of the years of assessment -

(i) in which the acquisition transaction or reorganisation transaction is entered into;

(ii) in which the amount of interest is incurred by that acquiring company; or

(iii) immediately prior to the year of assessment contemplated in subparagraph (i)

reduced by any interest incurred by the acquiring company in respect of debts other than debts contemplated in subsection (2).

(4) The percentage contemplated in subsection (3)(b) must be determined in accordance with the formula

A= B x C/D

In which formula

(e) 'A' represents the amount to be determined
(f) 'B' represents the number 40
(g) 'C' represents the average repo rate plus 400 basis points
(h) 'D' represents the number 10

but not exceeding 60 per cent of the adjusted taxable income of that acquiring company.

Section 23N confirmed the intention of legislators in that it did not allow for excessive debt to be used to achieve tax savings when an acquisition or reorganisation transaction was being undertaken (de Koker and Williams 2018:13.39B). Where a taxpayer was able to meet the criteria as set out in section 23N interest incurred on the debt is tax deductible albeit that a limitation would apply. Any excess interest not claimed as a deduction as a result of applying this limitation would not be allowed to be carried forward to the succeeding year of assessment (de Koker and Williams 2018:13.39B). The calculation would need to be performed for a period of 5 years after the year of assessment that the acquisition/reorganisation transaction takes place. (de Koker and Williams 2018:13.39B)

Concluding remarks

The provisions of section 23M and section 23N of the Act are complex and require careful analysis to fully understand the tax consequences thereof (Cliff Dekker Homeyr 2014). Whilst section 23N is subject to section 23M it is possible for one transaction to be subject to the provisions of section 31 of the Act, section 23N and section 23M and from the discussion above it was still unclear as to which section should take precedence. If an adjustment was made to align the interest to market related interest in terms of section 31, then is a deduction even required in terms of section 23M. (Cliff Dekker Homeyr 2014). The sections described above cover specific concerns of legislators and fall short of a holistic approach as recommended by the DTC (2014:3). Following this holistic approach would eliminate the need for numerous sections in the Act (DTC 2014:3).

Chapter 4 – Anti-avoidance provisions: Section 8F and section 8FA

Introduction

The South African income tax system has two sets of rules that apply in relation to the taxation of debt versus equity (shares). Like many other countries, South Africa is faced with taxpayers making use of tax planning techniques raising concerns on the classification of debt and equity instruments and the tax consequences thereof. Financial instruments are generally taxed according to their legal form (SARS 2004:19). Accordingly, an instrument that qualified as debt from a legal perspective usually then qualified for the full tax treatment under tax law and an instrument that was classified as a share usually qualified for the tax treatment applicable to equity share capital. (SARS 2004:19)

Classification of debt versus equity

The classification of debt versus equity as set out by Borghino J (2013) with reference to the *Dixie Diaries Corp* case, 74 T.C. 476 (1980) United States of America, where the court had to decide if an amount constituted debt or equity and listed 13 factors in this determination:

1. Name or label: The issuance of an equity certificate indicates an equity contribution and the issuance of a bond or debenture or note indicated debt;
2. Fixed maturity date: A debt obligation usually has a fixed repayment term where if a repayment is linked to the profitability of a company then this is indicative of equity;
3. Source of payments: if the repayment is out of company earnings it is equity but if the repayment is required regardless of profitability of a company it is debt
4. Right to enforce payments: If there is a definite obligation to repay the advance this indicates the nature of the amount is a loan
5. Participation in management or the affairs of the company as a result of the advance: where there is ownership or an increase in the percentage interest of the shareholder as a result of the advance this is indicative of equity where in the case of debt the lender does not have a say in the affairs of the company
6. Status in relation to other creditors: where the advance has equal or inferior rankings in relation to other creditors i.e. there is no guarantee of distributions to the shareholder in the event of liquidation, the amount is equity

7. Intent of parties: it is relevant whether parties intended at the date of advance to create a debtor-creditor relationship. It is however noted that the intent of the parties may change
8. Identity of interest between creditor and stockholder: if advances are made in proportion to equity owner, an equity capital contribution is indicated
9. Thinness of capital structure in relation to debt: Thin capitalisation is a strong indicator of an equity contribution where the debt to equity ratio was initially high the parties realised it would increase and a large portion of the funds were used for the purchase of capital assets and daily operations.
10. Ability of the company to obtain credit from external sources: if no reasonable person would advance funds to the company based on the financial position, it stands to reason that no shareholder would do the same. If the company was able to secure external financing the transactions could be inferred to be debt in nature
11. Use of the advances: Use of advances to acquire capital assets or business expansion suggest that the amount is equity in nature. To fund daily business operations could infer debt.
12. Failure to repay: the failure to repay the principal amount on the date that this is due and payable indicates equity.
13. Risk involved in making advances: A reasonable expectation of payment on the part of the lender at the time that the advance is made indicates the advance is a debt.

Income tax implications of debt versus equity

The taxation of debt versus equity is set out as follows in the case where loan funding is advanced between South African tax residents:

Debt	Tax implications to the lender (company):	Tax implications to the borrower (company):
Interest	Interest income: The interest earned will in most cases constitute interest as defined in terms of section 24J. Where interest earned on the 'instrument' (as defined in section 24J and	Interest expense: Where the provisions of section 24J apply the lender will qualify for a deduction of the interest paid. There expense will have to be

	includes any 'interest bearing arrangement or debt') falls within the ambit of section 24J, the taxpayer is required to determine the amount of the interest to be included in the gross income of the lender. (Haupt:482) Section 24J requires that the taxpayer calculate the interest accrued based on the yield to maturity (i.e. the rate on a day-to-day basis over the term of the loan). (Haupt 2018:482-485) The interest will thus be spread over the period of the loan by calculating the interest over the fixed accrual period on a compounding basis. Alternatively, where section 24J does not apply the interest income will be included in the gross income of the lender in accordance with section 1 of the Act. (Haupt 2018:482-485) The interest included in taxable income would be taxed at the company tax rate. (As at 2019, it is 28 per cent).	incurred in the production income as a consequence of carrying on a trade. The amount of the interest expense will be calculated on a day-to-day basis over the fixed period of the loan calculated on a compounding basis with reference to the yield to maturity. (Haupt 2018:483-485) Where the provisions of section 24J do not apply the taxpayer could potentially qualify for a deduction in terms of section 11(*a*) read with section 23(*g*) of the Act. Section 11(*a*) requires that the amount be: • Actually incurred • In the production of income • During the year of assessment and • Must not be of a capital nature. The interest expenses qualifies as deduction. (Haupt 2018: 138,142)
Loan	Per the Eighth Schedule of the Act the loan receivable would be held as a capital asset (other than in the case of a moneylender/bank). The amount	The amount received will be held by the borrower as a capital receipt. Any repayments in relation to the

	advanced will constitute the base cost of the loan and will be used to determine any capital gain/loss on redemption. As the loans are usually redeemed at face value no capital gain or loss should arise. (SARS 2018:17,22) Any repayments on the loan would reduce the above base cost of the loan receivable (Income Tax Act).	loan would not be deductible as this would be considered to be capital in nature and fall short of the provisions as contained in section 11(*a*) of the Act (Income Tax Act).

Equity	Tax implications for the shareholder	Tax implications for the company
Dividends	Dividends will be included in gross income by application of section 1 of the Act. On the basis that a dividend is received from a South African resident company, this would be exempt by application of section 10(1)(*k*) of the Act. No dividends withholding tax would apply by application of 64F of the Act. (Haupt 2018:87)	If the dividend is paid to a resident company shareholder no tax implications should arise. If a dividend is paid to a resident individual dividend withholding tax at a rate of 20 per cent will be withheld by the company declaring the dividend. (Haupt 2018:451)
Issue of shares	This will be an asset as set out in paragraph 1 of the Eighth Schedule of the Act. In general, the amount paid for the shares would then constitute the base cost of the shares	No tax implications should arise on the issue of shares. The amount will form part of the contributed tax capital (defined in section 1 of the Act

	as set out in paragraph 20 of the Eighth Schedule (SARS 2018). On the disposal of the shares a capital gain or loss would arise and would be taxed at an effective rate of 22.4 per cent in 2019 (being 80 per cent of the 2019 corporate tax rate of 28 per cent). (Income Tax Act)	and generally constitutes share capital plus share premium).
Buy back of shares	Dependent upon how the buyback is funded the amount could be a divided received (discussed above) or a repayment of contributed tax capital that will essentially reduce the base cost of the share. A capital gain could arise in the case where the return of capital exceeds the base cost of the share in accordance with paragraph 76 of the Eighth Schedule (SARS 2018:641, Haupt 2018:462).	In terms of section 1 of the Act, the buyback of a company's own shares can either be funded through retained income (in which case the amount paid would constitute a dividend paid by the company) or a reduction in contributed tax capital. (Haupt 2018:455-456)

Source: Compilation by the author from SARS 2018, Income Tax Act and Haupt 2018

In 2004, the Act contained only one provision dealing specifically with hybrid instruments as contained in section 8E. The only other sources to determine the tax treatment of hybrid instruments were case law, the general deduction formula, the section 1 definition of gross income and the general anti-avoidance legislation contained in section 103 of the Act (SARS 2004). The purpose of the section was to ensure that debt was not classified as short-term redeemable shares. If shares were disguised in this manner section 8E deemed the tax-free dividends to be interest for the holder (SARS 2004). The issuer at the time was then subject to Secondary Tax on Companies (STC) and did not qualify for a deduction in respect of the dividend (SARS 2004). National Treasury then recognised that an instrument may be classified as debt but may display the characteristics of equity and taxpayers on the basis of the different tax treatments that apply, chose to exploit this (National Treasury 2004:21-23). National Treasury was concerned that there was manipulation of financial instruments exploiting the difference between debt and equity in

order to reduce the overall tax liability of the taxpayer (SARS 2004). The Act at the time also did not contain any provisions that reclassified interest as dividends for the payer. Of specific concern at the time was debt that was essentially convertible into shares as there was no obligation for the payer to repay the principal amount of debt (a key characteristic that can be likened to equity and in the absence of this characteristic was not a true debt instrument). (National Treasury 2013b: 1-3)

Legislation up to 31 March 2014

National Treasury then introduced section 8F in 2014 which covered the following four types of hybrid instruments which applied up to 31 March 2014:

- A debt instrument that was at the option of the borrower convertible or exchangeable into equity within a period of three years from the date of issue of the instrument. This could be shares of another company provided that the other company was a connected person in relation to the borrower at the time of the issue of the instrument or could be the shares of the same company (Brincker 2011:3.3).
- An instrument where the issuer was required to make repayment within three years from the date of issue either partially or in full by the issue of shares by the issuer or a connected person of the issuer (Brincker 2011:3.3).
- An instrument where the issuer has a right to make repayment in whole or in part within three years from the date of issue and at the time of the repayment the holder of the instrument was required to subscribe for shares in the issuer or any connected person in relation to the issuer (Brincker 2011:3.3).
- At the option of the holder the instrument was convertible or exchangeable into shares in the borrower or any connected person in relation to the borrower within three years from the date of issue. It was further required that at the date of issue the value of the share at the time of conversion or exchange was likely to exceed the value of the debt by at least twenty percent. (Brincker 2011:3.3).

Section 8F(1) sets out the above categories of hybrid debt instruments. Once the taxpayer fell into one of the above categories, section 8F(2) denied the borrower a deduction in respect of the interest on the hybrid debt instrument deeming the interest to be dividend and subject to STC (SARS 2004).

At the time of its introduction, the shortfalls of section 8F was:

- The section was considered to be narrow and applying to specific instruments only (Brincker 2011).
- The legislation expressly referred only to a three-year period in relation to all instruments and this could easily be manipulated by taxpayers if the term conversion date of the instruments was set out at three years and one day for example (Brincker 2011:3.3).
- The definition of instrument was not set out in section 8F. Rather reference was given to the definition as contained in section 24J, however, the section 24J definition applied only in relation to section 24J. (Brincker 2011:3.3)
- The section deemed the interest on the instrument to be a dividend for the borrower only. The lender was still however subject to tax on the interest received in respect of the instrument (SARS 2004). This did not achieve a tax neutral position but rather resulted in STC being levied in the hands of the borrower and income tax being suffered by the lender on the same amount. (Brincker 2011:3.3)
- Brincker (2011) also set out that the effective date of the legislation was not clear. Although this applied from 26 October 2004 and applied in respect of any instrument issued or transferred to an issuer during any year of assessment it did not expressly state whether it was the year of assessment of the issuer or the holder of the instrument.
- Brincker (2011) stated that the deeming provision only applied to interest paid or payable after the legislation became effective and did not refer to interest that had already been paid in respect of the instrument.

Legislation effective 1 April 2014

On 1 April 2014, the anti-avoidance tax provisions concerning hybrid debt instruments were entirely overhauled (Bosman 2017). In order to address the above inadequacies of the legislation, section 8F was revised and the new section 8FA was introduced with effect from 1 April 2014. The definition of a hybrid debt instrument was amended and section 8FA was introduced (this section focussed on the yield on the instrument whilst section 8F focussed on the nature of the instrument). The instrument was more clearly defined and set out in detail. The provisions relating to the yield was assessed in section 8FA. The date of application of the section became clearer where it now applied to interest incurred on or after the effective date of 1 April 2014 and applied to all instruments in existence (Bosman 2017).

The definition of a hybrid debt instrument was amended and the legislation remained very specific in terms of which instruments fell into the ambit of section 8F. A hybrid instrument was defined as any form of arrangement or debt which bears interest, and under which a company owes an amount, if it is part of any 'transaction, operation, scheme, arrangement or understanding (whether enforceable or not) or part thereof and

- In the current or any future year of assessment the company was entitled to, forced to covert or exchange the amount of debt owed (including interest) into shares. This did not apply to the extent that the market value of the shares equated to value of the debt owed at the time of conversion (de Koker and Williams 2017:24.20)
- The obligation to repay the debt was dependant on the solvency of the debtor i.e. the obligation to repay the amount under the interest-bearing arrangement was dependent upon the market value of the assets of the company should be at least equal to or exceed the market value of the liabilities. To this effect subordination agreements needed to be considered as in all likelihood, the debt instruments under a subordination arrangement would fall foul of this section. (de Koker and Williams 2017:24.20)
- The debt owing is repayable to a connected person and there is no obligation to redeem that amount within thirty years from the date of issue. For this purpose, the term redeem referred to discharge of all liabilities under this instrument (de Koker and Williams 2017:24.20. If there were any redemption rights attaching to this arrangement (i.e. the company has the right to covert or exchange the debt into shares), this redemption period must be taken into account in determining the thirty-year period (de Koker and Williams 2017:24.20).

Any amount that is incurred by the borrower as interest after the date that the instrument becomes a hybrid debt instrument it is deemed to be a dividend in specie declared and paid by the borrower to the lender on the last day of assessment in which it was incurred i.e. the interest is denied as a deduction (de Koker and Williams 2017:24.20). From the above wording in the Act it appears that the interest incurred during the year falls within the ambit of the provisions of section 8F even if the instrument became a hybrid debt instrument after the interest date. When an instrument is no longer classified as a hybrid debt instrument it appears any interest incurred after this date is not caught by this section. (de Koker and Williams 2017:24.20)

The above legislation addressed the shortfalls of the previous version of section 8F. The legislation still however remained specific to certain debt instruments only and attempted to curb mischief in relation to specified transactions rather than being a principle-based approach to limit the deductibility of interest. It must however be noted that should the definition of the hybrid debt instruments be broadened this may become onerous in the area of compliance by taxpayers.

The amended legislation included exemptions to the provisions of section 8F as follows:

- Debt instruments owed by small business corporations
- Tier 1 and Tier 2 instruments referred to in the Government Notice R.1029 under section 90 of the Banks Act.
- Certain debt instruments as owed by short-term and long-term insurers
- Linked units held by a pension or provident fund, a Real Estate Investment Trust or a long or short-term insurer (applied only in certain instances up until 1 January 2017).

One of the biggest concerns of this legislation related to that of subordination agreements. Subordination agreements are commonly used in group scenarios and typically contain the following clause:

> The Creditor hereby agrees that, until such time as the assets of the Company fairly valued exceed its liabilities, it shall not be entitled to demand or sue for or accept repayment of the whole of any part of the said amount owing to it by the company and set-off shall not operate in relation to the subordinated claim in respect of any debts owing by it now or in the future; provided that if the auditor of the Company shall report in writing that he has been furnished with evidence which reasonably satisfies him that the amount of the subordinated claim exceeds the amount by which the liabilities of the Company exceed its assets, such excess portion of the subordinated claim as is specified in the said certificate shall be released from the operation of this agreement. (Grant Thornton 2015).

The above clause was common to most subordination agreements which meant that all subordination agreements (even in the absence of this clause as this was the very nature of why the agreement had been put in place) fell afoul of section 8F (Grant Thornton 2015). It is worth noting that where the repayments of loans are conditional on the liquidity rather than the solvency of the company these loans were not caught by the provisions of section 8F (Bosman 2017). Subordination agreements are typical to group structures where the intra-group or connected party loans were subordinated due to group company debtors experiencing financial distress. Auditors, in protection of third-party creditors often request

subordination agreements and in the absence of this agreement a qualified audit report may be issued (Bosman 2017). With effect from 1 January 2016 the legislation was slightly amended in this regard as discussed below.

Hybrid interest – Section 8FA

Introduction

In addition to the revised section 8F, section 8FA was introduced with effect from 1 April 2014. This section deemed 'hybrid interest' to be a dividend in specie. The instrument itself need not be a hybrid instrument itself for the provisions of section 8FA to apply (de Koker and Williams 2014). The section deems the hybrid interest to be a dividend in specie for both the borrower and the lender, subject to dividends tax. The provisions of this section focusses on the nature of the yield. Section 8FA sets out two distinct types of hybrid interest in relation to debt owed by a company:

- Interest which is not based on a specified rate of interest or is not determined with reference to the time value of money
- An increase in the interest rate is based on an increase in the profits of the company the hybrid interest is then prescribed as the rate of interest as exceeds the amount of interest of interest that would have been determined with reference to the lowest rate of interest during the current year and previous five years of assessment. de Koker and Williams (2017:9.32) set out that the hybrid interest is illustrated as follows:

Interest for the year	Rxxx
Less: Lowest rate of interest in relation to the debt for the current year and preceding five years of assessment	(xxx)
Hybrid Interest	xxx

The shortfalls of section 8FA related to the uncertainty in calculating the hybrid interest. Where a debt instrument had an interest rate that was determined partially with reference to the time value of money and partially based on other factors, there was no guidance as to whether the hybrid interest related to only a component of the interest or the entire interest amount (de Koker and Williams 2017:9.32).

Hybrid debt rules effective from 1 January 2016

The following definitions were introduced or amended in the Act in section 8F and section 8FA:

'Hybrid debt instrument' – means any instrument in which a company owes money, if in terms of an arrangement defined in section 80L:

(a) that company is in a year of assessment entitled to or obliged to, convert or exchange the instrument for shares, unless the market value of those shares is equal to the amount owed in terms of the instrument;
(b) the obligation to pay an amount so owed on a date or dates within that financial year has been deferred by reason of that obligation being conditional upon the market value of the assets of that company not being less than the amount of the liabilities;
(c) that company owes the amount to a connected party and is not obliged to repay it for a period of 30 years.

'Enforcement right' in relation to an instrument means any right, fixed or contingent, to require any person other than the issuer to acquire that instrument from the holder thereof:

(*a*) make any payment in respect of that instrument in terms of a guarantee, indemnity or similar arrangement;
(*b*) procure, facilitate or assist with any acquisition contemplated in (a) above or the making of any payment contemplated in (b).

'Instrument' means any form of interest-bearing arrangement or debt issued by a company that is:

(a) a resident;

(b) non-resident if the interest in in respect of that instrument is attributable to a permanent establishment of that company in the Republic;

(c) that is a CFC as envisaged in section 9D and the interest incurred in respect of that instrument is taken into account in determining the net income of that CFC as contemplated in section 9D.

'Interest' means interest as defined in s 24J.

'Issue' means the creation of a liability to pay an amount in terms of an instrument.

'Redeem' means the discharge of all liability to pay all amounts in terms of that instrument.

'Third-party backed instrument' means any instrument where an enforcement right is exercisable as a result of any amount relating to that instrument not being received by or accruing to a person entitled thereto.

The definitions in section 8F applied similarly to section 8FA and the exemptions remained largely the same. Both section 8F and section 8FA have the effect of deeming the interest that is incurred during the year of assessment on the debt instrument by the borrower to be a

dividend in specie declared and paid by the borrower to the lender on the last day of the borrowers year of assessment and this interest would not qualify for a deduction in the determination of the taxable income of the borrower (Haupt 2018:500-501). Likewise, the interest accrued to the lender is deemed to be a dividend in specie declared and paid to the lender on the last day of the borrower's year of assessment. The disallowance of the deduction will apply from the date that the debt instrument is classified as a hybrid debt instrument and the yield is determined to hybrid interest. The deemed dividend in specie are then subject to dividends tax as set out in section 64D of the Act (income Tax Act). Dividends tax would be due by the borrower at a rate of 20 per cent (the 2019 rate) unless the exemptions contained in section 64F apply (Haupt 2018 463:465). The borrower would then be required to pay over the dividends tax to SARS on the last day of the month following the end of the year of assessment as set out in section 64K of the Act. The lender would be required to include the dividend in specie in gross income and should be entitled to an exemption in terms of section 10(1)(*k*)(i) of the Act. (Haupt 2018 463:465)

The provisions of sections 8F and 8FA apply both to residents and non-residents to the extent that the non-resident is subject to tax in South Africa.

Revision of the legislation in relation to subordination agreements

The Taxation Laws Amendment Bill (2016) introduced an exclusion to paragraph (b) to definition of hybrid debt instrument. Section 8F(3)(*f*), and provides that Section 8F will not apply to any instrument 'that constitutes a hybrid debt instrument solely in terms of paragraph (b) of the definition of hybrid debt instrument if a registered auditor, as contemplated in the Auditing Profession Act, has certified that the payment, by a company, of an amount owed in respect of that instrument has been or is to be deferred by reason of the market value of the assets of that company being less than the amount of the liabilities of that company'. The exemption is not restricted to intragroup or connected party loans. (Bosman 2017)

Bosman states that there are two difficulties in applying this exemption:

- It is not expressly clear as to what this certification would entail and it is not usually the practice of the auditors to undertake such certification and therefore the ability to apply this in practice would not be easy.
- Moreover, the effective date of this exemption applied only from 1 January 2016. All instruments that fell into the provisions of section 8F when it was initially enacted (i.e.1 April 2014) until 1 January 2016 will not benefit from this relief.

The legislation in relation to the OECD recommendations

The current provisions of section 8F and section 8FA was a policy approach that National Treasury implemented in order to curb the deductibility of interest in the case where equity instruments were disguised as debt (SARS 2004). In its current provisions the section is narrow and allow for the ease of application for taxpayers. On the basis that the hybrid debt instruments were clearly defined as there was not much room for interpretation and reduced the burden on SARS to be able to police this area of the legislation.

The OECD has not however defined the term 'hybrid debt instrument'. It the 2015 report the OECD highlights that it would not be possible to set out a definition which is able to cover all types of hybrid instruments. Whilst the OECD does not define a hybrid debt instrument it does however provide a definition for a 'financial instrument'.

The introduction of sections 8F and 8FA targeted specific transactions or debt instruments. The DTC recommended in its interim report that it was important for South Africa to consider domestic tax legislation in relation to foreign tax legislation in line with OECD recommendations. With the view of ensuring coherence of corporate income tax at the international level, the OECD recommended that domestic rules be reconsidered and the model treaty provisions be applied and this would neutralise the effect of hybrid mismatch arrangements (OCED 2015:11). The recommendations set out to link the domestic tax rules by a country to the rules that apply to the foreign country of the other party to the transactions. The OECD recommends that the tax deductions, in this case the interest amount, should be denied in the jurisdiction of the payer to the extent that it has not been included in the ordinary income of the payee within a reasonable period of time in order to neutralise the effects of hybrid mismatches (OECD 2015:25). The OECD does however note that the ability to link domestic tax rules to international rules is not always simplistic.

Conclusion

The introduction of such specific sections in the Act, it begs the question as to whether or not these instruments or hybrid interest could have been dealt with in other sections of the Act without the need for an additional section in the Act that limited the deductibility of interest. The DTC in consideration of the number of provisions included in the Act that seek to regulate the deductibility of interest, concluded that the tax rules should be developed

holistically which regulate more transactions rather than a number of specific anti-avoidance provisions that capture only certain transactions (DTC 2014). The DTC also recommended that a principle-based approach be followed when putting into place anti-avoidance legislation that combat BEPS through the deductibility of interest. The committee identified that there was a need for the simplification of the rules in order to ensure that the legislation does not become complex and impractical to achieve compliance. The DTC also cautioned legislators to be wary of making changes only specific to South Africa. This could make South Africa unattractive from an investment perspective.

South Africa currently has in place a number of provisions that seek to limit the deductibility of interest, in addition to the legislation relating to withholding taxes, transfer pricing and anti-avoidance provisions. The operation of these provisions could more than likely prevent the excessive deductibility of interest in relation to hybrid debt instruments. The administrative burden that numerous provisions place on a taxpayer in order to ensure compliance could negatively impact South Africa from an investment perspective. In addition, South Africa has also chosen to deviate slightly from the OECD recommendations as discussed above. There is no evidence that legislators will in fact consolidate the provisions of the Act in order to ensure that the provisions are more broadly set out following a principle-based approach rather than being transaction specific. It would however be a positive improvement, one that would be welcomed by investors and ensure ease of compliance.

Chapter 5 – Transfer Pricing

One of the mechanisms that taxpayers achieve tax avoidance is through transfer pricing. The term transfer pricing describes the process by which entities set prices at which they transfer goods and services between one another (SARS 1999). The term 'transfer pricing' entails the process through which related parties set prices where they can transfer goods and services between themselves (Oguttu 2006).

Prior to 1995, South Africa did not have specific transfer pricing legislation. Exchange control regulations were put in place with regards to foreign loans to South African residents. The South African Reserve Bank managed in-bound financial assistance by implementing thin capitalisation regulations. In terms of these rules a debt to equity ratio of 3:1 was required. While exchange control regulations continued to regulate the flow of funds from South Africa, the gradual relaxation of exchange control rules provided greater flexibility and freedom for the movement of funds offshore (PWC, 2013/14 at 194).

Original provisions contained in section 31

The original provisions under section 31 were limited to the purchase and sale of commodities in circumstances where one of the two related enterprises was a foreign enterprises resident in a country with which South Africa had concluded a double tax treaty (Oliver, Brincker, Honnibal 2003). In this regard the provisions of the double tax agreement were used to establish if the commodity was in fact sold at an arm's length price.

As exchange control regulation fell under review, the recommendations of the Katz Commission were then tabled. To this effect SAICA (1995) sets out the following:

> The Katz Commissions first interim report recommended that rules be introduced to control the manner in which a foreign investor invests into South Africa, to replace the broad debt/equity ratios applied by the Reserve Bank and which will no longer be relevant when exchange control disappears. Clearly, a highly geared investment has the potential to enable operating profits of a South African operating company to be stripped by way of interest charges, essentially free of South African income tax. The 1995 Income Tax Act contains empowering legislation giving full discretion to the Commissioner to determine whether "financial assistance", in the form particularly of debt introduced by a foreign shareholder, is excessive. The Act, however, contains no guidelines as to the acceptable limits of debt finance. The omission led to concern that tax advisors were unable to advise investors as to the manner in which they should finance their businesses (informal enquiries from the Commissioner's office had indicated that they were not in a position to give that guidance verbally or otherwise, at the time the

> Bill was issued). The second interim report of the Katz Commission was then released dealing expressly with thin capitalisation and recommending that a practice note be issued simultaneously with the necessary legislation and containing draft contents for that note In summary, the report recommends that the Commissioner should use a 3:1 debt/equity ratio as a rule of thumb, but subject to negotiation to take account of particular circumstances and the requirements of different industries. (For example, the financial sector, in which a rule of thumb ratio of 5:1 is suggested). These ratios are substantially less liberal than those contained in the first interim report.

As a consequence of the above, there was the introduction of proposed legislation as well as a proposed practice note. This led to the introduction of section 31(3) of Act and the issuance by SARS on 14 May 1996 of Practice Note 2 – Income Tax: Determination of Taxable Income where Financial Assistance has been granted by a non-resident of the Republic to a resident of the Republic.

At the time of its introduction in 1995, this section allowed the Commissioner for the SARS to exercise his discretion should he be of the opinion that an arm's length price had not been paid or charged. He was entitled to adjust the value of the consideration to reflect an arm's length price. This adjustment (termed the 'excessive portion') was then deemed to be a dividend and subject to Secondary Tax on Companies (STC) by application of section 64C(2)(*e*) of the Act. The determination of this excessive portion was not set out in the Act. Taxpayers then looked to Practice Note 2 (PN2) where in the case of the ratio of debt to equity an acceptable limit was 3:1.

Thin capitalization, often regarded as a category of transfer pricing, relates to the funding of a business with a disproportionate degree of debt in relation to equity so as to provide the foreign investor the benefit of having the interest income derived therefrom exempt while, at the same time, conferring upon the company the tax advantage relating to the deductibility of interest payments on that debt (as opposed to the non-deductibility of dividends distributed on equity capital). Consequently, thin capitalization provisions are applied to limit the deductibility of interest on the excessive debt funds, thereby protecting the South African economy against distortions resulting from heavily-geared foreign investments (De Koker and Williams 2018). Thin capitalisation, which is often regarded as a category of transfer pricing, is defined as the funding of a company with an amount of debt that disproportional in relation to equity so as to provide the borrower with the benefit of having interest expenditure deductible for tax purposes (Oliver & Honiball 2011).

PN2 was released on 14 May 1996 and was applicable to cross border transactions entered into on or after 19 July 1995. Excessive financial assistance was determined with reference to the ratio of 3:1. Excessive financial assistance was determined with reference to the following formula as set out in PN2 (paragraph 4.1):

A=B*(C-D)/C

In which formula:

A- Represents the disallowable interest limited to interest incurred during such year in respect of financial assistance granted on or after 19 July 1995

B- Represents the total interest incurred during such year of assessment in respect of all financial assistance, contemplated in subsection (3), in existence during such year (whether or not such financial assistance was granted before, on or after 19 July 1995);

C- Represents the weighted average of all interest-bearing financial assistance which was in existence during such year (whether or not such financial assistance was granted before, on or after 19 July 1995);

D- Represents the greater of - * three times the fixed capital of the resident or recipient as at the end of the relevant year of assessment; and * the weighted average of interest-bearing financial assistance granted prior to 19 July 1995, which existed during such year.

The DTC Second Interim Report on BEPS in South Africa notes that the old provisions of section 31 were found to be narrow because they only applied to financial assistance granted by a foreign resident investor to certain residents and not to financial assistance by a foreign resident to another foreign resident even if the latter had a South African permanent establishment. As a result, some taxpayers sought to exploit the loophole by having a foreign company utilises a wholly owned subsidiary with most or all of its operations conducted in South Africa through a branch (permanent establishment). The foreign company would then capitalise the foreign subsidiary with excess debt, thereby using the interest deductions associated with excessive debt to offset income attributable to the South African permanent establishment. (SARS 2010)

Revised provisions of section 31

The transfer pricing rules were overhauled in 2010 and 2011 and applied for years of assessment commencing on or after 1 April 2012. The changes were introduced to focus on profit objectives rather than isolated transactions, to align with treaty wording referring to adjustments to profits rather than adjustments to price (PWC 2013/2014 at 194).

The revised section 31 is an anti-avoidance section which deals with transfer pricing and (effectively) thin capitalisation (Haupt 2018:585). It requires that an arms-length price be paid or be charged in respect of a supply or acquisition of goods or services between connected persons (Haupt 2018:585). The arm's length principle requires that transactions between related parties should be consistent with those that would have applied if the transaction was concluded with two independent parties in a comparable transaction under similar circumstances (OECD 2010).

The evolution of transfer pricing sees most countries applying the arm's length principle to prevent erosion of their tax bases through transfer pricing. The arm's length principle is internationally accepted and is a basis of ensuring that the *fiscus* receives its fair share of tax (Haupt 2018:585-586). For years of assessment commencing on or after 1 April 2012 the transfer pricing rules were amended and included in the scope of section 31. It referred to any transaction, operation, scheme, agreement or understanding entered into between connected persons. This is contrasted to the original provisions that were limited to the purchase and sale of commodities in circumstances where one of the two related enterprises was a foreign enterprise resident in a country with which South Africa had concluded a double taxation treaty (Oguttu 2003). The rules aimed at giving effect to the right conferred to South Africa as a contracting state to determine the taxable income of a taxpayer as if the commodity had been bought or sold at an arm's length price which was determined according to the provisions of the particular double-tax treaty (De Koker 2002).

The provisions set out as follows:

31(1) sets out the definitions pertinent to section 31. For the purposes of the section –

'**Affected transaction**' means any transaction, operation, scheme, agreement or understanding where –

(a) That transaction operation, scheme, agreement or understanding has been directly or indirectly entered into or affected for the benefit of either or both –

(i) (aa) a person who is a resident; and
(bb) any other person that is not a resident

(ii) (aa) a person that is not a resident; and

(bb) any other person that is not a resident that has a permanent establishment in the Republic to which the transaction, operation, scheme, agreement or understanding relates;

(iii) (aa) a person that is a resident; and
(bb) any other person that is a resident that has a permanent establishment outside the Republic to which the transaction, operation, scheme, agreement or understanding relates;

(iv) (aa) a person that is not a resident; and
(bb) any other person that is a controlled foreign company in relation to any resident

and those persons are connected to one another; and

(b) any term or condition of the transaction, operation, scheme, agreement or understanding is different from any term or condition that would have existed had those persons been independent persons dealing at arm's length;

'Financial assistance' includes any –

(a) debt; or
(b) security or guarantee

Section 31(2)(b) specifically states that the provisions only apply if 'any term or condition of the transaction, operation, scheme, agreement or understanding is:

- different from an arm's length term or condition; *and*

- results or *will result* in a tax benefit being derived by any person who is a party to the transaction, operation, scheme, agreement or understanding (Haupt 2018).

'Tax benefit' is defined in section 1 of the Act and refers to any avoidance, postponement or reduction of any liability, for tax.

'Tax' is defined in section 1 of the Act as any tax or penalty imposed on terms of the Income Tax Act.

In looking at whether a tax benefit is derived, it is submitted that one must look at the effect on the overall tax positions of the persons involved, and compare this to what the tax position would have been had the transaction etc. not been entered into this way (Haupt 2018:586).

Section 31(2) of the Act states that the taxable income or tax payable by any person who is a party to the transactions and that derives a tax benefit as a consequence of the transaction operation or scheme, must be calculated as if the transaction, operation, scheme, agreement or understanding had been entered into on the terms and conditions that would have existed had those person's been independent persons dealing at arm's length. (Haupt 2018: 588-587)

The Commissioner is entitled to make a primary adjustment when a company has entered into an affected transaction and the actual terms and conditions of the debt are not those that would have been agreed to by parties acting arm's length. The taxpayer is then required to calculate the difference between the non-arm's length portion and arm's length portion of the debt. The excessive interest on the excessive debt portion must be disallowed in computing taxable income (SARS 2013). Any interest, finance charges or other consideration payable

for or in relation to or on that portion of the non-arm's length basis must be disallowed as a deduction in determining the taxable income of the taxpayer. Other consideration are wide and looks at all cost associated with debt for example foreign exchange loss on a foreign denominated loan (SARS 2013).

Section 31(3) states that the adjustment must be treated as follows in relation to residents and non-residents who are connected persons in relation to the resident:

(a) if the South African resident is a company, the difference (between the actual amount and the arm's length amount) is deemed to be a dividend in specie paid by the South African resident company to the non-resident on the last day of the period of 6 months following the end of the particular year of assessment (Haupt 2018:588)
(b) if the South African resident is not a company, the difference is deemed to be a donation made by the resident to the non-resident on the last day of the period of 6 months following the end of the year of assessment in respect of the adjustment is made, for donations tax purposes only. (Haupt 2018:588)

This now places the onus on the taxpayer to transact as well as make an adjustment on an arm's length basis whereas under the old provisions the Commissioner had the discretion to make the adjustment. This was the introduction of the new self-assessment provision.

Section 31(3) provides for a secondary tax adjustment which arises from the primary transfer pricing adjustment. As set out in the SARS draft interpretation note, the OECD guidelines explain that-

> these adjustments serve to make the actual allocation of profits consistent with the transfer pricing adjustment, some countries … assert under their domestic legislation a constructive transaction (a secondary transaction), whereby the excess profits resulting from the primary adjustment are treated as having been transferred in some form and taxed accordingly.

In addition to the primary adjustment the amount disallowed as deduction is deemed to be loan by the taxpayer that constitutes an affected transaction per section 31(3). As a result, the taxpayer would have to account for interest income at an arm's length rate on the deemed loan. The accrued interest on the loan is then capitalised annually for the purposes of calculating and determining the capital amount outstanding (SARS 2013) until such time that the loan is repaid. The deemed loan as well as the accrued interest was deemed to be repaid if the taxpayer is refunded the excessive interest or the other party pays the interest on the deemed loan (SARS 2013).

Section 31(4) states that the definition of a connected person referred to the definition contained in section 1 of the Act. This section further widens the definition of connected person where the transaction, operation, scheme, agreement or understanding is in respect of:

(a) financial assistance or
(b) intellectual property or related knowledge as envisaged in section 23I of the Act.

Section 31(5) applies to financial assistance granted by a non-resident to a headquarter company. In specific instances section 31 does not apply to this financial assistance. (Haupt 2018:589)

Section 31(6) sets out the circumstances under which the transfer pricing rules do not apply to loans made or IP licensed by residents that are not headquarter companies. Once again, this subsection set out the specific criteria when this will apply. (Haupt 2018:589-590)

Section 31(7) was added for years of assessment commencing on or after 1 April 2014 and applies to financial assistance granted by a non-resident for more than 30 years. Section 31(7) states that the section 31 does not apply if the foreign company does not have to redeem the debt in full within 30 years and the redemption is conditional upon the market value of assets of the foreign company not being less than the market value of its liabilities. From 1 January 2015 an extra condition is added – the debt must be interest free for the transfer pricing rules not to apply (Haupt 2018:590).

The wording of section 31 is wide and applies to transactions, operations, schemes, agreements and understandings that have been directly and indirectly entered into or effected for the benefit of either or both parties specified in the definition (SARS 2013). The section is far wider than a loan between the two parties specified in the definition of an affected transaction.

In the context of financial assistance, indirect financial assistance includes but is not limited to, back-to-back transactions with banks or other financial institutions (for example when a non-resident member of a multinational enterprise funds a deposit with the bank and the bank loans the funds to a South African resident member), the provision of guarantees by a non-resident member to a bank or financial institution in connection with funding given by that bank or financial institution to a resident member or other arrangements in which funding provided by a foreign connected person is routed through one or more special purpose entities or other tax accommodating or indifferent parties. In general, any funding provided indirectly

will be treated as if the funding had been provided directly between two connected persons (SARS 2013).

The SARS Draft Interpretation Note

The purpose of the SARS draft interpretation note (IN) provides taxpayers with guidance on the application of the arm's length basis in the context of determining whether the taxpayer was thinly capitalised under section 31 and if so, calculating taxable income without claiming a deduction for the expenditure incurred on the excessive portion of the finance (SARS 2013).

Since the introduction of the new section 31, which contains no thin capitalisation provisions, reliance has had to be placed on the OECD outlook of when thin capitalisation arises (Haupt 2018:587). Haupt indicates the following key points arising from the draft IN:

- If a taxpayer is thinly capitalised, it cannot claim a deduction on the excessive portion of the finance
- The question of thin capitalisation is a question of fact, not law
- Thin capitalisation can apply to indirect finding (back-to-back transaction for example)
- A taxpayer that has too little equity when compared to debt is said to be thinly capitalised
- SARS's view is that an adjustment under section 31 may be required even if the taxpayer's choice of funding was not tax motivated
- Essentially there are two requirements before section 31 can be applied, i.e.
    - The terms and conditions of the transactions must differ from what they would have been had the parties been independent parties acting at arm's length
    - The transaction must result (currently or in the future) in a tax benefit being derived by a person that is a party to the transaction etc.
- If a tax benefit arises, SARS has to base its adjustment on what the transaction would have been had the parties been acting at arm's length
- SARS states that interest expenditure cannot be claimed as a deduction on the portion of a debt that is not arm's length
- In applying the arm's length test, one has to look at what the lender would lend in the circumstances and what the borrower would borrower would borrow in the circumstances
- SARS implies that if a borrower has a very healthy balance sheet, with excess cash and reserves and borrowing capacity, it has no need to borrow from an offshore parent company. If the South African subsidiary then does borrow funds from the offshore parent, the whole loan is not arm's length. The result is that no interest would be allowed as a deduction.
- Taxpayers can support an interest deduction by considering appropriate comparable data.
- Comparable data could be financial rations for comparable taxpayers using third party provided commercial databases, or potentially a competitor's position, if truly comparable

- A taxpayer's credit rating, an approximation of which would be available from the use of the third party provided database, credit risk and scorecard models, which SARS is investigating, may be used as a basis to determine the arm's length interest rate in conjunction with relevant external third party data
- In addition to the amount of debt being arm's length the rate of interest must also be at arm's length
- With a loan, the arm's length basis may have to be determined on an on-going basis, at appropriate intervals
- If a loan in excessive, then not only will the interest be disallowed but also other costs related to the loan and any foreign exchange losses
- SARS considers that a greater thin capitalisation risk exists if the Debt:EBITDA ratio of a South African taxpayer exceeds 3:1. This ratio is not a safe harbour. It may vary in different industries. A ratio of more than 3:1 is likely to raise a SARS query
- As a very rough guideline SARS considers that if the debt is in South African Rands, an interest rate of more than 2 percentage points above (the weighted average) of JIBAR is of 'higher risk' and if a foreign denominated debt is more than 2 percentage points above (the weighted average) of the base rate of the foreign country, then it is also considered riskier. Again this is not a safe harbour. If the rates are of higher risk, they are likely to spark a SARS query.

Thus, to be certain, taxpayers actually need to undertake a detailed analysis as to what is an arm's length level of debt would be based on the borrowing capabilities of the taxpayer and what interest rate this would be lent. Such an analyses are complex and costly, therefore is it unsurprising that this is an area that needs addressing (Chong and Miller 2018).

Chong and Miller (2018) further note that what is perhaps more concerning is that since the issue of the draft IN, there has been a significant change in international precedent concerned with excessive debt deductions, both through the release of the final OECD BEPS report and international case law. Furthermore, South Africa has so many interest limitation sections in the Act and there is a real need to align these.

Effectiveness of the arm's length principle

The DTC tasked in evaluating South Africa's tax policy noted in the Second Interim Report on BEPS that the OECD indicated that the use of the arm's length test, although a good test, is not be considered further as the best method of preventing BEPS in the context of Action 4 and the quantum of debt, due to the fact that is it can be time consuming and burdensome and very expensive for taxpayers to comply with (DTC 2014). The approach recommended by the OECD is that the arm's length test should only apply to the pricing of the debt i.e. the interest rate. This is deemed to be appropriate as the pricing of the debt is reflective of the quantum of the debt and the associated risk. Higher levels of debts are associated with higher levels of risk and higher interest rates. It is noted that in the South African context it is preferable to treat the

pricing of debt (i.e. the interest rate) and the evaluation of the extent of debt separately (DTC 2014).

The DTC recommended that the guidance from SARS should be changed to align with the recommendations of the OECD as a matter of urgency (Webber Wentzel 2018). The draft IN creates uncertainties for taxpayers as this has been in a draft format since March 2013. It is further important to align these rules as different rules between different countries could lead to double taxation.

In finalising the draft IN the DTC recommends that SARS consider the following:

- Simplification of rules

- Consistency with the OECD recommendations

- Transfer pricing should take into account the outcome of the *General Electric Capital Canada Inc. v. The Queen*, 2010 *and Chevron Australia Holdings Pty Ltd v Commissioner of Taxation*, 2015 cases on the relevance of parent credit ratings. These cases endorsed the 'halo effect' in terms of which the implicit support of the group resulting in a higher credit rating of a borrower should be considered in the factors determining the credit-worthiness of the borrower. (Chong and Miller 2018).

- Introduce ways of reducing the administrative burden for taxpayers with a low risk of BEPS through interest deductions. This could be for example:

- Introduction of a safe harbour (e.g. debt to equity of 2:1) and
- Threshold based on loan value or another measure whereby taxpayers falling below such threshold would not have to comply with the rules

- How to treat start-up operations where loan finding is required

- Guidance on debt pricing exercises which are costly even though certain financial ratios of the company indicating lower risk.

It is recommended that a 'safe harbour' with a fixed ratio be introduced in section 31 or the IN to provide non-residents and local entities with adequate guidance on the appropriate levels of debt to equity. The OECD guidelines to thin capitalisation sets out two recommended approaches i.e. the fixed ratio approach or the arm's length principle. These two approaches together with the advantages and disadvantages of the approaches are discussed below. (DTC 2014, Chong and Miller 2018)

The fixed ratio approach

In terms of the fixed ratio rules, the interest portion relating to the debt above the fixed ratio will not be tax deductible (DTC 2014). Financial ratios will determine the amount of interest that is deductible in relation to a specified ratio. There are no set rules as to what the financial ratios should be. Some countries make use of debt to equity ratios for example 2:1 where if the ratios are applied any excess interest on the amount of debt outside of the ratio would not be tax deductible. The composition of what constitutes debt may also differ from country to country. Some countries may include intercompany or intra-group debt only where others may use all debt (internal and external financing) when determine the above ratio.

The OECD do however set out the disadvantages of applying a fixed ratio rule:

- The rules can be relatively inflexible if the same ratio is applied in all sectors
- On the basis that the ratios are set subjectively this may be too high to too low thereby failing to address BEPS or lead to double taxation risks
- The rule still allows for manipulation in a group scenario where the amount of equity in a group company can be increased

The OECD concludes that even though this rule can play a role in limiting the deductibility of interest, in general, it is not a best practice to tackle BEPS (DTC 2014). This is advocated by Sweidan who questioned the feasibility of safe harbours. Safe harbours can be understood as thresholds provided by a tax authority for select taxpayers covered by transfer pricing regulations (Sweidan 2014). According to Sweidan, the problems of safe harbour rules exceed the potential benefits. The negative considerations include:

- The safe harbour may move away from a more appropriate method in specific cases, such as a CUP or other transactional method, or sacrifice accuracy — and thus be inconsistent with the arm's-length method;
- Safe harbours are likely to be arbitrary not achieving an arm’s length standard, and could place administrative burdens on SARS;
- The shifting of income to jurisdictions where the safe harbour rule is acceptable could lead to non-compliance or double taxation;

- Competent authority support from the safe harbour jurisdiction should not be available as a result of the election, so that relief could be obtained only by the taxpayer convincing the other country that its results were at arm's-length;
- Foreign tax authorities may find it necessary to audit more extensively situations where a safe harbour was elected abroad to avoid loss of income, thereby shifting the administrative burden to such countries;
- Tax planning opportunities might be created which can include the shifting of profits to low tax jurisdictions or tax havens;
- Equity and uniformity concerns based on the subjectivity applied in these rules i.e. there will be no standard approach in determine these rules and thus this could differ from one jurisdiction to the next.

The advantages of using the safe harbour rules as set out by Sweidan are as follows:

- Simplifying compliance and reducing compliance costs for qualifying taxpayers in determining and documenting appropriate conditions for eligible controlled transactions;
- Providing certainty to qualifying taxpayers that the price charged or paid on qualifying controlled transactions is acceptable to the tax administrations that have adopted the safe harbour. This reduces the need for an audit or results in a limited audit ensuring the taxpayer has met the eligibility conditions of, and complied with, the safe harbour provisions;
- Allowing tax administrations to redirect their administrative resources from the scrutiny of lower risk transactions to examinations of more complex or higher risk transactions and taxpayers;
- Reducing or eliminating the possibility of legal action or disputes in court; and
- Enhancement of foreign direct investment.

Although SARS notes that the use of ratios should not be used as a safe harbour it may be used as a risk-based approach to their audits against taxpayers (SARS 2013). SARS sets out that the arm’s length basis is an acceptable basis for determining the acceptable levels of financial assistance. The fact that a taxpayer has applied a fixed ratio and is within the range of the ratio, does not in itself preclude SARS from auditing the taxpayer (SARS 2013).

Arm's length approach

The arm's length approach is set out in article 9(1) of the OECD Model Tax Convention (MTC) which provides that when conditions are made or imposed between two associated enterprises in their commercial or financial relations differ from those which would have been made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of those enterprises but, for reason of those conditions, have not accrued, may be included in the profits of the enterprises and taxed accordingly (DTC 2014). The arm's length principle requires that the taxpayer determine whether the size of the loan would have been made in an arm's length transaction as well as whether the interest rate applicable to the loan would be an arm's length rate (SARS 2013). In applying the arm's length approach the facts and circumstances of each transaction in relation to the provision of financial assistance would need to be taken into account in order to assess if the terms and conditions would apply had the transaction been concluded with independent third parties (SARS 2013).

The SARS draft IN sets out that the risk assessment involved in the analysis of the arm's length approach involves the following:

- *Determining the arm's length amount of debt*
  The taxpayer is required to consider the transaction from both the lender and borrowers' perspective. Once the analysis is completed the arm's length amount of the debt is the lower of the amount that the borrower would have borrowed acting in the best interests of the company and what the lender would have been prepared to lend in an arm's length transaction. This amount could very well be zero. This assessment requires a consideration of both qualitative as well as quantitative factors into consideration (SAR 2013). This could very well be time consuming, difficult in the situation where there is no readily available comparable data and costly for the taxpayer to ensure compliance. A functional analysis is required to be undertaken and the draft IN sets out the following factors that need to be taken into account:
    - The funding structure – source of funds, dates of transactions, repayment terms, reasons why the funds have been obtained;
    - The business and the industry it operates in;
    - Financial strategy of the business including the sources of funding of cash flows for repayment, changes in funding transactions;

- The group companies that are involved in the transaction or have been impacted as a result of the transaction;
- The taxpayer's current and projected financial position including the assumptions used in this projection. This projection can be for a stipulated period of time;
- Financial ratios for example Debt:EBITDA, interest cover ratio, debt: equity ratio;
- Indicators of creditworthiness to the extent that this information is available;
- The availability and quantum of any security
- Any subordination terms
- Terms of the funding arrangement including repayments, period of funding and the costs of funding.

The taxpayer then undertakes to compare this data to the terms of the financial assistance in order to support the position the taxpayer has taken.

- *Classification of debt versus equity*

  SARS if of the view that the economic substance of an item would need to be considered in order to determine what constitutes debt versus equity or partly debt and partly equity (SARS 2013). SARS considers the classification in terms of IFRS to be a good starting point however all facts and circumstances would need to be taken into account.

- *Determination of whether the interest is at arm's length*

  The draft IN cautions that focus must be given not only to the value of financial assistance but also to the interest rate applicable to the transaction. A taxpayer may have an amount that is at arm's length however the interest rate may not be at arm's length. To this effect the taxpayer's credit rating may be used using rating agency data bases based on the current and projected financial position of the taxpayer. A poor credit rating would be indicative of high risk and thus high interest rates should be associated with the financial assistance.

Conclusion

The OECD supports the arm's length approach as a best practice over the fixed ratio approach. The fixed ratio approach has been criticised as being restrictive and not flexible to the industry of the taxpayers. It is however widely used and there are recommended ratios to address the risk of BEPS.

Sweidan states that the simplification of the rules with a view of reducing the administrative burden for taxpayers should be high on the list of priorities for the government. The method that is employed should be thought out in detail, with consideration of profit levels and regular publications of arm's length ranges. Competent authority support should be made available, profit level indicators should be considered and anti-abusive rules be taken into account. SARS should not be concerned about whether or not to apply a safe harbour rule but rather the focus should be on how to apply it (Sweidan 2014).

The challenges with the arm's length approach would be the ability to locate comparable data that is regularly available as well as being sufficiently comparable. The process is far too subjective and based on a number of factors both quantitative and qualitative.

The current guidance offered still remains unclear in its practical application and poses a significant administrative burden to the taxpayers.

Historically, as noted above South Africa followed a simple approach determined with reference to a formula in order to assess whether the level of debt was acceptable or not. (Chong and Miller). This was contained in PN2 and despite a significant change in the transfer pricing rules effective on 1 April 2012 which had the effect of making PN2 redundant, the practice note has not been officially withdrawn (Chong and Miller 2018). Instead SARS issued a draft interpretation note which was intended to replace PN2 however as this still remains in draft taxpayers are faced with two conflicting pieces of legislation, neither of which have legislative teeth. The above analysis indicates that there is a need to have a solid piece of legislation in order to ensure that taxpayers are able to comply but also in a cost-effective manner.

Withholding tax on interest

The Taxation Laws Amendment Act 31 of 2013 amended the Act by the insertion of Part IVB in Chapter II of Act 58 of 1962 to introduce a withholding tax on interest (National Treasury 2015). With effect from 1 March 2015, withholding tax on interest from a South African source paid to a non-resident came into effect. The non-resident as defined in section

50A of the Act will be liable for the tax on any interest that has been received or accrued (Haupt 2018:593).

Section 50B of the Act states that the withholding tax needs to be levied at a rate of 15per cent of the amount of interest paid for the benefit of a foreign person if the interest is regarded as being from a South African source (Haupt 2018:593). The source rules are determined with reference to section 9(2)(*b*) of the Act as set out in section 50B. The source rules apply in the following cases:

- The interest is paid by a South African resident provided it is not connected to an offshore permanent establishment or
- Where the funds are used in South Africa.

The interest is deemed to be paid on the earlier of the date that on which the interest is paid or becomes due and payable (section 50B(2). The interest paid is the final tax (section 50B(3)) (Haupt 2018:593).

Section 50C states that the foreign person will be liable for the tax, even though it has been withheld and paid on behalf of the foreign person by the South African resident (Haupt 2018:593).

The exemptions from withholding tax on interest as follows as set out in section 50D (Haupt 2018:593):

- if paid by the government of the Republic in the national, provincial or local sphere, or by any bank, the South African Reserve Bank, Development Bank of South Africa or the Industrial Development Corporation;
- if paid by a headquarter company in respect of the granting of financial assistance as defined in s 31(1) to which that provision does not apply as a result of the exclusion in s 31(5)(*a*);
- if paid in respect of a listed debt
- if payable as envisaged in s 21(6) of the Financial Markets Act 19 of 2012 to any foreign person who is defined as a client in terms of s 1 of that Act.
- paid to a foreign person in respect of a debt owed by another foreign person unless:
    - the other foreign person is a natural person who was physically present in the Republic for a period exceeding 183 days in aggregate during the twelve-month period preceding the date on which the interest is paid; or

    - the debt claim in respect of which the interest is paid is effectively connected with a permanent establishment of B in the Republic if B is registered as a taxpayer in terms of Chapter 3 of the Tax Administration Act.
- if paid to:
    - the African Development Bank established on 10 September 1964;
    - the World Bank established on 27 December 1945 including the International Bank for Reconstruction and Development and International Development Association;
    - the International Monetary Fund established on 27 December 1945;
    - the African Import and Export Bank established on 8 May 1993;
    - the European Investment Bank established on 1 January 1958 under the Treaty of Rome; or
    - the New Development Bank established on 15 July 2014.
- if the amount of interest is paid to any foreign person included in the income of a resident as is attributable to a donation, settlement or other disposition made by a resident as contemplated in section 7(8)(*a*).

A person who makes payment of interest to or for the benefit of a foreign person must withhold the withholding tax (section 50E(1)) (de Koker and Williams 2018:14.6). But no withholding is required

- to the extent that the interest is exempt; or
- where the foreign recipient has, by a date determined by the person making the payment (or if the person making the payment did not determine a date by the date of payment), submitted to the person making the payment a declaration in the prescribed form that the foreign recipient is, in terms of s 50D(3) or any double tax agreement, exempt from the withholding tax on interest.

A foreign person will be liable to pay the withholding tax to the Commissioner as well as submit the relevant return by the last day of the month following the month in which the interest payment has been made unless the tax has been paid by another person (section 50F) (de Koker and Williams 2018:14.6) .

Where the withholding tax is withheld because the necessary declaration was not made timeously by the non-resident, it must be refunded by the Commissioner if the declaration is submitted within three years after the date of payment of the interest. Section 50G(1) states that where:

- an amount is withheld from a payment of interest,
- a declaration of exemption or of a reduction in the rate of tax (as provided for in s 50E(2)(*b*) or (3)) is not submitted to the payer by the date of payment of the interest, but
- such a declaration is submitted to the Commissioner within three years after the payment of the interest covered by that declaration,

then so much of the amount that would not have been withheld had the declaration been timeously submitted, is refundable by the Commissioner to the payer (de Koker and Williams 2018: 14.6).

Section 50H states that If an amount of tax withheld by a person in respect of the withholding tax on interest is denominated in a foreign currency, the amount to be withheld and paid to the Commissioner must be translated to the currency of the Republic at the spot rate prevailing at the date of such withholding payer (de Koker and Williams 2018: 14.6).

The initial legislation did not contain a specific definition in relation to interest and the ordinary meaning of the word was used. The definition of interest was introduced by section 70 of the Taxation Laws Amendment Act 25 of 2015 to include in as defined with reference to section 24J as:

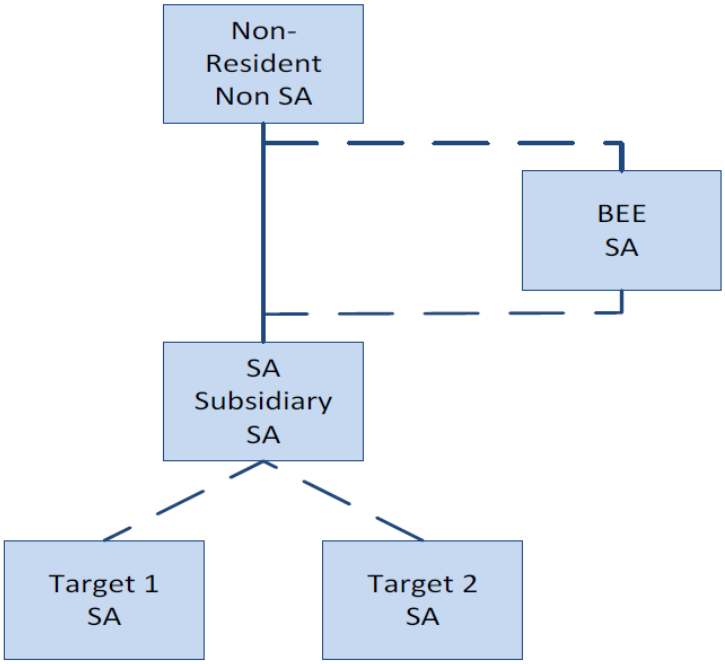
- gross amount of interest or similar charges, discount or premium payable in terms of or in respect of a financial arrangement
- amount or portion thereof payable by a borrower to a lender in terms of a lending arrangement as represents compensation for any amount to which the lender, but for such lending arrangement, have been entitled. (de Koker and Williams 2018: 14.6).

Conclusion

The DTC (2014:12) highlights that the OECD rejected the use of withholding taxes on interest as not being adequate for preventing BEPS relating to excessive interest unless the rates were aligned with the corporate tax rates (OECD 2015). The withholding tax rate is reduced to zero by most South African double tax agreements since the agreements have not been re-negotiated to achieve more favourable rates. Accordingly, a foreign lender was still able to advance funding from a jurisdiction which has a zero withholding tax rate in respect of interest earned from a South African source (OECD 2015). Despite the above rejection the

DTC still considered the WHT on interest provisions to be a mechanism in order to protect the South African tax base but would require the re-negotiation of a treaties to afford South Africa the taxing rights in respect of the interest. This is however a time-consuming process and so yet again, it is the recommendation of the DTC that this be done in a holistic manner where the objective is to achieve more than just one objective (DTC 2015:42). The DTC further highlights that the complexities in the legislation relating to cross-border debt is a discouragement to foreign investment. It highlights that there needs to be a balance between base erosion and the promotion of economic growth.

The DTC in an illustrative example highlights the complexities that a non-resident would face when investing in South Africa (DTC 2015:41):



The facts of the above scenario are as follows:

- foreign group intends to expands its operations into South Africa by acquiring investments
- it forms a local holding company and intends to provide funding to that company
- it has a choice between debt or equity funding subject to transfer pricing rules
- the acquisitions which the subsidiary may make could involve the application of the restructuring rules contained in section 45 and 47 of the Act.

The following factors would then need to be taken into account:

- Exchange control regulations to provide funding into South Africa (local holding company)
- The funding needs to take into consideration:
    - The requirements of section 11(*a*) – it must be in the production of income
    - Anti-avoidance provisions contained in section 8F and 8FA
    - Transfer pricing provisions contained in section 31
- If the parent company is not subject to tax on the interest it receives then section 23M will find application. This will impact cash flow of the local entity as the deduction in respect of the interest paid may be limited.
- Section 23N may find application if the funding is used in an acquisitions or re-organisation transaction
- Interest paid to the non-resident will be subject to WHT on interest. The relevant declarations and payments will also have to be made to the Commissioner
- The interest received by the non-resident may also be subject to tax in the country of its residency

The above illustrates that there are significant uncertainties regarding the deductibility of interest in any one year of assessment. The provisions of the Act could be complex for entities not having access to large, experienced in-house tax teams or the ability to outsource their tax function. The DTC recommended that there was a need to consider whether or not the number of provisions contained in the Act were warranted or whether this amounted to an 'over-kill' in the circumstances (DTC: 2015:44).

6. CONCLUSION

Aggressive tax planning by taxpayers has led to the erosion of the tax base in South Africa and has resulted in profits being shifted to low tax jurisdictions or tax havens. South Africa currently has numerous provisions in the Act that seek to address excessive deductions in respect of interest. Many of the policy recommendations by the DTC and OECD best practice approaches have been implemented in South Africa with a view of limiting the deductibility of interest and protecting the tax base. The combination of all the provisions seem to be more than adequate to address the concerns surrounding the deductibility of interest without the need for so many provisions. Currently the Act has in place the following provisions:

- Thin capitalisation rules – This is contained in section 31 of the Act with a radical change in the legislation effective in 2013. The rules move away from a safe harbour ratio of debt:equity of 2:1 contained in Practice Note 2 to the arm's length approach requiring taxpayers to benchmark the level of financial assistance and interest rates to market related comparable data in order to support the terms and conditions attaching to financial assistance
- Hybrid debt instruments – The purpose of the anti-avoidance legislation is to target debt instruments that have equity-like features i.e. loans or financial assistance that are in substance shares (or equity). Where the provisions of section 8F or section 8FA are triggered the interest on the instrument is deemed to be a dividend in specie and the issuer is not permitted to claim a deduction of the interest expense and the holder is deemed to have received a dividend (this income is treated as being exempt from tax and could then be subject to dividends tax).
- Section 23K – this section of the Act applied to re-organisation and acquisition transactions until its deletion where it no longer applied effective 1 April 2014.
- Section 23N – Section 23K was replaced by section 23N which has the effect of limiting the deductibility by the acquirer in an acquisition or reorganisation transaction.
- Section 23M – Applicable from 1 January 2015 limits the deductibility of interest payable to a creditor that is in a controlling relationship with a debtor. The section contains uncertainties due to the fact that 'subject to tax' has not been defined and the application of the provisions when relief is granted through the DTA. There is also no clear guidance on the interaction of section 23M and section 31 of the Act and thus

the need for an interpretation note is recommended. The benchmark ratio appears to be high in relation to the OECD recommendations and there are also concerns of the effect on the section in relation to foreign direct investment as the deductibility of interest by the local entities is limited increasing the overall effective tax rate.

- Withholding tax on interest – Effective from 1 January 2015 it is levied at a rate of 15 per cent on interest paid to a non-resident that is deemed to be from a South African source subject to certain exemptions as set out in section 50A- 50H of the Act. The rates can be reduced by application of the double taxation agreement between South Africa and the country of residency of the non-resident.
- Section 24J which contains the provisions relating to the incurral and accrual of interest and has been referred to as one of the most complex sections in the Act (ENS 2015). The section contains a large number of definitions which can hinder the ease of application. The section was recently amended to narrow the scope of what constituted 'interest'.

The Davis Tax Committee (2014:15) recommended that South African should seriously consider the costs by both local and foreign investors of complying with required tax legislation in relation to its benefits and the impact it has on doing business in South Africa. Instead of having a number of provisions in the Act that address the deductibility of interest, this should be considered holistically without the need for so many sections in the Act. There should be a careful balance of anti-avoidance provisions with a view of making them as investor friendly as possible.

Currently the Act seems to focus on a transaction (for example on hybrid debt instruments which are narrowly defined) basis rather than be principle focussed. A 'principle based' piece of legislation will have the effect of combatting BEPS in a wider context and allow taxpayers the ease of application. There is currently no indication that National Treasury intend to do this despite the recommendations of the DTC. The DTC in its interim report on BEPS assessed South Africa's tax policy in the promotion of inclusive economic growth, employment creation, development and fiscal sustainability (DTC 2015). The inability to do so could reduce the attractiveness of South Africa as a country of investment.

The DTC further recommends that the issue of the final IN on thin capitalisation be deferred until such time that a holistic evaluation of all the rules have been performed (DTC 2015). The DTC cautioned the need for South Africa to monitor the OECD recommendations on

domestic rules and ensure that the local legislation is aligned to the recommendations. The benefits of introducing complex legislation to combat BEPS needs to be weighed by the costs associated with its compliance, the necessity of having the legislation which needs to be easy to interpret, available to taxpayers and not unnecessarily voluminous. A good tax system is one where, amongst other things, taxpayers understand their obligation to the *fiscus* (DTC 2013).

The DTC notes in the interim report on BEPS that the current provisions and tax rules that regulate the finance and funding of entities, and specifically the deduction limitation rules, constitute over-regulation of this field (DTC 2015). The current provisions appear to be impractical for a taxpayer to comply with and this requires a balance to between the ease of application and the protection of the tax base. Whilst the DTC recognise that some deduction limitation rules are required the following were the findings noted in the Second Interim Report on BEPS:

- The current approach on the tax EBIDTA of borrowers results in false outcomes and disadvantages borrowers. This adversely affects the economy and reduces the investment by start-ups and certain industries. A group ratio rule as set out by the OECD Action 4 should be considered.
- The economy urgently needs certainty in regulations and ease of application in order to stimulate growth and foreign investment. Multiple and overlapping tax rules which limit the ability to leverage does not permit the above. The DTC recommends that only transfer pricing and interest withholding tax should be used to regulate cross-border group financing. The inclusion of deduction limitation rules in the Act discourages foreign investment.
- Taxpayers should be able to freely without prejudice choose which transaction they enter into and how this should be financed, to the extent that the transactions does not result in the erosion of the tax base. It is beyond the scope of the *fiscus* to limit the taxpayer's ability to transact in this manner.

In finalising the report the DTC recommended that SARS considers the following:

- Simplification of the current legislation
- Consistency with the international best practice as set out by the OCED recommendations
- Transfer pricing should take into account the relevance of parent credit ratings

- Reduction of the administrative burden for taxpayers where the risk of BEPS compliance is low by considering the following:
    - Use of safe harbour rules. This involves the introduction of a safe harbour in the form of a fixed ratio in section 31 or clear guidance in this regard in the draft IN. Non-resident (which bring about the investment in South Africa) will then have guidance as to acceptable levels of debt in relation to equity.
    - Thresholds for loan values or the introduction of thresholds where anything falling below this threshold would not require a taxpayer to comply with the regulations
    - Guidance on how to treat start-up companies where loan funding is needed
    - The costs of compliance for potential and current investors.

Whilst the limit on the deductibility is by no means a concept that is specific to South Africa only (as can be seen from global tax trends internationally) it seems that the South African legislation has some inadequacies that need to be addressed. The legislation is currently very broad and brings to question if this goes beyond the intention of the non-compliance or profit shifting that it originally intended to address. South Africa has so many interest rate limitations in the Act and there is a need to align these (Webber Wentzel 2018). The adverse impact of the above is the reduction in investment in the country. There are however mechanisms as highlighted in this report as well as recommendations of the DTC and OECD that will suffice to at least streamline the provisions contained in the Act to not only ensure ease of compliance but also for South Africa to remain attractive to investment.

The objective of the revenue authorities is to ensure that the tax policies in place are fair and do not prejudice any one taxpayer. It is recommended that the tax policies be reconsidered in this regard.

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