



UNIVERSITY OF THE WITWATERSRAND, JOHANNESBURG

**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 (TAXATION)**

**After the 2021 amendments to section 23M, what further
amendments are required in section 23M to align with BEPS
Action 4 recommendations?**

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ABSTRACT

Debt financing is an essential source of investment in South Africa as a country importing capital. As much as an economy in a good state depends on investments, taxpayers can use debt financing to create opportunities for base erosion and profit shifting (National Treasury, 2020a:5).

The use of interest deductions to fund tax-exempt income and tax relief obtained on the deduction of interest expense which is higher than the net interest expense of a group can also create opportunities and ways in which taxpayers erode the tax base (OECD, 2015:16).

Kruger (2015:12) noted that revenue authorities worldwide have been concerned for many years about the tax effect of debt financing, particularly what they perceive as debt funding that taxpayers utilise for tax avoidance and erosion of the tax base.

In order to combat base erosion, several foreign jurisdictions have enacted interest deduction limitations and anti-hybrid instrument provisions, and the Organisation for Economic Co-operation and Development (OECD) raised this issue as one of its focus areas on Base Erosion and Profit Shifting (BEPS) (Kruger, 2015:12).

Section 23N and s 23M became effective in the Income Tax Act 58 of 1962 (the Act) in South Africa between 2014 and 2015 respectively. Both of these provisions applied an interest limitation based on the ratio between the particular interest and a tax proxy for adjusted earnings before interest, taxes, depreciation, and amortisation (EBITDA) (Van der Zwan, Schutte and Krugell, 2018:1).

Kruger (2015:11) stated that:

'fiscal authorities around the world have been concerned for some time that excessive debt funding could lead to tax avoidance which is caused by a mismatch between the tax treatment of interest incurred and interest received, which could result in excessive deduction of interest expense.'

In the South African context, National Treasury also acknowledged in the 2013 Budget Review that, although debt financing might have a positive impact on a

healthier economy, taxpayers often use it to erode the South African tax base (National Treasury, 2013a:55).

In order to protect the South African tax base as far as excessive interest deductions are concerned, National Treasury introduced s 23M through the 2013 Taxation Laws Amendment Act No 13 of 2013, with effect of 1 January 2015.

In a joint project by the OECD and Group of Twenty (G20) on BEPS, it was identified that the deductibility of interest for purposes of calculating taxable profits should be one of the focus areas in order to counter BEPS, which was followed by the analysis and release of the final report titled *OECD/G20 Base Erosion and Profit Shifting Project: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4: 2015 Final Report (BEPS Action 4 Final Report)* (Van der Zwan *et al.*, 2018:1).

BEPS Action 4 contains recommendations for jurisdictions to implement the measures proposed to address the risks by interest payments and the related tax deductions to the corporate tax base (Van der Zwan *et al.*, 2018:1).

The purpose of this report is to examine how closely the South African interest limitations rules contained in s 23M align with BEPS Action 4 recommendations and to the extent that s 23M and BEPS Action 4 are not aligned, the report will determine further amendments that are required in s 23M of the Act to align with the BEPS Action 4 recommendations.

The research includes a comparison of s 23M and BEPS Action 4 recommendations before the 2021 amendments to s 23M; discussion of the 2021 amendments to s 23M; analysis of the current differences and similarities between s 23M and BEPS Action 4 recommendations; and discussion of what further amendments are required in s 23M to align with BEPS Action 4 recommendations.

Keywords: anti-avoidance, base erosion, controlling relationship, interest deduction, interest limitation rules, BEPS, BEPS Action 4 recommendations, debt, EBITDA, excessive interest, interest deductibility, OECD, s 23M.

DECLARATION

I declare that this research report is my own unaided work. It is submitted for the degree of Master of Commerce (specialising in Taxation), at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination at any other university.

Ndawoyakhe Busakwe

30 June 2023

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ABBREVIATIONS AND ACRONYMS

ATAF	African Tax Administration Forum
BEPS	Base Erosion and Profit Shifting
CFC	Controlled foreign company
EBITDA	earnings before interest, taxes, depreciation, and amortisation
G20	Group of Twenty
OECD	Organisation for Economic Co-operation and Development
REIT	real estate investment trust
s	means a 'section' of the Income Tax Act No 58 of 1962
SARS	South African Revenue Service
The Act	Income Tax Act No 58 of 1962

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CHAPTER 1 – INTRODUCTION

1.1. Background

In terms of the general principles of interest expense deduction, a South African taxpayer may claim an income tax deduction for interest expenditure in terms of the provisions of s 24J(2) of the Act. In terms of s 24J(2) of the Act, interest expenditure is deductible from the income which is derived from carrying on any trade and only if such interest expenditure was incurred in the production of income.

Notwithstanding the general principles outlined above, s 24O(2) deems interest incurred in the acquisition of certain shares to be in the production of income and laid out for the purposes of trade and hence deductible.

ENSAfrica Tax (2020:1) noted that:

'to determine the deductibility of interest incurred on a loan, it is necessary to determine whether monies outlaid constitute expenditure incurred in the production of income, requiring a consideration of the purpose of the expenditure, and what the expenditure actually effects. In this determination, a court will assess the closeness of connection between the expenditure and the income-earning operations of the taxpayer, and if the purpose is to apply the funding to produce income that is taxable, the interest expenditure incurred will be deductible (ENSAfrica Tax, 2020:1).'

The tax implications relating to interest are among the most intricate areas of taxation. This is because interest is unique in nature, as interest could be revenue or capital for tax purposes. Tax residency of the creditor receiving interest income and the debtor incurring interest expense is essential in determining when and where interest accrues and is incurred (Legwaila, 2022:2).

Many countries around the world have included various anti avoidance provisions in their tax legislation to limit the potential avoidance and evasion of tax through excessive deductions of interest expense (Legwaila, 2022:2).

In the 2013 Budget Review, National Treasury stated that, although debt financing is a feature of all healthy economies, debt is often used to erode the tax base and that closure of this artificial and excessive debt had been on the tax policy agenda for more than two years at the time. National Treasury further stated that in order to

bring this matter to a conclusion, the government proposed that limits would be imposed so that the interest on this form of debt did not exceed 40% of earnings after interest on other debts was taken into account and excess interest would be allowed to roll over for up to five years (National Treasury, 2013a:55).

National Treasury (2013b:37) stated that:

'Deductible interest paid to foreign (and other exempt) persons represents a risk to the fiscus because of the deduction/exemption mismatch. This mismatch leads certain parties to over-leverage because of the overall tax benefits. In view of these concerns, the tax system contains anti-avoidance measures to prevent this deliberate and excessive mismatch. At the end of the day, a balance is required between attracting debt capital and the protection of the tax base against base erosion.'

After the proposals mentioned in the 2013 Budget Review, National Treasury introduced s 23M to the Act through the Taxation Laws Amendment Act No 31 of 2013. In 2013, National Treasury stated (2013b:37) that

'It is proposed that the aggregate deductions for interest that is not subject to tax in the hands of the person to whom the interest accrues be subject to a limitation if a "controlling relationship" exists between the debtor and the creditor.'

The interest limitation is determined using a formula in s 23M(3). National Treasury stated that the aggregate deduction for interest paid or incurred concerning a debt owed to a person that is in a controlling relationship with a debtor who incurred the interest expense would be subject to the interest limitation rules in s 23M, which were determined using a formula which contained a 40% limitation on the adjusted taxable income (National Treasury, 2013b:37).

Deductible interest payments pose a risk to the tax base as this deduction reduces the taxable income of the payer. In contrast, the taxable income of the recipient increases. Suppose the recipient is non-taxable or is taxed at a lower rate resulting from applying a double tax agreement between South Africa and the recipient's country of residence. In that case, this can erode the overall tax base in South Africa (Stiglingh, Koekemoer, van Heerden, Wilcocks and van der Zwan 2022:562).

The risk of base erosion, as described above, materialises when a deduction is granted in respect of interest paid to a person who will not be subject to tax on the interest received, as recipients who are not subject to tax on the interest received include persons whose receipts and accruals are exempt from tax, for example pension funds or foreign persons in whose hands the interest is exempt (Stiglingh *et al.*, 2022:562). With effect of 1 January 2015, s 23M of the Act was introduced to address this risk of base erosion through excessive interest deductions and to limit the amount of interest that may be deducted when interest is paid to certain persons who are not subject to tax (Stiglingh, *et al.*, 2022:562).

Van der Zwan, *et al.*, (2018:1) stated that as part of the OECD and Group of Twenty (G20) project on BEPS, the OECD identified the deductibility of interest for purposes of calculating taxable profits as one of the areas that required attention to counter BEPS and this led to the drafting and finalisation of *BEPS Action 4 Final Report*.

Van der Zwan, *et al.* (2018:1) further stated that:

'chapter 1 of the BEPS Action 4 Final Report contains recommendations for governments to implement proposed measures to address the risks posed to the corporate tax base by interest payments and related tax deductions. The suggested approach includes a general interest limitation based on an interest-to-profit ratio which is coupled with de minimis exclusion rules, exceptions for highly geared groups, and specific anti-avoidance rules to target identified instances not addressed by the general interest limitation rule.'

The Davis Tax Committee pointed out in its Final Report on BEPS in 2016 that, limiting base erosion and profit shifting due to interest deductions is a high priority for South Africa due to the potential risk of loss to the fiscus because of tax avoidance strategies implemented by multinationals (Davis Tax Committee, 2016:1). In the 2017 Budget Review, the National Treasury stated that in relation to South Africa's position on BEPS Action 4, the government was at the time strengthening its efforts to curb excessive debt financing, which erodes the tax base, and review the current regime in light of OECD recommendations (National Treasury, 2017:50).

In the 2019 Budget Review, the National Treasury stated that, although South Africa had measures in place to curb excessive debt financing, the government was

reviewing these rules against OECD best practice, and that it was important to strike a balance between attracting capital and investment, and adequately protecting the corporate tax base (National Treasury, 2019:45).

Ernst & Young (2020:1) noted that the National Treasury published the 2020 Budget Review together with a discussion document titled *Reviewing the Tax Treatment of Excessive Debt Financing, Interest Deductions and Other Financial Payments (2020 Discussion Document)* aimed at curtailing excessive corporate interest deductions, and stated that the policy rationale for the proposal was to align the interest limitation rules in s 23M with OECD's BEPS Action 4 recommendations, considering South Africa's need to attract investment and fund existing businesses.

Ernst & Young (2020:1) stated further that the *2020 Discussion Document* proposed that the existing provisions of s 23M at the time be amended and replaced with a new set of rules. The proposals provide that:

- Section 23M will apply to all entities operating in South Africa that are part of the same group of companies as defined in s 1 of the Act.
- Taxpayers should apply the transfer pricing provisions in s 31, and then the interest limitations provisions will follow. This ordering of the rules means interest limitation rules should be applied after the arm's-length test has been conducted on the excessive interest.
- The interest deductibility on a connected person and third-party debt will be limited to 30% of the entity's tax EBITDA.
- The excessive interest determined after the application of s 23M(2) may be carried forward under s 23M(4), on a first-in-first-out basis, for a maximum period of five years.
- The introduction of transitional rules to address existing third-party loans will be considered.
- A *de minimis* rule is tentatively proposed, which could see entities with a net interest expense below a certain threshold (suggested at between R2 million and R5 million) being excluded from the new rules.

- Section 23N, an existing targeted interest limitation rule, will be retained.

National Treasury stated in the *Explanatory Memorandum to the Taxation Laws Amendment Act 20 of 2021* that the government published a *2020 Discussion Document* to analyse the limitation of interest deductions in respect of debts owed to persons not subject to tax in s 23M, in line with BEPS Action 4 (National Treasury, 2021b:16).

During the writing of this research report, National Treasury published the 2023 Budget Review on 22 February 2023 which contained certain proposals to amend s 23M. At the time of finalisation of this research report, the draft amendment bill containing these proposals had not been published by National Treasury; however these will be discussed in Chapter 5.

1.2. The Research Problem

1.2.1. Research Question

The research report will discuss, after the 2021 amendment to s 23M, what further amendments are required in s 23M to align with BEPS Action 4 recommendations.

1.2.2. The Sub-Questions

The research question will be addressed by the following sub-questions:

- How did s 23M and BEPS Action 4 recommendations compare before the 2021 amendments?
- What were the 2021 amendments made to s 23M to align with BEPS Action 4 recommendations?
- What are the current similarities and differences between s 23M and BEPS Action 4 recommendations after the 2021 amendments?
- What further amendments are required in s 23M to align with BEPS Action 4 recommendations?

1.3. Research Methodology

The research method adopted will be qualitative in nature. The primary sources to be analysed will include the South African tax legislation, OECD material, books, journal articles and government publications.

CHAPTER 2 – COMPARISON OF SECTION 23M WITH THE BEPS ACTION 4 RECOMMENDATIONS BEFORE THE 2021 AMENDMENTS

2.1. Prior to the introduction of s 23M on 1 January 2015

Breslin (2021:1) stated that before the introduction of BEPS Action 4, the most common approach taken by African tax authorities (including South Africa) for addressing the profit shifting risk was through a fixed ratio thin capitalisation rule, and this approach linked interest deductibility to the level of equity in an entity by using the debt-to-equity test.

Breslin (2021:1) further stated that this method did not necessarily have the intended impact because the debt-to-equity test allowed significant flexibility in terms of the interest rates that an entity was charged on debt, which had the effect of multinational groups claiming excessive interest deductions by charging relatively high interest rates on debt.

In the South African context, National Treasury (2013b:37) stated that:

‘debt equity ratio rule of 3:1 had to be changed in favour of a more facts and circumstances approach so as to satisfy international transfer pricing standards, National Treasury added that the 3:1 debt limit also allowed for debt levels that are far too great with the prior rule arguably encouraging debt limits to the 3:1 level.’

The Davis Tax Committee pointed out in its final report on BEPS in 2016 that South Africa had various anti-avoidance provisions in the South African tax legislation in order to curb tax avoidance using interest and other similar instruments (Davis Tax Committee, 2016:1). The anti-avoidance provisions include transfer pricing and thin capitalisation in s 31, hybrid debt instrument rules in s 8F / s 8FA and the interest limitation rules in s 23M and s 23N (Davis Tax Committee, 2016:1).

Concerning thin capitalisation, Legwaila (2022:11) stated that thin capitalisation refers to the practice of funding a connected party with excessive debt in order to obtain the tax benefit of the deductibility of a higher amount. Until 2012, South Africa applied debt to equity ratio of 3:1, also known as the safe harbour, which meant taxpayers could deduct interest on debt up to three times their capital investment. The safe harbour rules were applicable to years of assessment commencing before 1 April 2012. Legwaila (2022:11) further stated that in April 2012, the thin

capitalisation rules were strengthened by incorporation into the transfer pricing rules, which are contained in s 31(2) / s 31(3) of the Act, which focuses on international transactions, operations, schemes, arrangements or understandings effected between or undertaken for the benefit of connected persons, and this is applicable for years of assessment commencing on or after 1 April 2012.

National Treasury deleted the specific thin capitalisation rules contained under s 31. Since then, thin capitalisation practises formed part of the general arm's length principle under the general transfer pricing provisions of s 31 (Bowmans, 2023:1)

In relation to transfer pricing, Legwaila (2022:11) added that transfer pricing rules allow the South African Revenue Service (SARS) to apply the arm's length test and determine the tax consequences of affected transactions between connected persons.

The terms 'connected person' and 'affected transaction' are important in the application of transfer pricing rules and both these terms are defined in s 1 and s 31 of the Act respectively.

Legwaila (2022:11) briefly explains what constitutes an affected transaction: it is a transaction that, when entered into, would effectively have an impact on the fiscus, either by shifting income from South Africa to another country, or through the increase of the deduction, i.e., interest expense creating a tax benefit for the South African taxpayer.

Legwaila (2022:11) stated that the transfer pricing rules in s 31 apply to an affected transaction entered between:

- a resident person and a non-resident person;
- a non-resident person and another a non-resident person that has a permanent establishment in South Africa to which the affected transaction relates;
- a resident person and a non-resident person that has a permanent establishment in South Africa to which the affected transaction relates; and

- a non-resident person and another person that is a controlled foreign company in relation to any resident, and those persons are connected person in relation to one another.

Section 31(2) applies where an affected transaction, as defined in s 31(1), is entered into by connected persons and results in a tax benefit. The taxable income or tax payable by any person forming part of that affected transaction must be calculated as if that transaction had been entered into on the terms and conditions that would have existed had these persons been independent persons dealing at arm's length (Legwaila, 2022:11).

Kruger (2015:13) stated that:

'it was acknowledged that the transfer pricing provisions in s 31 the withholding tax on interest provisions which were introduced with effect from 1 March 2015 to provide protection against tax avoidance using debt funding structures could lead to non-taxation of interest income accruing to the recipient and a deduction of interest by the payor of the interest expense. The revenue authorities decided that the current methods to limit excessive interest deductions that were in respect of debts owed to persons who were exempt from tax largely contained many gaps; it was therefore proposed that interest deductions in respect of debts to persons not subject to tax be subject to a limitation if a controlling relationship existed between the debtor and the creditor.'

2.2. Provisions for deductibility of interest and anti-avoidance to curb the abuse of excessive interest

The South African tax legislation contains provisions for deductibility of interest and various anti-avoidance provisions that are aimed at limiting the abuse and deduction of excessive interest. These provisions are summarized below.

Section 24J – deductibility of interest

- A South African taxpayer may claim an income tax deduction for interest expenditure in terms of the provisions of section 24J(2) of the Act. In terms of section 24J(2) of the Act, interest expenditure is deductible from the income which is derived from carrying on any trade if and only if such interest expenditure was incurred in the production of income.

Section 24O – deductibility of interest

- Section 24O(2) of the Act deems interest incurred in the acquisition of certain shares to be in the production of income and laid out for the purposes of trade and hence deductible, provided that certain requirements contained in that section are met.

Section 23N – anti-avoidance

- Section 23N of the Act contains interest limitation rules in respect of reorganisation transactions, which mean s 45 intra-group transactions and s 47 liquidation distributions, and acquisition transactions as defined in s 24O. Section 23N(2) limits interest deductions in respect of debt applied to fund reorganisation and acquisition transactions.

Section 8F / 8FA – anti-avoidance

- The South African tax legislation contains specific anti-avoidance rules for debt instruments that have equity-like characteristics and interest amounts which are not founded on any debt instrument as such. These rules are contained in s 8F and s 8FA.
- Where these rules apply, s 8F(2) and s 8FA(2) provide that any amount of interest incurred by a company, on or after the date that the instrument becomes a hybrid debt instrument, or on or after the date that the interest becomes hybrid interest, is deemed to be a dividend *in specie* in respect of a share that is declared and paid by that company to the person to whom that amount accrued, and that amount incurred is not deductible.

2.3. Introduction and application of s 23M

Section 23M was introduced into the Act with effect of 1 January 2015 by the 2013 Taxation Laws Amendment Act No 31 of 2013, which provided that the aggregate deduction for interest not subject to tax in the hands of the creditor whom the interest accrues be subject to a limitation if a 'controlling relationship' exists between the debtor and the creditor (National Treasury, 2013b:37).

Section 23M(2) of the Act limits the amount of interest deducted by a taxpayer who incurred an amount of interest as defined in s 23M(1) in respect of a debt owed to a creditor that is not subject to tax in South Africa, and a creditor that is in a controlling relationship with a debtor, or a creditor that is not in a controlling relationship with that debtor, if that creditor obtained the funding for the debt advanced to the debtor from a person that is in a controlling relationship with that debtor (Legwaila, 2022:14).

2.3.1. Section 23M(2)

Haupt and Haupt (2023:485) stated that s 23M(2) is the operative provision and it limits interest deductions by a South African resident debtor and by certain non-resident persons if:

- a creditor is in a controlling relationship with a debtor;
- a creditor that is not in a controlling relationship with a debtor, if that creditor obtained the funding for the debt from a person that is in a controlling relationship with the debtor;
- a creditor that is not in a controlling relationship with a debtor, if that creditor and the debtor would be part of the same group of companies if by the expression 'at least 70% of equity shares in' paragraph (a) and paragraph (b) of the definition of group of companies in s 1(1) of the Act were replaced by the expression 'more than 50% of equity shares or voting rights in'; or
- a creditor that is in a controlling relationship with a debtor if that creditor directly or indirectly through another creditor that is a controlling relationship with that creditor obtained the funding for the debt advanced to the debtor from a person that is in a controlling relationship with that creditor or the other creditor; and
- the amount of the interest is not subject to tax in South Africa in the hands of the creditor / lender, nor included in the net income of a controlled

foreign company as contemplated in s 9D, and not disallowed under s 23N.

Legwaila 2022:14 stated that:

‘the s 23M(2) applies limitation of deduction if the amount of interest incurred is not subject to tax in the hands of the person to whom the interest accrues or is included in the net income of a controlled foreign company as contemplated in s 9D in the foreign tax year of the controlled foreign company commencing or ending in that year of assessment. Additionally, the amount of interest incurred should not be disallowed under s 23N of the Act.’

Section 23M is aimed at effectively focusing the attention of the limitation of deductibility on payments made by South African tax residents or out of income that could be taxable in South Africa, and this provision ensures the protection of the South African tax base (Legwaila, 2022:14).

In order for s 23M to apply, the provisions of s 23M(2) should be complied with; and the provisions of s 23M(6) described in section 2.2.4. below, which contain the exemptions, should not apply.

Furthermore, s 23M(1) contains some important definitions which include the definition of a debt, debtor, controlling relationship and interest. Some of the important definitions contained in s 23M(1) of the Act are provided below.

‘controlling relationship means a relationship where—

- (a) a person, whether alone or together with any one or more persons that are connected persons in relation to that person; or
- (b) persons that are connected persons in relation to that person,

directly or indirectly hold at least 50 per cent of the equity shares or can exercise at least 50 per cent of the voting rights or participation rights, in a company;

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

‘debtor means a person that incurs an amount of interest and—

- (a) *is a resident; or*
- (b) *in the case of a person that is not a resident, owes a debt that is effectively connected with a permanent establishment of that person in the Republic;’*

‘interest means interest as defined in section 24J, and includes—

- (a) *amounts incurred or accrued under any “interest rate agreement” as defined in section 24K (1);*
- (b) *any finance cost element recognised for purposes of IFRS in respect of any lease arrangement that constitutes a finance lease as defined in IFRS16;*
- (c) *amounts taken into account in determining taxable income in terms of section 24I (3) and (10A); and*
- (d) *any amount deemed to be interest under section 24JA,*

but excludes any amount that is deemed to be a dividend in specie as contemplated in sections 8F and 8FA;’

These are important in the interpretation and application of s 23M(2). The current provisions of s 23M(1) do not contain the definition of a creditor. However, in the 2023 Budget Review, National Treasury announced that government made a proposal that the definition of a creditor be added to s 23M (National Treasury, 2023:145).

In essence, where a debtor and creditor are in a ‘controlling relationship’ as defined in s 23M(1), and the amount of interest payable by the debtor to the creditor is not subject to tax in the hands creditor to whom interest income is received or accrued, or included in the net income of a controlled foreign company under s 9D, the amount of interest that may be claimed by the debtor is limited to an amount determined in terms of a formula provided for in s 23M(3) of the Act (Kruger, 2015:13).

Mbana (2022:26) noted that the provisions of s 23M generally apply in circumstances where the creditor is a foreign holding company of the South African debtor and is not subject to tax on the interest income from South Africa. In contrast, the debtor would be allowed to deduct the interest against its taxable income, thus reducing the group's tax liability, and therefore such structures result in the erosion of the South African tax base. Mbana (2022:26) further stated that the provisions of s 23M can also apply where the creditor is a South African tax resident company that is exempt from tax, for instance, if it is a public benefit organisation as contemplated in s 30 of the Act and has a controlling relationship with the debtor.

2.3.2. Calculation of the interest limitation in s 23M(3)

Section 23M(3) of the Act provides that:

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

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

(b) an amount determined by multiplying the adjusted taxable income of that debtor for that year of assessment by 0,3.

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

Haupt and Haupt (2023:486) state that the amount of interest that is deductible as set out in s 23M(3) is calculated as follows:

Amount of interest (gross) income received of the debtor	Rxx xxx
Plus: Adjusted taxable income (as defined below) x 0,3	xx xxx
Less: Interest incurred on non s 23M debts (reduced by s 23N)	<u>(xx xxx)</u>
Deductible interest of the debtor	<u>Rxx xxx</u>

Adjusted taxable income is defined in s 23M(1) of the Act as follows:

‘adjusted taxable income means taxable income calculated before applying this section—

(a) *reduced by—*

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

(b) *with the addition of—*

- (i) *any amount of interest incurred that has been allowed as a deduction from income;*
- (ii) *any amount allowed as a deduction in terms of this Act in respect of a capital asset as defined in section 19 for purposes other than the determination of any capital gain or capital loss;*
- (iii) *any assessed loss or balance of assessed loss allowed to be set off against income in terms of section 20, before applying this section; and*
- (iv) *any qualifying distribution as defined in section 25BB that is deductible under subsection (2) of that section.’*

According to Legwaila (2022:16), the definition of adjusted taxable income above is crucial in the determination of what amount would be allowed as a deduction.

Haupt and Haupt (2023:485) note that the most important definition in s 23M is the definition of ‘adjusted taxable income’ which has changed for years of assessment ending on or after 31 March 2023. Haupt and Haupt (2023:485) provide the simplified version of the definition of ‘adjusted taxable income’ below:

<i>Taxable income</i>	<i>R xx xxx</i>
<i>Less: Interest received / accrued</i>	<i>(xxx)</i>
<i>S 9D(2), CFC income</i>	<i>(xx)</i>
<i>Capital recoupments</i>	<u><i>(xx)</i></u>
	<u><i>R xx xxx</i></u>
<i>Add: Interest expenditure deducted</i>	<i>xxx</i>
<i>Capital allowances</i>	<i>xx</i>
<i>Assessed loss brought forward or from other trades</i>	<i>xx</i>
<i>S 25BB REIT qualifying distributions</i>	<u><i>xx</i></u>
<i>Adjusted taxable income</i>	<u><i>R xx xxx</i></u>

2.3.3. Carry-forward provisions in s 23M(4)

Section 23M(4) of the Act contains carry-forward provisions which provide that:

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

Any interest in excess of the limitation may be carried forward to the succeeding year of assessment which will be deemed to be interest incurred in that particular year of assessment, and its deductibility must be assessed in light of the interest limitation deduction in terms of s 23M that applies to that year of assessment. There is no expiry period on the carrying forward of these interest amounts (Stiglingh, *et al.* (2021:564).

2.3.4. Section 23M(6) – exclusions

Section 23M(6) of the Act contains exclusions to the application of s 23M(2) and provide that:

‘(6) This section does not apply—

- (c) to so much of the interest as is incurred by a debtor in respect of a debt owed to a creditor as contemplated in subsection (2) where—*
 - (i) that creditor funded that debt amount advanced to that debtor with funding granted by a lending institution that is not in a controlling relationship with that debtor; and*
 - (ii) that interest is determined with reference to a rate of interest that does not exceed the official rate of interest plus 100 basis points.*
- (d) to any interest incurred by a debtor in respect of any linked unit that is held by a creditor as contemplated in subsection (2) where that creditor is a long-term insurer as defined in the Long-term Insurance Act, a pension fund or a provident fund, if—*
 - (i) the long-term insurer, pension fund or provident fund holds at least 20 per cent of the linked units in that debtor;*
 - (ii) the long-term insurer, pension fund or provident fund acquired those linked units before 1 January 2013; and*
 - (iii) at the end of the previous year of assessment 80 per cent or more of the value of the assets of that debtor, reflected in the annual financial statements prepared in accordance with the Companies Act for the previous year of assessment, is directly or indirectly attributable to immovable property.’*

Haupt and Haupt (2023:485) state that s 23M(6) sets out when the interest limitation rules in s 23M do not apply. Careful consideration has to be given to these provisions before s 23M is applied.

2.3.5. Section 23M vs transfer pricing rules in s 31

Both s 23M and s 31 of the Act are anti-avoidance provisions which are aimed at disallowing excessive interest deductions by taxpayers. Since the inception of s 23M, there has been a question about the interaction between s 23M and s 31 and around the priority or sequence of application of these provisions, more specifically noting

that the Act does not expressly deal with the question of which takes priority over the other (PwC, 2022b:1).

SARS *Interpretation Note 127* provides that:

‘Section 31 applies prior to considering the impact, if any, of s 23M and s 23N. This is apparent from the wording in section 31, s 23M and s 23N and if the requirements of s 31 are met, s 31(2) requires that taxable income must be calculated as if the affected transaction had been entered into [at] arms’ length terms and conditions’ (SARS, 2023:37).

The SARS *Interpretation Note 127* further provides that:

‘in calculating taxable income, and therefore the amount that is prima facie deductible, s 31(2) requires the application of the arm’s length principle and since s 31 is applied in calculating taxable income and, if applicable, would have an impact on the amount received or accrued that is part of taxable income, and that is incurred and has been allowed as a deduction, it is clear that s 31 applies before s 23M or s 23N’ (SARS, 2023:37).

The above makes it clear that SARS is of the view that s 31 will be applied first before the interest limitation rules in s 23M and s 23N can be applied.

Kruger (2015:20) stated that:

‘given that the limitation in s 23M requires the determination of the taxpayer’s taxable income, and such taxable income can only be determined after the application of s 31. However states that it may be argued that s 23M should be applied before s 31, as it may be that after the application of those provisions, the taxpayer may not have derived a ‘tax benefit’ as contemplated in s 31, resulting in s 31 not being applicable, and given that s 23N and s 23M require as starting point a determination of the taxpayer’s taxable income, it would be argued that s 31 should be applied to determine the taxpayer’s taxable income prior to application of the other two provisions.’

PwC (2022b:2) express a different view that s 23M should be applied first and s 31 thereafter, and that it is inherently more sensible, efficient and business-like to apply the objective and more certain s 23M before applying s 31. After a detailed analysis to support the view above, in conclusion PwC (2022b:2) state that where the

provisions of s 23M and s 31 of the Act apply to the same inbound loan, the approach should be to first attempt to read the provisions of these sections together, which would mean firstly applying the statutory formula set out in s 23M. PwC (2022b:2) further state that the provisions of s 31(2) of the Act would then be applied to the same debt, and a determination made as to whether there is a tax benefit (after applying s 23M and any other provisions of the Act) and whether the arrangement constitutes an affected transaction.

Mazansky (2015:184) shares a similar view to PwC that, given that s 23M incorporates an amount easily determined in terms of a fixed formula, whereas the transfer pricing rules are heavily dependent on facts and circumstances and are determined through analysis of comparable data, in the event of any conflict, s 23M of the Act should, in his view, prevail over s 31.

As can be seen above, SARS' (2023) view is different from what PwC and Mazansky have expressed. The SARS view was expressed in its interpretation note which is similar to Kruger's (2015) view that the transfer pricing rules in s 31 should be applied first prior to the application of s 23M and s 23N.

As stated in the case of *Commissioner for SARS v Marshall NO 2017 (1) SA 114 (SCA)*, interpretation notes, although not binding on the courts or a taxpayer, constitute persuasive explanations in relation to the interpretation and application of the statutory provisions in question. With that being said, taxpayers can rely on interpretation notes as SARS guidance on a particular issue in legislation; however the same cannot be used in court as it is not law (*CSARS v Marshall*, 2017:13).

2.4. Background to BEPS Action 4

Several academic studies have established that taxpayers can use tax rules to influence where debt is located within sizeable multinational group entities, and it has been established that groups can use group financing to increase the level of debt within the group. Taxpayers can escape tax measures aimed at restricting interest deductibility by using financial instruments to make payments which are economically equivalent to interest but have a different legal form (OECD, 2015:11).

The OECD (2015:19) noted at the time that prior to BEPS Action 4 recommendations, countries already had existing rules in place to counter BEPS and they formed part of six comprehensive groups, with some jurisdictions using a collective approach which includes more than one type of rule:

- Transfer pricing, which compares the level of interest or debt in an entity with a situation that would have existed had the entity been dealing with unrelated parties.
- Withholding tax on interest provisions which collect tax.
- Rules which restrict a specified percentage of the interest expense paid or incurred by entity, irrespective of the nature of the payment or to whom it is made.
- Interest limitations rules or rules which limit debt in an entity with reference to a fixed ratio, such as debt / equity, interest / earnings or interest / total assets.
- Interest limitations rules, or rules which limit debt in an entity with reference to the group's overall position.
- Targeted rules which disallow the deduction of interest expense on specific transactions.

The OECD (2015:11) states that BEPS risks in this area may arise in three basic scenarios:

'Multinational groups placing higher levels of third party debt in high tax countries.

Multinational groups using intragroup loans to generate interest deductions in excess of the group's actual third party interest expense.

Groups using third party or intragroup financing to fund the generation of tax exempt income.'

To address these risks, BEPS Action 4 recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, and

the *BEPS Action 4 Final Report* analyse several best practices and recommend an approach which directly addresses the risks outlined above (OECD, 2015:11).

The OECD (2015:11) stated that:

'The recommended approach is based on a fixed ratio rule which limits an entity's net deductions for interest and payments economically equivalent to interest to a percentage of its earnings before interest, taxes, depreciation and amortisation (EBITDA) and as a minimum this should apply to entities in multinational groups. To ensure that countries apply a fixed ratio that is low enough to tackle BEPS, while recognising that not all countries are in the same position, the recommended approach includes a corridor of possible ratios of between 10 per cent and 30 per cent. The report also includes factors which countries should take into account in setting their fixed ratio within this corridor, and the approach can be supplemented by a worldwide group ratio rule which allows an entity to exceed this limit in certain circumstances.'

2.4.1. BEPS Action 4 recommendations

The use of debt for one entity or country to bear an excessive portion or shift taxable income to countries with a lower tax rate can give rise to base erosion and profit shifting arrangements (OECD, 2015:18).

Cliffe Dekker Hofmeyr (2016:1) states that,

'In October 2015, the BEPS Action 4 Final Report was released, setting out a common approach to address BEPS involving interest and payments economically equivalent to interest. The Report included a 'fixed ratio rule' which limits an entity's net interest deductions to a set percentage of its tax earnings before interest, taxes, depreciation and amortisation (tax EBITDA) and a group ratio rule which permits an entity to claim higher net interest deductions, based on the financial ratio of its worldwide group.'

Cliffe Dekker Hofmeyr (2016:1) further states that,

'BEPS Action 4 emphasises the need to address BEPS through the use of deductible payments such as interest (particularly related and / or connected party interest) and other financial payments economically equivalent to interest and the use of

deductible payments such as interest to achieve inter-jurisdictional profit shifting is one of the simplest and most effective weapons in the international tax planning armoury.

Multinational groups take advantage of the heterogeneity of tax deduction rules by reallocating debt to high tax jurisdictions, international debt shifting is rife, with multinational groups leveraging greater debt in subsidiaries located in high tax jurisdictions, thereby reducing their international tax incidence.

Accordingly, the leverage of a multinational group is acutely sensitive to a jurisdiction's tax rate, and fiscal authorities are confronted with ever diminishing corporate tax receipts from multinationals that employ excessively high leverage and concomitant interest deductions and further research indicates that developing countries are more susceptible to the adverse impact of debt shifting than developed countries.'

Ernst & Young (2015:1) stated:

'The BEPS Action 4 Final Report defends the need for agreement on limiting deductions for net interest expense by pointing to the ability of multinational enterprises to selectively place higher levels of third-party debt in high-tax countries, to use intercompany loans to generate interest deductions above the group's actual third party interest expense, and to borrow to generate tax-exempt income such as dividends from subsidiary corporations, all of which are BEPS techniques that give multinationals an unjustified advantage relative to groups operating only in one country. To deal with this perceived problem, the Final Report adopts an approach founded on the twin pillars of a fixed ratio rule and a group ratio rule, with certain modifications and enhancements.'

The BEPS Action 4 proposals to limit excess interest deductions which are also known as the recommended approach or best practice approach are discussed from section 2.4.2. to 2.4.5 below.

The crucial objective of the project of BEPS Action 4 was to recognise comprehensible and reliable solutions to address base erosion and profit shifting using interest and payments economically equivalent to the interest, which is balanced by the need for an approach to be reasonably straightforward for groups and tax authorities to apply (OECD, 2015:25).

2.4.2. The fixed ratio

The recommended approach is based on a fixed ratio rule to limit an entity's net deductions for interest and economically equivalent payments to a percentage of its EBITDA, and using the EBITDA approach will ensure that a portion of an entity's profit remains subject to tax in a country (Deloitte, 2015:2).

Deloitte (2015:2) stated that:

'The percentage restriction should be set by each jurisdiction at a single benchmark fixed ratio of between 10 per cent and 30 per cent of EBITDA and factors that may indicate that a higher benchmark EBITDA ratio would be appropriate (within the 10% – 30% range) include the following:

- (i) the country intends to operate the fixed ratio rule in isolation, rather than operating the rule in combination with a group ratio rule;*
- (ii) the country disallows the carry forward of excess interest capacity or carry back of disallowed interest expense;*
- (iii) the country has higher interest rates compared to other jurisdictions;*
- (iv) the country has other targeted rules that address BEPS concerns under Action 4; and*
- (v) the country is obliged for other reasons (e.g. constitutional reasons, EU law) to treat different types of comparable legal entity on similar terms, even where they pose differing levels of risk (Deloitte, 2015:2).'*

The fixed ratio rule was chosen as the cornerstone of the BEPS Action 4 recommendations because it most efficiently links a group's net interest deductions to its income-producing activities. However, there are some noted disadvantages as well, and most obviously, average leverage ratios vary for companies in various industries, and a fixed benchmark ratio cannot accommodate these variations. In addition, earnings can be volatile, and groups cannot always reasonably forecast earnings for future years, so various jurisdictions are encouraged to consider using an average EBITDA ratio to address the latter problem (Ernst & Young, 2015:1).

The African Tax Administration Forum (ATAF) noted that the fixed ratio rule is straightforward and ensures that an entity's interest expense deductions are directly linked to its economic activity and taxable income, making the rule reasonably robust against planning (ATAF, 2018:4).

According to Oguttu (2016:142), to ensure that countries apply a fixed ratio that is low enough to address base erosion and profit shifting, while recognising that not all countries are in the same position, the OECD recommended an approach that included a corridor of possible ratios of between 10% and 30%.

Oguttu (2016:142) further argues that:

'although the fixed ratio rule may provide a country with a level of protection against base erosion and profit shifting, it is a blunt tool that does not take into account the fact that groups operating in different sectors may require different levels of leverage, and even groups within some sectors can be more highly leveraged for non-tax reasons (which could result in double taxation for groups which are leveraged above the level). Therefore, the OECD recommends that the use of a fixed ratio rule can be supplemented by a worldwide group ratio rule which allows an entity to exceed this limit in certain circumstances.'

2.4.3. The group ratio

Another recommended approach is the group ratio. Deloitte (2015:2) states that:

'recognizing that some groups are highly leveraged with third-party debt for non-tax-related reasons, and that the fixed ratio rule is a 'blunt tool', the final report proposes a group ratio rule 'fall-back'. Deloitte (2015:2) further states that the group ratio rule could be introduced as a separate rule or as an integral part of an overall rule that includes a fixed ratio rule; a country may choose not to introduce a group ratio rule, although, where it does implement such a rule, it may choose to uplift net third-party interest expense by up to 10% to reduce the risk that some of a group's third-party interest may be subject to disallowance. Furthermore, a group ratio rule aims to match net interest expense within a consolidated group to economic activity, so that the group's aggregate tax deductions should not exceed its actual third-party interest expense.'

The use of the group ratio would allow an entity with net interest expense above its country's fixed ratio to deduct interest up to a level of the net interest/EBITDA ratio of its worldwide group, and countries may also apply an uplift of up to 10% of the group's net third party interest expense to prevent double taxation (Oguttu, 2016:142).

2.4.4. Carry-forward and carry-backs

With regards to carry-forward and carry-back rules Ernst & Young (2015) stated that:

'Both the fixed ratio and the group ratio rule rely on EBITDA; as such, the amount of interest expense an entity may deduct will be affected by changes in its earnings or those of other members of its group, or by differences between financial statements and taxable income. The Final Report acknowledges that earnings volatility could make long-term planning difficult and that permanent disallowance of interest expense could result in double taxation because, in most cases, the creditor will be taxed on the corresponding interest income. Countries may therefore wish to allow entities to carry out unused interest capacity and carry forward and carry back disallowed interest expense.'

The OECD (2015:69) noted a risk and stated that allowing disallowed interest expense and unused interest capacity to be carried forward or back and used in other periods does introduce potential BEPS risks. This is mainly the case for unused interest capacity where a long or unlimited carry forward could give rise to a sizeable tax asset which can only be realised either by increasing the level of the entity's net interest expense or by reducing the level of EBITDA in a future period, neither of which should be incentivised by a rule to tackle BEPS.

Further, where carry forwards or carry backs are allowed, a country should consider introducing limits in terms of time and / or value. This is particularly important as unlimited carry forward or carry back provision will give rise to greater potential BEPS risks (OECD, 2015:69).

2.4.5. Targeted rules

Ernst & Young, 2015:1 stated that:

'Rules which targeted specific transactions giving rise to BEPS may be necessary to counteract planning undertaken by groups to reduce the effect of the fixed ratio and group ratio rules; for example, entities may attempt to convert interest expense into a different form of a deductible expense or to convert other taxable income into interest; entities may enter into structured arrangements with third parties to increase the amount of net third party interest expense taken into account under the group ratio rule; or groups may be restructured, for example by placing an unincorporated holding entity at the top of a structure to create two groups. Beyond noting a few other types of possible responses to the limitations of the fixed ratio and group ratio rules, the Final Report does not give much guidance on the design of targeted rules, presumably because such rules would be significantly influenced by the particular features of each country's existing tax system (Ernst & Young, 2015:1).'

After the release of the BEPS Action 4 Report, there were many uncertainties of how the rules would apply and also how countries would implement them. Ernst & Young (2015:1) stated that, while it was not possible to predict exactly how or when various countries would adopt the recommendations of BEPS Action 4, companies should expect additional limitations on interest expense and should arrange any new financing transactions with an eye towards flexibility and the possible need to unwind or alter such transactions before maturity.

Van de Water (2018:14) stated that:

'the best practice approach is directly linked to an entity's net interest expense, although a general interest limitation rule may also operate indirectly, by restricting the amount of debt in which interest deductions may be claimed. In deciding which approach to apply, the OECD has taken into account that limitation of the level of debt does not necessarily address base erosion and profit shifting risks with regard to excessive interest rates. To combat these risks, countries would need to introduce additional rules, such as an arm's length test, increasing the complexity of the best practice approach. Additionally, the level of debt may vary over a certain period, which means that the measured debt may not be representative for an entity's true position. The interest expense, however, is a more reliable source, as it will reflect all changes of borrowings over time.'

2.5. BEPS Action 4 – Interest and payments economically equivalent to interest

Most jurisdictions treat interest as a deductible expense for tax purposes. However, each jurisdiction applies a unique approach to determine how and which interest items will be deductible according to local tax rules (OECD, 2015:29).

The OECD (2015:29) noted that:

'it is not the aim of the BEPS Action 4 Final Report to recommend a definition of interest that is applied by all countries for all tax purpose ... for the purposes of BEPS Action 4, using interest expense should therefore apply to: (i) interest on all forms of debt; (ii) payments economically equivalent to interest; and (iii) expenses incurred in connection with the raising of finance which should include but [are] not limited to the following:

- *payments under profit participating loans;*
- *imputed interest on instruments such as convertible bonds and zero coupon bonds;*
- *amounts under alternative financing arrangements, such as Islamic finance;*
- *the finance cost element of finance lease payments;*
- *capitalised interest included in the balance sheet value of a related asset, or the amortisation of capitalised interest;*
- *amounts measured by reference to a funding return under transfer pricing rules, where applicable;*
- *notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowings;*
- *certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance;*
- *guarantee fees with respect to financing arrangements.*
- *arrangement fees and similar costs related to the borrowing of funds.'*

The concept of interest under BEPS Action 4 has a wide application which broadens the scope of the interest limitation rules under BEPS Action 4 (National Treasury, 2020a:18).

2.6. Comparison of section 23M and BEPS Action 4 prior to the 2021 amendments

As s 23M was enacted in the 2013 Taxation Laws Amendment Act No 31 of 2013 with an effective date of 1 January 2015 and the *BEPS Action 4 Final Report* being formally released in October 2015, it is interesting to know whether s 23M was aligned with BEPS Action 4 prior to the 2021 amendments as discussed under this section and whether s 23M is aligned with BEPS Action 4 post the 2021 amendments which is discussed in section 4.2 below.

The Davis Tax Committee (2016:53) stated in its Final Report that South Africa should monitor the domestic tax legislation to limit excessive interest deductions and ensure that it is aligned with the BEPS Action 4 recommendations.

Van der Zwan, *et al.* (2018:2) stated that, even though South Africa is not a member of the OECD, it participated actively in the OECD / G20 BEPS project and the recommendations stemming from BEPS Action 4 should therefore be considered by the National Treasury and the SARS. According to Van der Zwan, *et al.* (2018:2), a number of key differences existed between s 23M provisions and BEPS Action 4 at the time to address the risk of base erosion from excessive interest deductions. The South African measures implemented at the time focused on interest paid in respect of related party debt, while the OECD's proposal suggests an overall interest deduction limitation that would apply to both multinationals and stand-alone domestic entities; but it notes that countries should decide what is best for their economies.

BDO (2021:1) hold that s 23M was not aligned with the recommendations contained in the BEPS Action 4 but it will also not be aligned with those recommendations if the proposed changes in 2021 to the provision are implemented:

'the BEPS Action 4 Final Report recommended that the interest deduction rules apply to net interest expense which is the interest expense net of interest income, whereas s 23M applies to limit interest expense deductions before setting off interest income.

the interest limitation rules under the BEPS Action 4 Final Report apply to both related party and third party net interest expense, whereas s 23M applies only to interest deductions where the creditor is in a controlling relationship with the debtor or, if the creditor is not in a controlling relationship with the debtor, where the creditor obtained the funding for the debt from a person that is in a controlling relationship with the debtor.' (BDO, 2021:1)

According to Van der Zwan, et al. (2018:2):

'it is evident that the implementation or partial implementation of the BEPS Action 4 recommendations is likely to result in stricter interest deduction limitations in South Africa and if further measures are introduced to limit the tax deductibility of interest more closely aligned with the BEPS Action 4 recommendations, this may confirm that limitations are being imposed.'

National Treasury (2020a:4) stated in its 2020 Discussion Document that:

'South Africa's interest limitation rules in s 23M at the time have similar design features to the fixed ratio rule recommended by the OECD under BEPS Action 4, but differences exist. The existing rules are comparatively less strict than the OECD BEPS Action 4 recommendations and narrower in the application. They are targeted at a smaller set of transactions, and the limitation for net interest expense deductions is set at a higher percentage of earnings.'

The above statement by National Treasury was not supported by a detailed analysis of the issues raised and the differences and similarities between BEPS Action 4 and s 23M were not specifically outlined in its 2020 Discussion Document.

The table below contains a comparison of BEPS Action 4 and s 23M prior to the 2021 amendments and highlights the pertinent differences and similarities between the two provisions.

Table 1: Comparison of BEPS Action 4 and section 23M prior to the 2021 amendments

Item	BEPS Action 4	Section 23M	Comment
Scope of application	The BEPS Action 4 recommendations apply to multinational group entities, domestic group entities, and standalone entities which are not part of a group (OECD, 2015:38).	Section 23M is applied where a debtor and creditor are in a controlling relationship and the amount of interest payable by the debtor to the creditor is not subject to tax in South Africa or included in the net income of a controlled foreign company under s 9D of the Act (Kruger, 2015:13).	Difference – the scope of application of the interest limitation rules under BEPS Action 4 is wider than s 23M.
Determination of interest limitation	OECD (2015:48) stated that <i>'calculating the amount of any interest expense disallowance under a fixed ratio rule involves a three-step process: firstly, calculating the appropriate measure of EBITDA; secondly, applying the statutory benchmark fixed ratio between 10% to 30% to an entity's EBITDA to determine the maximum deductible interest expense; and thirdly, comparing this with the actual interest expense of the entity'</i>	Interest limitation was calculated using a formula contained in s 23M(3)(b) as follows: $A = B \times C/D$ where A represents the percentage to be applied; B represents 40; C represents the average repo rate plus 400 basis points; and D represents 10, but not exceeding 60% of adjusted taxable income of the debtor (Kruger, 2015:19).	Difference – The calculation of interest limitation under BEPS Action 4 is based on EBITDA calculation which will then be multiplied by benchmark fixed ratio between 10% and 30%. The interest limitation calculation under s 23M is based on a formula which takes into account adjusted taxable income which should not exceed 60% of the adjusted taxable income.
Method of calculation	The calculation of an entity's EBITDA is determined by adding back to its taxable income the tax values for (i) net interest expense and net payments	Section 23M(3) uses a formula which takes into account adjusted taxable income in calculating the interest limitation. As noted under section 2.3.2.	Similarity – Although the name of the concepts maybe be different, however the method of calculation is similar.

	equivalent to interest payments as defined in Chapter 2 and (ii) depreciation and amortization (OECD, 2015:48).	above, an adjusted taxable income amount is taxable income before: interest income, controlled foreign company income, recoupments, interest incurred, deduction of allowances (depreciation), assessed loss.	
Group ratio	The OECD also recommended countries to use the group ratio as discussed in section 2.4.3. above as a separate additional provision or as an integral part of an overall rule including a fixed ratio (Deloitte, 2015:2)	National Treasury (2020a:18) indicated that, while the commercial reality of having a group ratio makes some sense, auditing the group ratio would be difficult as SARS would not have access to much of the required information as South Africa does not have group taxation. The feasibility of introducing such a ratio successfully is questionable as it would be complex to design, comply with and administer. Section 23M does not contain a group ratio.	Difference – BEPS Action 4 recommended countries to use the group ratio. Section 23M does not contain a group ratio.
Benchmark corridor	In determining the amount of interest limitation, the OECD recommended that countries set their benchmark fixed ratio within the corridor of 10% to 30% of EBITDA (OECD, 2015:50).	Prior to the 2021 amendments, the interest limitation amount was determined based on a formula in s 23M(4), and the amount determined should not exceed 60% of the adjusted taxable income (Stiglingh <i>et al.</i> , 2021:563).	Difference – BEPS Action 4 recommended a benchmark corridor set between 10% and 30% of EBITDA. Section 23M(3) contained a benchmark corridor not exceeding 60% of adjusted taxable income.
Carry forward / back rule	The OECD recommended that disallowed interest expense and unused interest capacity to be used in other periods through carry forward or	Any interest above the limitation may be carried forward to the succeeding year of assessment, which will be deemed to be interest incurred in that	Similarity – BEPS Action 4 contains carry forward or carry back provisions. Section 23M(4) provides for a carry

	carry back provisions and should be the deductible net interest expense that is in excess of the amount permitted under the fixed ratio rule and group ratio rule, (OECD, 2015:68).	year of assessment, and its deductibility must be assessed in light of the interest limitation deduction in terms of s 23M that applies to that year of assessment (Stiglingh, <i>et al.</i> 2021:564).	forward of excess interest.
Carry forward / back limits	The OECD recommended that where carry forwards or carry backs are permitted, a country should consider imposing limits in terms of time and / or value in order to avoid greater potential BEPS risks (OECD, 2015:69).	Section 23M(4) has no expiry period on the carrying forward of the interest in excess of the limitation amounts (Stiglingh, <i>et al.</i> , 2021:564).	Difference – BEPS Action 4 recommended that the carry forwards and carry backs of unutilised interest be subject to a limitation period. Section 23M(4) has no expiry period for the utilised interest i.e., no limitation period.
Transfer pricing (arm's length principle) and interest limitation rules	The OECD (2015:38) stated that: <i>'a country may continue to apply an arm's length test alongside the best practice approach but the amount of interest after the application of the arm's length test is then subject to limitation under the best practice approach.'</i>	Section 31 which contains provisions that are aimed at ensuring that tax payable in respect of international transactions are based on the arm's length principle apply prior to considering the impact of s 23M (SARS, 2023:37).	Similarity – BEPS Action 4 recommends that an arm's length test should be applied first and then the interest limitation. National Treasury and SARS hold a view that the arm's length principle in s 31 should be applied first and then the interest limitation rules should be applied.
Targeted rules	BEPS Action 4 contains targeted interest limitation rules which include any provisions which apply to restrict interest deductions on payments made under specific transactions or arrangements, (OECD, 2015:71).	Section 23M generally applies to limit interest deductions in respect of debts owed to persons not subject to tax while s 23N deals with the limitation of interest deductions in respect of reorganisation or acquisition transactions and s 23N is an existing targeted rule (National Treasury, 2020:48).	Difference – BEPS Action 4 recommended targeted rules as part of the general interest limitation rules. Section 23M is not and does not contain targeted rules.
Definition of	As noted under section 2.5. above, the	Section 23M(1) contained a definition of	Difference – BEPS Action 4 provides

interest	concept of interest expense is wider under the OECD as it was recommended that the interest limitation rules apply to total (external and connected) net interest expense and equivalent payments.	interest for the purposes of s 23M to mean interest as defined in s 24J. 'Interest' is broadly defined in s 24J as not only including interest, but also related finance charges, discounts or premiums payable or receivable in terms of or in respect of a financial arrangement, and certain payments under a lending arrangement or sale and leaseback arrangement (Kruger, 2015:16).	a wider meaning of what should be included in interest. The s 24J definition of interest is not wide enough to include payments economically equivalent to interest, including the examples listed in BEPS Action 4.
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2.7. Conclusion

Although s 23M does share some of the recommendations contained in BEPS Action 4, it appears that s 23M was not entirely aligned with the BEPS Action 4 recommendations prior to the 2021 amendments as there are more differences than similarities.

The differences and similarities between BEPS Action 4 and s 23M were expected as National Treasury and SARS have held a view which was also announced in the 2017 and 2019 Budget Reviews and also stated in the 2020 *Discussion Document* that government is working on strengthening the interest limitation rules as a measure to counter base erosion in South Africa, and will review these rules to align with BEPS Action 4 recommendations (National Treasury, 2017, National Treasury 2019)

The next chapter will discuss the 2021 amendments made to s 23M in order to align with BEPS Action 4.

CHAPTER 3 – 2021 AMENDMENTS MADE TO SECTION 23M TO ALIGN WITH BEPS ACTION 4

3.1. Introduction

In the 2017 Budget Review, the National Treasury stated that in relation to South Africa's position on BEPS Action 4, the government is strengthening its efforts to curb excessive debt financing which erodes the tax base and will review the then-current regime in light of OECD recommendations (National Treasury, 2017:50).

In the 2019 Budget Review, the National Treasury stated that although South Africa has measures in place to curb excessive debt financing which erodes the tax base, the government was reviewing these rules against the OECD best practice and it was important to strike a balance between attracting capital and investment, and adequately protecting the corporate tax base (National Treasury, 2019:45).

National Treasury (2020b:42) published the 2020 Budget Review which stated that

'the government proposed to restrict net interest expense deductions to 30% of earnings for years of assessment commencing on or after 1 January 2021. This measure would address a typical form of base erosion and profit shifting by multinational corporations. This practice involved artificially inflating company debt and / or the interest rate on that debt to a related party in another jurisdiction with a lower corporate income tax rate. The resulting interest payments were deducted in South Africa, reducing the domestic tax base and effectively shifting profits to be taxed at a lower rate offshore'

The 2020 Budget Review was published together with the 2020 Discussion Document noted above; National Treasury (2020a:46) stated in the 2020 Discussion Document that based on the analysis conducted in that document, the government proposed to implement the BEPS Action 4 recommendations; further, examples showed that replacing the then existing interest limitation rules in s 23M with the BEPS Action 4 recommendations would provide a more uniform approach to all interest payments flowing out of the country and protect the South African tax base.

In the 2021 Budget Review, the National Treasury noted that in February 2020 the 2020 Discussion Document mentioned above on limiting excessive interest deductions was released for public comment which was followed by public

consultation. After assessing the comments, government proposed to expand the scope of the current interest limitation rules in s 23M to include some similar interest items to adjust the fixed-ratio limitation for net interest expense to 30% of earnings and to restrict only connected-party interest rather than total interest (National Treasury, 2021a:47).

3.2. 2021 amendments made to section 23M to align with BEPS Action 4

Subsequent to the 2021 Budget Review announcement, the 2021 Taxation Laws Amendment Act No 20 of 2021 was published alongside the Explanatory Memorandum to the 2021 Taxation Laws Amendment Act No 20 of 2021. National Treasury provided in the reasons for change section that the government published the *2020 Discussion Document* to conduct a review of s 23M in line with BEPS Action 4 recommendations (National Treasury, 2021b:16).

The above statement by National Treasury makes it clear that the 2021 amendments to s 23M were made in order to align with BEPS Action 4. This was also confirmed by the 2017 and 2019 Budget Reviews as mentioned in section 3.1. above.

The following section discusses amendments made by National Treasury in the 2021 Taxation Laws Amendment Act No 20 of 2021.

3.2.1. Definition of interest in s 23M(1)

National Treasury (2020a:46) stated that the definition of interest in s 23M(1) is not wide enough to include payments economically equivalent to interest and included the examples listed under paragraph 36 in chapter 2 of the *BEPS Action 4 Final Report*.

National Treasury (2021b:19) further noted that in light of the BEPS Action 4 recommendations, the definition of interest in the then-existing rules was narrow and the definition of interest for the purposes of s 23M was expanded beyond the then-current definition of interest contained in s 24J to include:

- Payments made under interest rate swap agreements;
- Finance cost elements included in finance lease payments;

- Foreign exchange gains and losses;
- Amounts deemed to be interest in terms of Sharia-compliant financing arrangements.

3.2.2. Deductible interest limitation – formula calculation

The fixed ratio contained in s 23M(3) was changed and the deduction of interest expenditure would with effect of 31 March 2023 be limited to a fixed ratio of 30% of adjusted taxable income (National Treasury, 2021b:19).

The level of fixed ratio under BEPS Action 4 is within the corridor of 10% to 30% (National Treasury, 2020a:47).

The amendment to 30% was guided by international research, and it is difficult to argue with a benchmark that appears to be the subject of broad consensus. However, the bulk of OECD countries have experienced significantly less currency volatility and inflation than South Africa, and it is appropriate to ask whether due consideration was given to factors that differentiate our economy from the economies of developed countries. With that said, 30% lies at the top end of the range recommended by the OECD, and the interest deduction limitation rule is narrower than that recommended by the OECD, which was to apply it to all interest, regardless of whom it is paid to and regardless of whether it is subject to tax or not (PwC, 2022a:5).

3.2.3. Back-to-back loans

National Treasury (2020a:20) made amendments to s 23M(2) such that interest limitation rules also apply in two additional instances where a debtor incurs an amount of interest owed to a creditor that:

‘(i) forms part of the same group of companies as that debtor; and

(ii) is in a controlling relationship with that debtor and the interest is taxable in the hands of the immediate creditor, but is not fully subject to tax in the hands of the ultimate creditor, if that creditor, directly or indirectly through another creditor that is in a controlling relationship with that creditor, obtained the funding for the debt

advanced to the debtor from a person that is in a controlling relationship with that creditor and that other creditor and would not be taxed on interest accrued.'

Before the 2021 amendments, s 23M considered whether the creditor is subject to tax either in the form of normal tax or withholding tax. It did not look beyond the creditor, and in these circumstances s 23M would only apply when the creditor was tax exempt or was a non-resident who was not subject withholding tax as result of a relief provided by a tax treaty. After the 2021 amendments, s 23M will apply even if the funds which are lent out by a taxable person are sourced from a person who is not subject to tax (KPMG, 2021:1).

3.2.4. Adjusted taxable income – REIT / controlled company qualifying distribution

A real estate investment trust (REIT) or a controlled company is not taxed on the income it derives due to a deduction for qualifying distributions made by that REIT or controlled company. The issue becomes that the deduction for qualifying distributions will distort their adjusted taxable income and will result in their having a much lower adjusted taxable income than other taxpayers (National Treasury, 2021b:18).

In order to address this issue, the definition of adjusted taxable income in s 23M(1) was amended to take into account a qualifying distribution made by an REIT or controlled company as contemplated in s 25BB (National Treasury, 2021b:20).

The qualifying distributions made by an REIT or controlled company are added back to the adjusted taxable income calculation under the amendment in terms of the definition of adjusted taxable income in s 23M(1) (KPMG, 2021:1).

3.3. 2020 proposals not included in the 2021 amendments to section 23M

Mazansky, (2021:1) indicated that:

'some of the more unfortunate proposals made in the 2020 Discussion Document have not been included in the legislation, including the fact that it would apply even where the South African company has not borrowed from a foreign affiliate but has merely invested abroad. There is also no de minimis exemption, but given the fact

that the scope of the limitation has been reduced so dramatically, the absence of a de minimis exemption is not that serious.'

3.3.1. Interaction of section 23M with other provisions in the Act

National Treasury's *2020 Discussion Document* included a proposal on the interaction of s 23M with other provisions in the Act, in particular, the transfer pricing provisions.

The government proposed in 2020 that companies should start by applying the transfer pricing provisions contained in s 31 to transactions followed by the interest limitation rules in s 23M and s 23N, i.e., the interest limitation rules should apply to net interest expense after the application of the transfer pricing provisions (National Treasury, 2020a:48).

This proposal was not included in the 2021 amendments to s 23M, and National Treasury (2021c:30) stated in the *Response Document to the 2021 Draft Taxation Laws Amendment Bill* that while National Treasury and SARS have always maintained that the transfer provision in s 31 should be applied before s 23M, National Treasury and SARS believe this is an interpretation issue which will be addressed under an interpretation note to clarify that a taxpayer should apply s 31 first and then s 23M.

3.4. Impact of the 2021 amendments to section 23M of the determination on the interest limitation

Section 23M was amended in 2021 but the amendments are only effective from years of assessment ending on or after 31 March 2023 and the amendment applies to interest incurred on or after this date which means that pre-existing funding arrangements will be impacted by the amendments (Rudnicki, 2023:26).

In light of the changes highlighted above, Rudnicki (2023:31) provided the following example to illustrate the determination of the adjusted taxable income and calculation of the interest limitation under after the 2021 amendments to s 23M:

Illustration example

<u>Adjusted Taxable Income calculation</u>	Amount (R)
Net income before tax	300 000 000
Add:	
Wear and tear	12 000 000
Interest: Controlling relationship, not subject to tax	6 000 000
Interest: Other	1 000 000
Foreign exchange losses	
• Unrealised: non-related parties	500 000
• Unrealised: related parties (R100 000), s 24I(10A)	-
Less:	
Interest derivative gains	(40 000)
Foreign exchange gains	
• Realised: related parties	(60 000)
Adjusted Taxable Income	319 400 000
30% Amount: $319\,400\,000 \times 30\% =$	95 820 000
<u>Determination of the s 23M interest limitation</u>	
Interest received: interest derivative & foreign exchange gains	100 000
30% determination	95 820 000
Interest expenditure (excluding s 23M interest), (interest, foreign exchange loss)	(1500 000)
Interest limitation amount	94 420 000

3.5. Conclusion

As announced by National Treasury, the reason for the amendments to s 23M in 2021 was to align with the BEPS Action 4 recommendations on interest limitation deductions (National Treasury, 2021b:16). As noted under 3.3 above, not all of the proposals from the *2020 Discussion Document* have been included in legislation.

Given the research questions noted in Chapter 1, it then becomes crucial to determine whether s 23M post the 2021 amendments is aligned with the BEPS Action 4 recommendations. The next chapter will provide a comparison of the current provisions of s 23M with BEPS Action 4 recommendations.

CHAPTER 4 – COMPARISON OF THE CURRENT PROVISIONS OF SECTION 23M WITH BEPS ACTION 4 RECOMMENDATIONS AFTER THE 2021 AMENDMENTS

4.1. Introduction

In section 2.6. a comparison of s 23M and BEPS Action 4 prior the 2021 amendments was provided. It was concluded that s 23M was not fully aligned with BEPS Action 4 as there were some differences as noted in the table under section 2.5. As discussed in section 3.2. above, National Treasury made amendments to s 23M through the 2021 Taxation Laws Amendment Act No 20 of 2021 and the main aim of these amendments was to align s 23M with BEPS Action 4. This chapter will compare the current provisions of s 23M with BEPS Action 4 recommendations since the 2021 amendments. Although a comparison of s 23M with BEPS Action 4 recommendations was performed prior to the 2021 amendments, the comparison performed in this chapter will also include the differences and similarities analysed after the 2021 amendments, and a comparison prior to the 2021 amendments as necessary.

National Treasury announced in its 2017, 2019 and 2020 Budget Reviews that it was strengthening its efforts to curb excessive debt financing, which erodes the tax base, and would review the current regime in light of OECD recommendations. It further published proposals at the time to restrict net interest expense deductions to curb BEPS. This was followed by a consultation process with the relevant stakeholders and then the finalisation of the amendments to s 23M in 2021.

The above statement serves as evidence of commitment by National Treasury working together with SARS to show that the need for the alignment of s 23M with BEPS Action 4 has been on the government's agenda. It is one of the arrears prioritised as a measure to curb base erosion in South Africa.

4.2. Comparison of section 23M and BEPS Action 4 after the 2021 amendments

BDO (2021:1) stated that:

'Section 23M was not aligned with the recommendations contained in the BEPS Action 4 Final Report, but it also will not be aligned with those recommendations if

the then-proposed changes which have been included in the current provisions of s 23M are implemented, as there are still differences. For example, the BEPS Action 4 Final Report recommends that the interest limitation applies to both related party and third-party net interest expense, whereas section 23M applies only to interest deductions where the creditor is in a controlling relationship with the debtor; or, if the creditor is not in a controlling relationship with the debtor, where the creditor obtained the funding for the debt from a person that is in a controlling relationship with the debtor.'

The table below contains a comparison of BEPS Action 4 and s 23M post the 2021 amendments and highlights the pertinent differences and similarities between the two provisions.

Table 2: Comparison of BEPS Action 4 and section 23M after the 2021 amendments

Item	BEPS Action 4	Section 23M	Comment
Scope of application	The BEPS Action 4 recommendations apply to multinational group entities, domestic group entities, and standalone entities which are not part of a group (OECD, 2015:38).	The scope of s 23M is broadened to cover back-to-back intra group loans (Stiglingh <i>et al.</i> , 2022:585).	Difference – the scope of application of the interest limitation rules under BEPS Action 4 is still wider than s 23M.
Determination of interest limitation	The OECD (2015:48) stated that: <i>‘Calculating the amount of any interest expense disallowance under a fixed ratio rule involves a three-step process: firstly, calculating the appropriate measure of EBITDA; secondly, applying the statutory benchmark fixed ratio to an entity’s EBITDA to determine the maximum deductible interest expense; and thirdly, comparing this with the actual interest expense of the entity.’</i>	Section 23M(3) of the Act provided that interest limitation is calculated using a formula contained for in s 23M(3) as follows: $A = B \times (C-D) / C$ where A is the amount to be determined; B is the amount of interest incurred or paid which the withholding tax on interest provisions will apply; C represents the number 15; and D represents the rate at which withholding tax on interest will be levied, multiplied by 100. The interest limitation calculation under s 23M is based on a formula which takes into account adjusted taxable income which should not exceed 60% of the adjusted taxable income.	Similarity – The calculation of interest limitation under BEPS Action 4 is based on EBITDA calculation which will then be multiplied by a benchmark fixed ratio between 10% and 30%. The interest limitation calculation under s 23M is based on a formula which takes into account adjusted taxable income, which should not exceed 60% of the adjusted taxable income.
Method of calculation	An entity’s EBITDA should be calculated by adding back to its taxable income, the tax values for: (i) net interest expense and net payments equivalent to interest payments as	Section 23M(3) uses a formula which takes into account adjusted taxable income in calculating the interest limitation. As noted in section 2.3.2. above an adjusted taxable income	Similarity – Although the name of the concepts maybe be different, the method of calculation is similar.

	defined in Chapter 2 of the <i>BEPS Action 4 Final Report</i> ; and (ii) depreciation and amortization (OECD, 2015:48).	amount is taxable income before: interest income, controlled foreign company income, recoupments, interest incurred, deduction of allowances (depreciation), assessed loss.	
Group ratio	The OECD also recommended countries to use the group ratio as discussed in section 2.4.3 above as a separate additional provision or as an integral part of an overall rule including a fixed ratio (Deloitte, 2015:2)	National Treasury (2020a:18) indicated that, while the commercial reality of having a group ratio makes some sense, auditing the group ratio would be difficult as SARS would not have access to much of the required information – South Africa does not have group taxation and the feasibility of introducing such a ratio successfully is questionable. It would be complex to design, comply with and administer. Section 23M the does not contain a group ratio.	Difference – BEPS Action 4 recommended countries use the group ratio. Section 23M does not contain a group ratio.
Benchmark corridor	In determining the amount of interest limitation, the OECD recommended that countries set their benchmark fixed ratio within the corridor of 10% to 30% of EBITDA (OECD, 2015:50).	Section 23M(3) provides that the deduction of interest expenditure should not exceed 30% of adjusted taxable income (National Treasury, 2021b:19).	Similarity – BEPS Action 4 recommended a benchmark corridor set between 10% and 30% of EBITDA. Section 23M(3) provides a limitation which contains a benchmark corridor of 30% of the adjusted taxable income.
Carry forward / back rule	BEPS Action 4 recommended that disallowed and unused interest expense should be used in other periods through carry forward or carry back provisions and should be the	Any interest in excess of the limitation may be carried forward to the next year of assessment which will be deemed to be interest incurred in that year of assessment. Its deductibility must be	Similarity – BEPS Action 4 contains carry forward or carry back provisions. Section 23M(4) provides for a carry forward of excess interest.

	deductible net interest expense that is in excess of the amount permitted under the fixed ratio rule and group ratio rule (OECD, 2015:68).	assessed in light of the interest limitation deduction in terms of s 23M that applies to that year of assessment (Stiglingh <i>et al.</i> , 2021:564).	
Carry forward / back limits	The BEPS Action 4 recommended that where carry forwards or carry backs are allowed, a country should consider limiting the time or value to avoid greater potential BEPS risks (OECD, 2015:69).	National Treasury (2021b:17) stated that the indefinite carry forward is being retained and no interest expense deductions will expire; however provisions of s 23M(4) will be reviewed after 5 years.	Difference – BEPS Action 4 recommended that the carry forwards and carry backs of unutilised interest be subject to a limitation period. Section 23M(4) has no expiry period for the utilised interest i.e., no limitation period.
Transfer pricing (arm's length principle) and interest limitation rules	The OECD (2015:38) stated that: <i>'a country may continue to apply transfer pricing rules alongside the best practice approach; but the amount of interest after the application of the transfer pricing is then subject to limitation under the best practice approach.'</i>	Section 31, which contains provisions that are aimed at ensuring that tax payable in respect of international transactions are based on the arm's length principle, apply prior to considering the impact of s 23M (SARS, 2023:37).	Similarity – BEPS Action 4 recommends that arm's length test should be applied first and then the interest limitation. National Treasury and SARS hold a view that the arm's length principle in s 31 should be applied first and then the interest limitation rules should be applied.
Targeted rules	BEPS Action 4 contains targeted interest limitation rules which include any provisions which apply to restrict interest deductions on payments made under specific transactions or arrangements (OECD, 2015:71).	Section 23M generally applies to limit interest deductions in respect of debts owed to persons not subject to tax, while s 23N deals with the limitation of interest deductions in respect of reorganisation or acquisition transactions and s 23N is an existing targeted rule (National Treasury, 2020:48).	Difference – BEPS Action 4 recommended targeted rules as part of the general interest limitation rules. Section 23M is not aligned with BEPS Action 4 on this item as it does not contain targeted rules provisions.
Definition of	As noted under section 2.4. above, the concept of interest expense is wider	Section 23M(1) contained a definition of interest for the purposes on s 23M to	Difference – BEPS Action 4 provides a wider meaning of what should be

interest	under the OECD as it includes a number of items as discussed in section 2.4. on the meaning of interest. It was recommended that the interest limitation rules apply to total net interest expense and equivalent payments.	mean interest as defined in s 24J. 'Interest' is broadly defined in s 24J as not only including interest, but also related finance charge, discount or premium payable or receivable in terms of or in respect of a financial arrangement, and certain payments under a lending arrangement or sale and leaseback arrangement (Kruger, 2015:16).	included in interest. However, the 2021 amendments expanded the definition of interest for the purposes of section 23M by including amounts: • such as Islamic finance, • related to foreign exchange gains and losses, • related to lease arrangements. Interest definition in s 23M(1) is not wide enough to be aligned with the concept of interest contained in BEPS Action 4 as the s 23M(1) definition of interest does not contain all the items included in the meaning of interest as contained in BEPS Action 4.
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4.3. Conclusion

Like the conclusion in section 2.6., it also appears in this chapter that although some changes were made in s 23M in the 2021 Taxation Laws Amendment Act No 20 of 2021, s 23M is still not entirely aligned with the BEPS Action 4 recommendations after the 2021 amendments as there are still some differences between the two provisions, as noted in the table under section 4.2 above.

The next chapter will discuss further amendments required in s 23M to align with BEPS Action 4 recommendations.

CHAPTER 5 – FURTHER AMENDMENTS REQUIRED IN SECTION 23M TO ALIGN WITH BEPS ACTION 4 RECOMMENDATIONS

5.1. Introduction

A key focus of the government has been to minimise the erosion of the South African tax base. In this regard, National Treasury has sought to amend the domestic anti-avoidance rules to limit the use of various funding mechanisms in reducing the tax liability of companies and the legislative changes are largely influenced by the BEPS Action 4 (Mbana, 2022:25).

As noted in section 3.5. above, amendments were made in 2021 to s 23M to broaden the tax base and strengthen the provision in line with BEPS Action 4 (National Treasury, 2023:144).

In section 4.3. above, it was noted that s 23M is still not entirely aligned with the BEPS Action 4 recommendations post the 2021 amendments as there are still some differences between the two provisions (see Table 2 under section 4.2. above).

The following section will discuss the important amendments needed in s 23M in order to align with BEPS Action 4 and this will take into account some of the differences noted in section 4.2.

5.2. What further amendments are required in section 23M to align with BEPS Action 4?

In establishing rules to prevent inappropriate interest deductions, developing countries must balance the need to attract investment against the necessity of protecting the tax base (United Nations, 2017:15).

ATAF has done much work to assist African countries in this regard by producing a publication to assist African countries in amending their domestic legislation with the BEPS Action 4 recommendations (National Treasury, 2020a:3).

National Treasury's and SARS's policy objectives to align s 23M with BEPS Action 4 recommendations since the release of the *BEPS Action 4 Final Report* were noted in the 2017, 2019 and 2020 Budget Reviews. Section 4.2. above contained a comparison of s 23M after the 2021 amendments that are the current provisions of s 23M with BEPS Action 4. This exercise was performed in order to determine whether

these provisions are now aligned post the 2021 amendments to s 23M. Based on this comparison, the outcome was that while s 23M contains some principles of BEPS Action 4, it is not entirely aligned. (National Treasury, 2017, National Treasury 2019, National Treasury 2020b)

The following are the main differences between s 23M and BEPS Action 4. In order for the two provisions to align, National Treasury should consider these in line with its policy objectives, and take into account the South African tax landscape and need to attract foreign investments:

- Scope of application of the interest limitation rules – s 23M is currently not wide enough compared to BEPS Action 4 recommendation to include third parties and companies not forming part of a group.
- Group ratio – s 23M currently does not contain a group ratio.
- Carry forward / back limits – the carry forward proviso in s 23M(4) currently does not have an expiry date, i.e., s 23M(4) has unlimited carry forward provision and that could lead to erosion of the tax base.
- Definition of interest – the definition of interest for the purposes of s 23M is not wide enough to include payments economically equivalent to interest, including, to name a few examples listed in section 2.4. above, payments under profit participating loans, notional interest amounts under derivative instruments, or hedging arrangements related to an entity's borrowings.

5.3. Section 23M tax proposals

In the 2023 Budget Review, National Treasury (2023:144) indicated that it has noted that measures in s 23M require further clarification in the following areas:

“Clarifying the definition of ‘adjusted taxable income’ – The definition of ‘adjusted taxable income’ in s 23M(1) of the Act means taxable income calculated before applying the interest limitation rules, including the addition of any assessed loss or balance of assessed loss allowed to be set off against income in terms of s 20. There is uncertainty stemming from the inclusion of the terms ‘assessed loss’ and ‘balance of assessed loss’. Government proposes that the legislation be amended to align with the

policy intent that only the balance of assessed losses from the prior year be added in the adjusted taxable income calculation.

Introducing a definition of the term “creditor” – Currently, s 23M(1) of the Act defines “debt” and “debtor”, but it does not define the term “creditor”. Government proposes that this definition be added to s 23M of the Act.

Clarifying the treatment of exchange gains and losses – s 23M(7) of the act provides that any exchange difference deducted from the income of a person as contemplated in s 24I(3) or s 24I(10A) of the Act is deemed to have been incurred by that person. While s 23M(7) deems exchange losses to be incurred, a corresponding deemed accrual does not apply to exchange gains. This could result in exchange gains not being taken into account as interest received or accrued for purposes of s 23M of the Act. Government proposes that exchange gains be classified as interest received or accrued for the purposes of s 23M of the Act.

Clarifying the application of the proviso to s 23M(2) of the Act – The proviso to s 23M(2) contains a formula that reduces the amount of interest disallowed for deduction based on the extent to which withholding tax on interest must be withheld under Part IVB of the chapter. However, it does not adequately specify that this adjustment should only apply in the case of interest flowing to non-residents. Government proposes that the legislation be clarified in this regard.

Extending the provisions of s 23M(6) of the Act to apply to South African lending institutions – s 23M(6) generally makes provision for the exemption from the application of interest limitation rules where the creditor provides a loan to a taxpayer with funds granted by a lending institution – in this instance, a foreign bank. Government proposes that s 23M(6) of the Act be amended to extend this exemption to apply to South African lending institutions.

Reviewing the outcome of the interaction between the “controlling relationship” definition in s 23M(1) and the rule in s 23M(2)(c) of the Act – In 2021, changes were made to the definition of “controlling relationship” in s 23M(1) by adding a connected person test. In addition, further changes were made to s 23M(2)(c) by inserting a group companies test in instances where the creditor is not in a controlling relationship with the debtor. Government will review how the definition of “controlling relationship” in s 23M(1) and the provisions of s 23M(2) interact in light of the intended policy outcome.’

Unlike the 2020 Budget Review which stated that the main aim of the proposals was to strengthen the alignment between s 23M and BEPS Action 4, the 2023 Budget Review only stated that the proposals were made to clarify the application of s 23M. With that being said, one cannot conclude that the proposals were not intended to align s 23M and BEPS Action 4 as they provided a further clarification to legislation that was intended to align with BEPS Action 4 recommendations.

The following proposals made in the 2023 Budget Review are, in my view, seeking to align or strengthen the alignment of s 23M with BEPS Action 4:

- Providing clarity to the definition of adjusted taxable income;
- Providing clarity to the treatment of exchange gains and losses.

SARS is involved in the drafting of tax legislation in conjunction with National Treasury and the preparation of both primary and secondary legislation starts annually in February with the announcements in the Minister of Finance's Budget Review where the Minister of Finance announces all tax policy matters and the intended changes for a particular year in his Budget Speech (SARS, n.d:1).

Engel (2019:57) stated that National Treasury works with the SARS policy team to convert the tax proposals in the Budget Review into a draft taxation laws amendment bill, and that this process peaks in June and early July each year of the legislative cycle. After the internal process are complete and the Minister of Finance has signed the submission of the Draft Taxation Laws Amendment Bill alongside with the explanatory memorandum, these documents are then released for public comments.

In light of the above, and because by the time of the submission of this research report National Treasury has not yet published the 2023 Draft Taxation Laws Amendment Bill (which should contain amendments to s 23M), this research report does not discuss or look beyond what is contained in s 23M after the 2022 Taxation Laws Amendment Act No 20 of 2022, and the proposals made in the 2023 Budget Review.

CHAPTER 6 – CONCLUSION

National Treasury (2013a:55) also noted that the use of debt financing is often used to erode the tax base and the closure of this loophole was a tax policy agenda at the time. This concern continued to be in the tax proposals as noted in various Budget Reviews in the years 2017, 2019, 2020 after the introduction of s 23M with the latest set of proposals in the 2023 Budget Review. (National Treasury, 2017, National Treasury, 2019, National Treasury, 2020, National Treasury, 2023)

Section 23M was enacted by the 2013 Taxation Laws Amendment Act No 31 of 2013 and became effective from 1 January 2015. Section 23M was introduced as part of South Africa's reaction to the BEPS initiatives set out by the OECD with the specific intention of limiting excessive interest deductions in respect of debts owed to persons not subject to tax in South Africa. Since its introduction, s 23M has undergone several amendments, with the latest set out in the 2022 Taxation Laws Amendment Act No 20 of 2022 (Accountancy SA, 2022:1).

National Treasury (2014:20) stated that certain unintended anomalies in the application and impact of these interest limitation rules had been identified and changes had to be made to the section. National Treasury (2018:52) further stated that the amendment of s 23M sought to clarify wording for ease of application, and in 2021 National Treasury (2021b:16) stated that the main drive was to align with the provisions of BEPS Action 4.

Oguttu (2016:143) argued that:

'African countries adopting appropriate measures to prevent base-eroding excessive interest deductions had to balance the need to attract foreign investment against the necessity of protecting their tax bases. The numerous and complex anti-avoidance provisions (as is the case with South Africa) might not be advantageous in this regard as they pose overwhelming administrative burdens and regulatory uncertainty.'

6.1. Research findings

Section 23M came into effect on 1 January 2015 and that was before BEPS Action 4 was finalised in October 2015. That being the case, the question arise whether the

interest limitation rules in s 23M are aligned with the BEPS Action 4 recommendations.

Some tax commentators including the Davis Tax Committee welcomed the introduction of s 23M as a measure to curb base erosion in South Africa through the interest limitation rules. However, the Davis Tax Committee and BDO as noted in section 2.6. concluded that the provisions of s 23M are still not aligned with the BEPS Action 4 recommendations (Davis Tax Committee, 2016, BDO, 2021)

PwC (2022a:3) indicated that in 2021, National Treasury made major amendments to s 23M which were made mainly to align s 23M with BEPS Action 4. PwC (2022a:3) further indicated that the BEPS report issued by the OECD recommended that countries should amend their domestic law to counter BEPS and set out what it considered benchmark guidelines to limit excessive deductibility of interest in the source country.

This research report conducted a comparison of s 23M and BEPS Action 4 to determine whether s 23M was aligned with BEPS Action 4 recommendations. This comparison was conducted in two phase. It looked at:

- whether s 23M was aligned with BEPS Action 4 prior to the 2021 amendments to s 23M; and
- whether s 23M is aligned with BEPS Action 4 post the 2021 amendments to s 23M.

Both these comparisons concluded that although s 23M contains some similarities with the principles of BEPS Action 4, there are also some differences between these two provisions, which result in s 23M still not being fully aligned with BEPS Action 4.

The 2023 Budget Review contains proposals to clarify the provisions of s 23M, but at the time of writing this research report, National Treasury had not published the draft taxation laws amendment bill for public comments.

6.2. Areas for further research

The interest limitation rules in s 23M have been on National Treasury's agenda since the introduction of s 23M in 2013. This anti-avoidance provision which was aimed at

curbing the deduction of excessive interest in South Africa as well as protecting the South African tax base has been subject to a number of amendments over the years.

The main aim of these amendments as expressed by National Treasury in its Budget Reviews in 2017, 2019 and 2020 and the *Explanatory Memorandum to the 2021 Taxation Laws Amendment Act No 20 of 2021* was to clarify the application of s 23M and to strengthen it with further provisions to align with BEPS Action 4. (National Treasury, 2017, National Treasury, 2019, National Treasury 2020b)

The 2023 Budget Review announced that further amendments will be made to provide more clarifications to s 23M. The legislation was being drafted at the time of writing this report and will normally be published in draft for public comments. After the comments have been submitted to National Treasury, public workshops, consultations and parliamentary presentations will be made before the legislation is published in final draft.

As this research report only covers the 2023 budget proposal to s 23M mentioned in section 5.3. in Chapter 5 and does not cover any draft legislation published after the submission of this research report, it follows that further analysis on whether the s 23M are in line with BEPS Action 4 recommendations might be necessary.

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