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University of the Witwatersrand, Johannesburg

School of Accountancy

A research proposal submitted to the Faculty of Commerce Law and Management in partial fulfilment of the requirement for the degree of Master of Commerce (Taxation)

Anti-avoidance provisions limiting interest deductions: A comparative analysis between the OECD and South Africa

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Declaration

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

_____

Nebresca Williams

_____ day of _____ , 2021

First, I would like to thank God, who has granted me countless blessings and opportunities. To my mom and grandparents, who sacrificed so much for me, I am forever grateful.

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TABLE OF CONTENTS

ABSTRACT IX

1 INTRODUCTION 1

1.1 Background 1

1.2 The OECD and BEPS relating to interest 3

1.3 Research problem 8

1.3.1 Problem statement 8

1.3.2 Research Methodology 9

2 A BRIEF OVERVIEW OF THE OECD'S RECOMMENDATIONS RELATING TO BEPS AND OTHER INTEREST LIMITATION RULES 10

2.1 Introduction 10

2.2 The arm's length approach 11

2.3 Withholding Tax on Interest 12

2.4 Rules that disallow a percentage of all interest paid 12

2.5 Rules that limit the amount of interest expense or debt in a company based on a fixed ratio like debt:equity, interest:earnings or interest:total assets 13

2.6 Fixed ratio and group ratio rule 13

2.7 Who should the best practice approach apply to? 15

2.8 Applying a best practice approach depending on the amount of interest paid or the amount of debt owed 15

2.9 Measuring economic activity using earnings 15

2.10 Measuring economic activity using asset values 16

2.11 Addressing volatility and double taxation 16

2.12 Other payments that may be economically equivalent to interest. 16

2.13 Targeted Rules 17

2.14 Best-practice-based approach to banking and insurance groups 18

2.15 Implementing the best practice approach 18

2.16 Hybrid mismatch rules under Action 2 and their relationship with the best practice approach 19

2.17 Controlled foreign company rules under Action 3 and their relationship with the best practice approach 19

2.18 Withholding taxes on interest and its interaction with the best practice approach 19

2.19 Additional interest deduction limitations and their relationship with the best practice solution 20
2.20 Conclusion 20
3 AN OVERVIEW OF THE NORMAL INTEREST DEDUCTION RULES AND ANTI-AVOIDANCE PROVISIONS IN SOUTH AFRICA 23
3.1 Section 24J: The fundamentals of interest deductions 23
3.1.1 Introduction 23
3.1.2 The definition of interest 24
3.1.3 Similar finance charges 26
3.1.4 Requirements for the deductibility of interest 27
3.1.5 The 'in production of income' requirement 28
3.1.6 The 'trade' requirement 29
3.1.7 Conclusion 30
3.2 Section 31: Thin Capitalisation and Transfer Pricing Rules 33
3.2.1 Introduction 33
3.2.2 Application of the old legislation's s 31 provisions 35
3.2.3 Application of the provisions of s 31 in new legislation 36
3.2.4 Conclusion 44
3.3 Section 23N and Section 23M 46
3.3.1 Introduction 46
3.3.2 Application of s 23N 47
3.3.3 Application of s 23M 52
3.3.4 The interaction between s 23N, s 23M and s 31 53
3.3.5 Conclusion 54
4 CONCLUSION 56
4.1 South Africa and the OECD's BEPS Action 4 56
4.2 How the new fixed ratio rule will interact with other provisions in South Africa 59
4.3 Interest limitation rules in BRICS countries 60
REFERENCES 61

List of tables

Table 1: Comparison of s 24J, s 31, s 23N and s 23M and the recommendations of BEPS Action 4 57
Table 2: Interest limitation rules in BRICS countries 60

List of figures

Figure 1: Outbound investment 5
Figure 2: Inbound investment 6
Figure 3: Debt push down 49
Figure 4: Debt push up 50

Abbreviations and Acronyms

OECD	Organisation for Economic Co-operation and Development
BEPS	Base erosion and profit shifting
The Act	Income Tax Act (No 58 of 1962)
SARS	South African Revenue Service
IN	Draft Interpretation Note for Determination of The Taxable Income of Certain Persons From International Transactions: Thin Capitalisation
MNE	Multinational enterprises

Abstract

Companies have two options to finance their operations: equity injections from their shareholders or loans (SARS, 2013, p. 3). The cash outflows as a result of these two methods of financing are dividends and interest respectively (SARS, 2013, p. 3). Since dividends are not allowed as a tax deduction in South Africa, it is clear that companies would benefit by financing their businesses with debt rather than equity since the interest expense on a loan is deductible for tax purposes under s 24J of the Income Tax Act 58 of 1962 (the Act) (SARS, 2013, p. 3). A study completed by de Mooij, R. & Hebous, S. suggests that debt/asset ratios increase by at least 0.14% - 0.46% for corporations every time there is a 1% increase in the tax rate, which proves company tax bias towards debt (Hebous & de Mooij, 2017). Using debt rather than equity also allows for the existing owners in a company to raise funding without the possibility of losing control of the company, which may be the case when equity instead of debt funding is utilised (Halka, et al., 2017, pp. 182-183).

For multinational enterprises, it may be easier to raise debt funding from a company within the same group of companies versus debt obtained from external parties such as banks as they can take advantage of internal synergies (Reynolds & Wier, 2016, p. 4) this creates a problem for tax authorities in certain instances.

The reason for concern is that some multinational enterprises choose to engage in excessive debt financing particularly from companies within their group to charge high interest rates to those branches situated in high tax jurisdictions (Palanský, 2019). Some groups issue loans from a company based in a low-tax jurisdiction allowing the borrower to deduct their interest costs in the high tax jurisdiction resulting in large interest deductions that lower not just the net tax bill for the group but also erodes the tax base in the high-tax jurisdiction (OECD, 2017a, p. 23). This research report will review how multinational enterprises use debt funding as an opportunity to avoid tax and what the regulations are in South Africa to protect the tax base in comparison with the recommendations from the Organisation for Economic Co-operation and Development.

Section 24J of the Act governs the fundamentals of interest deductibility. Section 31(2) of the Act limits interest deductions to the arm's length amount of cross-border debt and interest. Section 23N of the Act limits interest deductions by a company on debt obtained to purchase assets or shares in reorganisation and acquisition transactions. Section 23M limits the deductibility of interest on debt from a foreign person that is not subject to tax in South Africa and is in a controlling relationship with the resident borrower.

Keywords:

Interest deductibility

Base erosion and profit shifting

Thin capitalisation

Interest limitations

Transfer pricing

1 Introduction

1.1 Background

In a study on estimating profit shifting in South Africa using firm-level tax returns, Hayley Reynolds & Ludvig Wier noted that for the 2009 to 2014 fiscal years, corporate income tax on average made up about 20% of total tax revenue (Deloitte, 2019).

For the 2019/20 fiscal year, corporate income tax dropped to 15.9% of total tax revenue (National Treasury, SARS, 2020a, p. 152). The decline is mainly because the corporate tax base shrunk following the great recession of 2008/09 (National Treasury, SARS, 2020a, p. 161).[1] Tax revenue collections have struggled to recover in subsequent years and the technical recession in 2018 also impacted tax revenue growth (National Treasury, SARS, 2019, p. 4). Like other developing countries, South Africa relies on tax revenues especially from corporate income tax (Avi-Yonah, 2017, p. 3). Corporate income tax decreased over the years, but it is still one of the three most significant sources of tax revenue in South Africa (National Treasury, 2020b, p. 152) and it is for that reason essential to protect the tax base.

Globalisation has resulted in multinational enterprises being able to take advantage of discrepancies in tax laws in the different countries within which they operate to reduce their global tax bill and increase profits reported to their investors (OECD, 2019a).

This research report will examine how multinational enterprises (MNEs) attempt to minimise their global tax bill through a practice known as international tax avoidance

[1] Investopedia defines the term Great Recession as both the U.S. recession, officially lasting from December 2007 to June 2009, and the ensuing global recession in 2009 (Investopedia, 2020).

According to (United Nations, 2009, p. 2) 'The effects of the 2008/09 global recession on the commodity economy included a decline in the demand for commodities, shrinking commodity finance and the cancellation of investments, leading in turn to an economic slowdown in commodity dependent economies.'

(Ehrhart & Guerineau, 2012, p. 5) found robust evidence that tax revenues in developing countries increase with the rise of commodity prices but that they are hurt by the volatility of these prices.

specifically related to the use of debt over equity funding to claim high interest deductions and how s 24J, s 31, s 23N and s 23M of the Income Tax Act 58 of 1962 (the Act) in South Africa limits the tax benefits to groups making use of these strategies.

A general bias exists towards debt funding, because interest paid on debt is considered tax deductible in most jurisdictions (OECD, 2017a, p. 19. In contrast, no deductions are allowed for the cash outflows related to equity (OECD, 2017a, p. 19). Some MNEs within the same group of companies take advantage of internal synergies to enter into loan agreements with each other and charge excessive rates of interest to allow for high interest tax deductions for companies situated in high tax jurisdictions when the group of companies as a whole has a minuscule amount of external debt if at all (Ting, 2017).

This research report will examine s 24J, s 31, s 23N and s 23M of the Act that combat profit shifting arrangements relating to the deductibility of interest. The report will provide a brief background to the sections and point out recent developments relevant to those sections.

This report will also outline the recommendations by the Organisation for Economic Co-operation and Development (OECD) with regard to base erosion and profit shifting (BEPS) relating to interest deductions and other financial payments and how a recent proposal to change the interest limitation rules under s 23M in South Africa compare to what other developing countries have done.

As South Africa is one of the BRICS group of nations, a comparison of the proposed changes will be made with the other four countries. BRICS is an acronym for the world's leading emerging market economies, namely Brazil, Russia, India, China and South Africa (South African Government, 2021).

This research report does not cover a detailed analysis of the regulations and issues in specific developing countries except South Africa.

1.2 The OECD and BEPS relating to interest

Multinational enterprises (MNE's) that operate across the globe in different tax jurisdictions can take advantage of misaligned tax laws between countries to reduce the amount of tax payable; this gives them an unfair advantage over domestic companies that do not have the resources to do so (OECD, 2017a, p. 19). In a meeting on 19 June 2012 in Mexico, the G20 leaders highlighted the importance of combating base erosion and profit shifting (G20, 2012). The Organisation for Economic Co-operation and Development (OECD) responded to this request by releasing OECD *Action Plan on Base Erosion and Profit Shifting,* pointing out 15 actions to curb this problem (OECD, 2013, p. 11).

It's important to note that although the strategies MNE's use to avoid tax results in base erosion and profit shifting from certain countries, usually those with higher tax rates, they are entitled to arrange their affairs in such a way that the result is the group paying the least amount of tax, this was confirmed in *IRC v Duke of Westminster* [1936] 19 TC 490 (Williams, 2015, p. 686).

Tax avoidance, unlike tax evasion, is not illegal so long as the methods used are legally permissible; the South African Revenue Service (SARS) believes that certain tax avoidance practices, although legal, are not permissible because they exploit shortcomings in the tax law and achieve tax benefits that were not intended by the legislature (SARS, 2005, p. 3). SARS views permissible tax avoidance as tax planning that results in the most favourable tax outcome intended by the law for a taxpayer, which is in line with Lord Tomlin's view[2] (SARS, 2005, p. 4). Tax evasion per the OECD glossary of terms happens when tax responsibility is withheld or overlooked in fraudulent arrangements, in which the taxpayer pays less tax than he is lawfully obliged to pay by concealing revenue or facts from the tax authorities. (OECD, 2021):

Given that tax avoidance is not illegal, the only way it can be prohibited is through legislation that serves to prevent impermissible practices utilised by taxpayers to obtain

[2] IRC v Duke of Westminster [1936] 19 TC 490, Lord Tomlin: 'every man is entitled to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be'

favourable tax outcomes not intended by the tax law (Oguttu, 2016, p. 7). Despite the fact that tax avoidance is legal, it is frowned upon as it results in revenue loss for governments which impacts on governments' ability to implement economic policy and it negatively impacts taxpayer compliance due to unfair distribution of the tax burden (SARS, 2005, p. 1).

Base erosion and profit shifting (BEPS) occurs due to tax systems not being able to keep up with the constant changes in the economic environment and the way in which business is conducted. (OECD, 2016a, p. 7). Country specific tax rules are centred around a lower degree of business integration across borders – instead of today's setting of worldwide businesses with MNE's operating in and between different jurisdictions (Oguttu, 2016, p. 10). Business is highly synchronised between entities in different countries, the tax rules between countries are not and companies get creative with the types of transactions they enter into that are legal but disadvantage the countries they operate in by not paying their fair share in tax (OECD, 2013, pp. 7-8).

The OECD notes that governments, individuals and businesses are harmed by MNE's paying little or no tax (OECD, 2013, p. 8). Governments lose out on tax revenue which could have been used to stimulate economic growth, individuals perceive the tax system as being unfair since they are required to pay a greater amount of tax and businesses suffer reputational damage from being viewed as tax avoiders and domestic companies are unable to compete fairly with their multinational counterparts (OECD, 2013, p. 8).

An MNE has a number of ways to arrange its affairs to pay the least amount of tax, one of which is strategically funding certain operations using debt rather than equity (Buettner & Wamser, 2013, p. 63). The flexibility of money makes it easy to manipulate the ratio of debt to equity in controlled companies (OECD, 2017a, p. 19). Third party or related party interest can be used as a means to shift profits in a manner that results in the MNE paying very little tax (OECD, 2017a, p. 9).

The OECD advises that base erosion and profit shifting (BEPS) from interest deduction can be achieved in 3 situations (OECD, 2017a, p. 13):

1. Placing a higher degree of third party debt in countries with high rates of taxation (OECD, 2017a, p. 13),
2. Intragroup debt used by companies to generate interest deductions that are greater than the group's real third party interest payments (OECD, 2017a, p. 13) and
3. Financing the production of tax free revenue through the use of third party or intragroup debt (OECD, 2017a, p. 13)

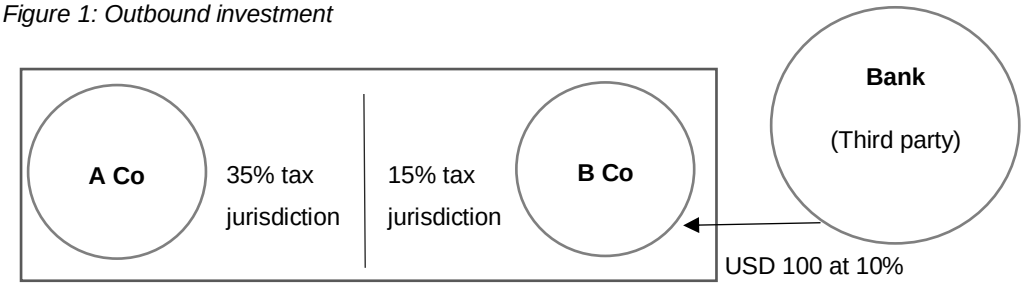
The examples below reflect how income tax rates influence where MNEs position interest expense in both outbound and inbound investment scenarios (OECD, 2017a, p. 20).

Outbound Investment

Consider the group structure below consisting of two entities (A Co and B Co), A Co is based in a country where the corporate tax rate is 35% and international source dividends are tax free, while B Co is based in a country where the corporate tax rate is 15% (OECD, 2017a, p. 20).

A third party bank lends USD 100 to B Co at a 10% rate of interest, B Co earns incremental operating profit of USD 15 by using the loan from the bank (OECD, 2017a, p. 20). B Co has a profit before tax of USD 5 and a profit after tax of USD 4.25 when deducting the interest expense of USD 10 (OECD, 2017a, p. 20). Figure 1 reflects the outbound investment scenario explained above.

Figure 1: Outbound investment



Instead of the structure above, if the third party bank lends the USD 100 to A Co and A Co uses the loan to purchase equity in B Co, in these circumstances, dividends received by A Co from B Co would be tax free, B Co does not pay interest and its entire profit of USD 15 is taxable (OECD, 2017a, p. 20). B Co now has a profit before tax of USD 15 and a profit after tax of USD 12.75, when A Co offsets its interest cost against other revenue, A Co has a cost before tax of USD 10 and cost after tax of USD 6.50 (OECD, 2017a, p. 20). The group makes a total profit before tax of USD 5 and a total profit after tax of USD 6.25 (OECD, 2017a, p. 20).

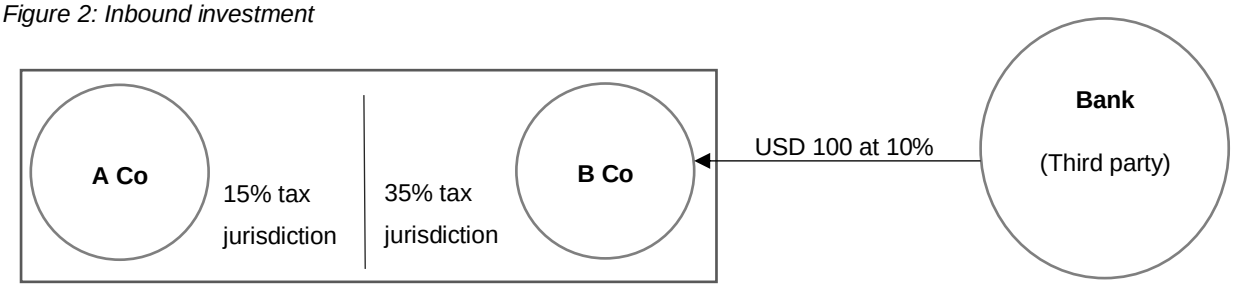
The group now has a negative effective tax rate (the group's profit after tax is greater than its profit before tax) as a consequence of shifting interest expense from B Co to A Co (OECD, 2017a, p. 20).

Inbound Investment

In an inbound investment scenario, where A Co is based in a country with a 15% corporate tax rate and B Co is based in a country with a 35% corporate tax rate (OECD, 2017a, p. 20).

A third party bank lends USD 100 to B Co at a 10% rate of interest, B Co earns incremental operating profit of USD 15 by using the loan from the bank, when offsetting its interest cost against other revenue, B Co has a profit before tax of USD 5 and a profit after tax of USD 3.25 (OECD, 2017a, p. 20). Figure 2 reflects the inbound investment scenario explained above.

Figure 2: Inbound investment



If A Co substitutes USD 50 of B Co's current equity with a loan for the same amount, at a 10% interest rate, B Co will have a profit before tax and a profit after tax figure of 0

(OECD, 2017a, p. 20). Since A Co has interest income on B Co's debt, as well as a profit before tax of USD 5 and a profit after tax of USD 4.25, the group's effective tax rate has been reduced from 35% to 15% by transferring profit from B Co to A Co (OECD, 2017a, p. 20).

Furthermore, A Co could substitute USD 100 of its equity in B Co with a loan for the same amount, when B Co offsets its interest cost against other revenue, B Co has a loss before tax of USD 5 and a loss after tax of USD 3.25 (OECD, 2017a, p. 20). The group has a profit before tax of USD 5 and a profit after tax of USD 5.25 while A Co earns interest income from B Co, A Co has a profit before tax of USD 10 and a profit after tax of USD 8.50 (OECD, 2017a, p. 20). The group has a negative effective tax rate as a result of thinly capitalising B Co and transferring profit to A Co (OECD, 2017a, p. 20).

Action 4 is focused on limiting base erosion due to interest deductions and other financial payments economically equivalent to interest (OECD, 2013, p. 31). This research report aims to provide an overview of the OECD's recommendations in *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update: Inclusive Framework on BEPS.*

The United Nations (UN) assists in combating BEPS in Africa; in 2014, the UN's Capacity Development Unit initiated a plan to provide assistance to developing countries in determining what poses the greatest threats for BEPS in their local tax laws and treaties. One of the most important issues highlighted was BEPS as a result of excessive interest deductions (Halka, et al., 2017, p. 2). The South African government also noted that the deductibility of interest needed to be reviewed and released a discussion paper *Reviewing the Tax Treatment of Excessive Debt Financing, Interest Deductions and Other Financial Payments* in February 2020 (National Treasury, 2020b, p. 1).

South Africa has a number of provisions within the tax law to prevent excessive interest deductions including s 23N which deals with interest relating to reorganisation and acquisition transactions, s 23M which deals with loans to resident taxpayers from taxpayers that do not pay tax in South Africa, s 24J that disallows the deduction of interest if it is not incurred in the production of income through the carrying on of a trade and where the debt funding results in the generation of non-taxable income and s 31 that

deals with cross border loan agreements, between connected parties, where one party to the agreement receives a tax benefit owing to the terms and conditions of that agreement not being at arm's length (ENSafrica, 2020). This research report will include an analysis of the provisions mentioned above.

1.3 Research problem

1.3.1 Problem statement

Some multinational companies take advantage of discrepancies and shortcomings in the tax law and therefore will choose to disproportionately finance their operations with debt, particularly from companies within their group of companies with the intention to avoid paying tax.

The foundation of interest deductions in South Africa lies in s 24J(2) of the Income Tax Act 58 of 1962. Interest is tax deductible provided it is inter alia incurred in the production of income. The amount allowed for interest deductions is limited by s 31, s 23N and s 23M of the Income Tax Act 58 of 1962. The Davis Tax Committee is of the opinion that the rules that regulate interest deductibility in South Africa are unclear (Davis Tax Committee, 2018a, p. 27). Government agrees that the current legislation requires a review and needs to be simplified to create certainty and make it easy for taxpayers to comply (National Treasury, 2020b, p. 6).

The problem that this research report seeks to address is:

How do the South African anti-avoidance provisions comply with OECD recommendations on limiting base erosion involving interest deductions and other financial payments?

The following sub-problems will be addressed:

Sub-problem 1

How are interest deductions used to achieve BEPS?

Sub-problem 2

What are the recommendations from the OECD with regard to BEPS as a result of interest deductions and other financial payments?

Sub-problem 3

How does s 24J of the Act define interest and what requirements must be met for interest to be deductible?

Sub-problem 4

What are the anti-avoidance rules that govern the deductibility of interest under s 31, s 23N and s 23M?

Sub-problem 5

How does 24J, s 31, s 23N and s 23M compare to the recommendations from the OECD?

1.3.2 Research Methodology

The research method adopted is of a qualitative, interpretive nature. The research has been undertaken as a literature review. The sources of information include tax legislation, government releases, books, publications, websites and any other publicly available document relevant to the research.

2 A brief overview of the OECD's recommendations relating to BEPS and other interest limitation rules

2.1 Introduction

In most countries' domestic tax law, the tax consequences of dividends and interest are different (OECD, 2017a, p. 19). Interest expense on debt is tax deductible in the hands of the borrower and included in the taxable income of the lender (OECD, 2017a, p. 19). Dividends are not tax deductible in the hands of the payer; it is included in the income of the beneficial owner of the share (OECD, 2017a, p. 19). An exemption for the dividend income is normally granted, which means that from a domestic point of view, dividends and interest have similar tax consequences (OECD, 2017a, p. 19). The tax consequences in a cross-border transaction are where the problems lie (OECD, 2017a, p. 19). The controlling entity usually seeks to claim high interest deductions and pay very low or no tax on dividend income on its return on equity in a controlled entity; to achieve this, the subsidiaries are highly leveraged (which may result in subsidiaries being thinly capitalised) with intragroup debt in high tax jurisdictions (OECD, 2017a, p. 20).

Tax authorities around the world have developed rules to combat BEPS as a result of excessive interest deductions from third party and related party debt (OECD, 2017a, p. 22). The base erosion and profit shifting (BEPS) action four recommendations from the Organisation for Economic Co-operation and Development (OECD) is centred on the utilisation of third party and intragroup loans to claim interest deductions greater than the group's actual third party interest payment and to fund the generation of tax free or delayed income (OECD, 2017a, p. 23).

The OECD divided the rules implemented by countries to handle BEPS due to interest expense deductions into six groups and noted that some countries use a combination of these rules which are (OECD, 2017a, p. 23):

1. The arm’s length approach
2. Interest withholding tax
3. The disallowance of a portion of all interest paid based on a percentage
4. Rules that limit the amount of interest expense or debt in a company based on a fixed ratio like debt:equity, interest:earnings or interest:total assets
5. Rules that limit the amount of interest expense or debt in a company based on a group’s external debt
6. Specific anti-avoidance laws that do not allow the deduction of interest expense on particular transactions not addressed by any of the other rules

2.2 The arm’s length approach

The arm’s length approach requires that the economic climate in which a business operates and other business and market related factors that determine the amount of debt each company that is part of a larger group of companies would be able to secure should be taken into account when determining whether the rate or amount of interest expense is reasonable or not (OECD, 2017a, p. 24). Owing to the complexities of this system, it is a very difficult process for both tax authorities and taxpayers, and this view is held by countries that have implemented it for many years (OECD, 2017a, p. 24).

Each company in a group is considered separately from the group meaning the results of the arm’s length test could be unpredictable, although it appropriately perceives each company within a group as a separate entity with differing levels of interest expense subject to their unique state of affairs (OECD, 2017a, p. 24). The arm's length test does not prohibit a company from deducting interest on loans used to fund investments in non-taxable assets or exempt income in excess of its group's actual third-party interest cost and it permits interest on loans used to finance investments in non-taxable assets or exempt income to be deducted (OECD, 2017a, p. 24).

Despite the disadvantages of the arm’s length test, it could be a valuable addition to other rules, such as determining the value of the interest income and expense of a

company before applying interest limitation rules (OECD, 2017a, p. 24). The Arm's length test cannot be used on its own as an effective and efficient rule to combat BEPS (OECD, 2017a, p. 24).

2.3 Withholding Tax on Interest

The main purpose of withholding tax is to assign taxing rights to a source jurisdiction (OECD, 2017a, p. 24). Withholding tax is a straightforward, non-resource intensive rule for governments to implement and although it decreases the benefit to multinational groups from BEPS through cross-border interest payments, the chance of BEPS still exists since the withholding tax rate is usually lower than the corporate tax rate (OECD, 2017a, p. 24). In South Africa, the withholding tax rate is 15% which is substantially lower than the corporate income tax rate of 28% (SARS, 2021). The OECD discards withholding tax as an effective rule to address BEPS; they advise that countries may continue utilising withholding tax rules while implementing the best practice approach (OECD, 2017a, p. 24).

2.4 Rules that disallow a percentage of all interest paid

Rules that disallow a portion of all interest expense incurred by companies based on a percentage could assist in decreasing the tax bias that exists for debt over equity funding; this type of rule causes the cost of debt funding to rise and results in companies that are low leveraged and not necessarily involved in BEPS being faced with the same percentage of disallowance as those with higher leverage (OECD, 2017a, p. 24).

2.5 Rules that limit the amount of interest expense or debt in a company based on a fixed ratio like debt:equity, interest:earnings or interest:total assets

Rules limiting interest based on a fixed ratio are fairly easy to apply because it is easy for tax administrators to obtain the relevant information on the level of debt and equity in a company from its published financial statements, interest expense is linked to a company's economic activity and it gives MNE's some certainty with regard to planning their financing (OECD, 2017a, p. 25). Most countries make use of a fixed ratio rule linking the deductibility of interest to the level of equity in a specific company through thin capitalisation rules subject to a debt:equity test (OECD, 2017a, p. 25). On the negative side, thin capitalisation rules do not limit the cost of debt, meaning companies could still claim excessive interest deductions based on very high interest rates charges on debt (OECD, 2017a, p. 25). The greater the amount of capital invested in a company, the greater the amount of interest it will be able to claim as a tax deduction; this may result in MNE's manipulating the amount of equity in specific companies (OECD, 2017a, p. 25). According to the OECD, thin capitalisation rules are not appropriate to use as part of a best practice approach to combat BEPS because of its disadvantages; nevertheless, it is a rule that may still be adopted by countries as part of the overall tax policy (OECD, 2017a, p. 25).

2.6 Fixed ratio and group ratio rule

Fixed ratio rules on the basis of a company's interest-to-earnings ratio are more suitable for fighting BEPS; unlike equity earnings, it is a direct measure of a company's economic activity (OECD, 2017a, p. 25). The OECD's best practice recommends a fixed ratio rule based on a company's interest:earnings should be used to limit interest deductions. Earnings before interest, taxes, depreciation and amortisation (EBITDA) is the common indicator of earnings (OECD, 2017a, p. 25). It is possible that some companies in multinational groups can still claim more interest than the value of the group's overall third-party interest cost (OECD, 2017a, p. 25). Research has shown that based on their consolidated financial statements, most publicly traded MNE's have a net third party net interest:EBITDA ratio below 10% if they have a positive EBITDA (OECD, 2017a, pp. 25-26).

Fixed ratio rules that compare ratios in a specific company to that of its worldwide group are not popular (OECD, 2017a, p. 26). The countries that do have group ratio rules in

place mostly compare an individual company's debt:equity ratio to that of its group (OECD, 2017a, p. 26).

Targeted rules may be used to supplement a general interest limitation provision and thus, targeted rules as part of the best practice approach are highly recommended as they address specific BEPS risks (OECD, 2017a, p. 26). Companies usually stay a step ahead of the legislation and as they formulate new strategies to avoid tax new targeted rules may need to be implemented, which would make the legislation difficult to understand and apply for both taxpayers and administrators and increases the cost of compliance for companies as they would have to hire experts to interpret the law and assist them in the application of it (OECD, 2017a, p. 26).

An important goal for the OECD was to have a best practice approach that is effective in preventing or reducing its use or effect, that does not require too many additional targeted rules, although some may still be required and is easy for both taxpayers and tax authorities to apply (OECD, 2017a, pp. 26-29).

The best practice approach involves limiting Interest and payments economically equivalent to interest to a fixed ratio of net interest:EBITDA calculated using tax figures (OECD, 2017a, p. 29). Interest above the fixed ratio is disallowed as a tax deduction; it is also advised that a *de minimis* threshold would make it easier to administer this rule by excluding low risk groups of companies situated in a particular country from the interest limitation rule (OECD, 2017a, p. 29). Alongside a rule that limits interest expense deductions to a fixed ratio, it is also recommended that an optional group ratio rule is implemented to allow companies that are highly leveraged for non-BEPS purposes to deduct interest expense from taxable income up to the amount of its group's net interest cost charged by third parties if it is greater, in this case only the interest higher than the group ratio is disallowed (OECD, 2017a, p. 30).

2.7 Who should the best practice approach apply to?

It is recommended that the fixed ratio rule to limit interest must apply to all companies in an MNE; the rule may also be applied to domestic groups or companies that do not form part of a group (OECD, 2017a, p. 31). A group consists of a controlling company and all of its subsidiaries that are consolidated in the controlling company's financial statements (OECD, 2017a, p. 63).

2.8 Applying a best practice approach depending on the amount of interest paid or the amount of debt owed

The main reason for MNEs successful BEPS behaviour is that they can artificially separate taxable income from the value creating practices that underpin it (OECD, 2017a, p. 41). The best practice approach includes a fixed ratio rule which limits the interest that a company can deduct based on a percentage of EBITDA; it also suggests a group ratio rule that addresses some of the difficulties that are created by the fixed ratio rule (OECD, 2017a, p. 42).

2.9 Measuring economic activity using earnings

The fixed ratio and group ratio rule are based on a percentage of earning and EBITDA (earnings before interest, taxes, depreciation and amortisation) and EBIT (earnings before interest and taxes) are two alternatives for countries to choose from when it comes to defining earnings (OECD, 2017a, p. 48).

Using earnings to measure economic activity is the best way to guarantee that interest tax deductions are linked with the activities that generate taxable income (OECD, 2017a, p. 47). Earnings make the fixed ratio and group ratio rule more effective against planning because, in order to claim more interest deductions, a company would have to increase their earnings in a particular country, increasing earnings increases taxable income and therefore will deter companies from manipulating earnings to receive bigger interest deductions similarly, moving profits or earnings out of a tax jurisdiction would decrease the tax deduction for interest in that jurisdiction (OECD, 2017a, p. 47).

Earnings could be erratic and MNEs cannot reasonably control this, which creates uncertainty as companies would not be able to forecast their net interest deductions from year to year (OECD, 2017a, p. 47).

2.10 Measuring economic activity using asset values

Asset values are usually less volatile than earnings, thus providing some predictability with regard to the amount of interest that will be deducted for tax purposes (OECD, 2017a, p. 47). Using an asset based approach affords companies with negative earnings the opportunity to deduct interest that might not be the case if the interest limitation fixed ratio rule is based on earnings (OECD, 2017a, p. 47).

2.11 Addressing volatility and double taxation

To minimise the impact of interest expense and related earnings not occurring in the same tax periods and the volatility of earnings, governments may allow companies to bring forward or back the portion of interest payments that are disallowed for use in future or earlier tax periods or use an average EBITDA over three years or introduce a group ratio rule (OECD, 2017a, p. 30).

2.12 Other payments that may be economically equivalent to interest.

Countries around the world have their own definition of what constitutes interest (OECD, 2017a, p. 33). The OECD notes that in order to address BEPS from excessive interest deductions, it will be best for countries to adopt a consistent approach to identifying expenses that should be regarded as interest, to apply the interest limitation best practice rule, as this creates certainty for MNE's and a co-ordinated approach for tax authorities to combat BEPS internationally (OECD, 2017a, p. 33). It is important to apply interest limitation rules to interest on all types of debt, other financial payments economically equivalent to interest and expenses incurred in connection with raising debt (OECD, 2017a, p. 33). A partial list of costs that should be considered to be economically equivalent to interest is provided by the OECD as part of the best practice approach (OECD, 2017a, p. 33). This list will be included in chapter 3 of the research report.

2.13 Targeted Rules

The fixed ratio and group ratio rules are general interest limitation rules and that is why targeted rules are required to supplement the best practice approach to address specific BEPS risks that are not covered by the general rules (OECD, 2017a, p. 75). Most countries rely only on targeted rules and do not have a general interest limitation rule; this approach is not ideal since it would require too many rules to target specific transactions, which will result in a complex tax system (OECD, 2017a, p. 75). The OECD report points out some risks which will require targeted rules that the general fixed and group ratio rule does not address (OECD, 2017a, p. 76):

- A company with net interest cost enters into an agreement to lower net interest expense to comply with the fixed ratio rule by, for example, converting interest expense into a different type of tax deductible expense or converting taxable income into a type of income economically equivalent to interest (OECD, 2017a, p. 76)

- Under the group ratio rule, a company that is part of a group enters into an agreement with a connected or third party to raise the amount of net third party interest cost, for example, by making a payment to a connected party or third party under a structured agreement or converting interest income into a different type of income (OECD, 2017a, p. 76)

- A group is restructured to produce two entities by putting an unincorporated holding company at the top of the hierarchy; this may be to avoid the application of the fixed ratio rule (for example, in a jurisdiction where the rule is not applicable to standalone companies) or to split the initial group into two sections for the purposes of the group ratio rule (OECD, 2017a, p. 76)

The fixed ratio and group ratio rule (best practice approach) recommended by the OECD provides a robust solution to combat BEPS relating to interest and payments economically equivalent to interest if a country chooses to limit the general rule to companies in MNE's only then targeted rules would be required for those companies that do not form part of an MNE and therefore are not subject to the general rule (OECD,

2017a, p. 77). The OECD prescribes that the definitions of 'related parties' and 'structured arrangements' ought to be clear to address the risks (OECD, 2017a, p. 77).

2.14 Best-practice-based approach to banking and insurance groups

Based on the uniqueness of the banking and insurance industries, such as how strongly regulated they are, interest being a large amount of their earnings compared to other sectors and the fact that they hold financial assets and liabilities as part of their primary business activities, a different approach from the recommended general interest limitation rule should apply when addressing BEPS related to interest in these industries (OECD, 2017a, p. 79).

The OECD suggests that banks and insurance companies should not be exempted from the best practice approach but that an approach that incorporates rules which are suitable to combat BEPS by companies in this industry. To that end, additional work will be undertaken to combat the potential BEPS risks by companies in this industry (OECD, 2017a, p. 80).

2.15 Implementing the best practice approach

Countries are advised to grant sufficient time to companies to restructure existing financing arrangements before the best practice interest limitation rules come into effect (OECD, 2017a, p. 83). Whether or not prior debts before the implementation of this approach will be excluded or not is up to each country (OECD, 2017a, p. 83).

Countries that apply separate entity taxation systems may apply the best practice approach in the following manner (OECD, 2017a, p. 84):

- Apply best practice approach to companies separately based on each company's EBITDA;

- Apply the best practice approach to companies within a tax group as a single entity; or

- Treat all companies, which are part of the same financial reporting group in the country as a single entity to make use of the best practice approach.

2.16 Hybrid mismatch rules under Action 2 and their relationship with the best practice approach

Applying the best practice approach decreases but does not eradicate the BEPS threat caused by hybrid mismatch arrangements, the final report prescribes that the rules to address hybrid mismatch arrangements should first be applied before the fixed ratio and group ratio rules are applied to a company (OECD, 2017a, p. 85). When the total net interest expense amount has been established using the hybrid mismatch rules, then it is possible to use the fixed ratio and group ratio rules to determine what portion of interest expense will be disallowed as a tax deduction (OECD, 2017a, p. 85).

2.17 Controlled foreign company rules under Action 3 and their relationship with the best practice approach

The best practice approach should reduce the pressure on controlled foreign company (CFC) rules by promoting MNEs to evenly distribute their net interest expense between companies in the group such that the interest is linked to taxable economic activity (OECD, 2017a, p. 86). A country may introduce both the CFC rules under Action 3 as well as the best practice approach under Action 4 (OECD, 2017a, p. 85).

2.18 Withholding taxes on interest and its interaction with the best practice approach

Countries like South Africa that apply withholding tax on interest should have no problem applying the best practice approach, there ought to be no impact on withholding tax on interest and therefore, it may remain in force (OECD, 2017a, p. 86).

2.19 Additional interest deduction limitations and their relationship with the best practice solution

Countries may additionally apply other common interest limitation rules, for instance, the arm's length rule and thin capitalisation rules, to limit the deductibility of interest expense (OECD, 2017a, p. 86). In the majority of cases, targeted rules ought to be applied before the best practice approach is applied (OECD, 2017a, p. 86).

2.20 Conclusion

The OECD's best practice approach consists of a general interest limitation rule that addresses the majority of BEPS relating to interest and costs that are equal to interest in terms of economic value coupled with targeted rules that will combat BEPS risks that the general rule does not address (OECD, 2017a, p. 31). There are six components in the best practice approach (OECD, 2017a, pp. 29-31):

1. A fixed ratio rule enabling companies to deduct net interest expense not greater than a fixed net interest:EBITDA ratio set between the range of 10%-30%. This rule is mandatory.

2. A group ratio rule enabling companies to deduct net interest expense up to a fixed net interest:EBITDA ratio of its worldwide group if this ratio is higher than the fixed ratio. This rule is optional.

3. The ability for companies to carry forward or carry back prohibited/unused interest for use in future or earlier tax periods. This rule is optional.

4. Targeted anti-avoidance rules to combat the risks of BEPS relating to interest that is not covered by the fixed or group ratio rule. These rules are mandatory.

5. A *de minimis* threshold dependent on local groups' net interest cost to exclude low risk domestic groups from the interest limitation rules. This rule is optional.

6. Rules that are specific to the risks of BEPS relating to interest in the banking and insurance sectors. This rule is mandatory.

A suitably low baseline ratio should be used to effectively combat BEPS due to interest (OECD, 2017a, p. 52). With interest rates changing over time, it may be necessary to change the range as they change (OECD, 2017a, p. 58). The baseline ratio should allow most group entities to claim net interest up to their net interest expense from third parties and reduce the use of intra group loans by groups to claim interest payments greater than interest expense from third parties, a list of other factors to consider when setting a baseline ratio is provided (OECD, 2017a, pp. 53-54):

1. If a country uses a fixed ratio rule on its own instead of it being used in combination with a group ratio rule, it can use a higher baseline fixed ratio (OECD, 2017a, p. 54)

2. If a country does not allow companies to bring forward or back disallowed interest deductions, it can use a higher baseline fixed ratio (OECD, 2017a, p. 54)

3. A country can use a higher baseline fixed ratio if it also uses additional targeted rules to limit interest deductions (OECD, 2017a, p. 54)

4. If a country's interest rates are higher than those in other countries, it should use a higher baseline fixed ratio (OECD, 2017a, p. 54)

5. A country can use a higher baseline ratio if it is required to consider different categories of institutions that are considered as legally equal, even if they pose different risk levels, for constitutional purposes (OECD, 2017a, p. 54)

6. Depending on the size of a company's group, a country can use various fixed ratios (OECD, 2017a, p. 54)

A general rule like the arm's length principle may be used to establish the cost of debt (OECD, 2017a, p. 24). Other targeted rules are important, especially in countries that do not make use of a group ratio rule (OECD, 2017a, p. 76).

The best practice approach is reasonably easy for tax authorities and multinational groups to apply and is effective against planning to reduce or avoid its application (OECD, 2017a, p. 29). Figures from a company's audit consolidated and individual financial statements can be used to calculate the measure of earnings (EBITDA) (OECD, 2017a, p. 63). The best practice approach hinders the potential of a company claiming large amounts of interest expense based on an objective measure of its economic activity hence making it difficult for companies to manipulate since they would have to increase earnings to increase the amount of interest that is tax deductible and increasing earnings would increase taxable income and attempting to shift profits would reduce the amount of interest deductible in any country (OECD, 2017a, p. 47).

Interest is generally the cost of borrowing funds; the OECD advises that this definition may not be sufficient to also address BEPS by companies that make use of different structures and financing arrangements that result in payments that are similar to interest if these payments are not included in the limitation rules companies that make use of these arrangements will therefore avoid paying tax (OECD, 2017a, p. 33). The OECD recognises that the definitions of interest in different countries are due to specific tax policy objectives and advises that rather than changing the definition of interest that tax authorities should identify the payments for which tax deductions may be claimed with regard to debt funding (OECD, 2017a, p. 41).

To address BEPS risks in the insurance and banking industries, a best practice approach with specific rules relating to these entities should be implemented (OECD, 2017a, p. 80). The OECD released a discussion draft on the plan to address BEPS involving interest in the banking and insurance industries (OECD, 2016b).

3 An overview of the normal interest deduction rules and anti-avoidance provisions in South Africa

3.1 Section 24J: The fundamentals of interest deductions

3.1.1 Introduction

In South Africa, it makes no difference whether interest is capital in nature or not; as long as it is spent in the generation of revenue and as part of the carrying on of a trade, the cost is tax deductible (ENSafrica, 2020). Section 24J of the Income Tax Act 58 of 1962 (the Act) will be examined from the point of view of the borrower. Section 24J includes provisions that manage the tax consequences of the 'issuer' and the 'holder' of a debt.

The definition of a holder of an instrument and the tax consequences of the holder is outside the scope of this research report since it is the issuer which is the taxpayer that would attempt to claim an interest deduction under s 24J(2). The definition of an 'issuer' as per s 24J(1) is:

> (a) any person who has incurred any interest or has any obligation to repay any amount in terms of such instrument; or
>
> (b) at any particular time, means any person who, if any interest payable in terms of such instrument was due and payable at that time, would be liable to pay such interest.

From the definition of an 'issuer', it is evident that the issuer is the borrower that incurs interest expense (Oguttu, 2005, p. 163). Based on the above definition, it is important to first identify what an 'instrument' is prior to determining whether or not the interest and finance charges will be tax deductible (Sonnenbergs, 2011, p. 5). Section 24J(1) defines an 'instrument' as:

> (c) any interest-bearing arrangement or debt;
>
> (d) any acquisition or disposal of any right to receive interest or the obligation to pay any interest, as the case may be, in terms of any other interest-bearing arrangement; or
>
> (e) any repurchase agreement or resale agreement, which was—
>
> i. issued or deemed to have been issued after 15 March 1995;
>
> ii. issued on or before 15 March 1995 and transferred on or after 19 July 1995; or

iii. in so far as it relates to the holder thereof, issued on or before 15 March 1995 and was unredeemed on 14 March 1996 (excluding any arrangement contemplated in subparagraphs (i) and (ii)), but excluding any lease agreement (other than a sale and leaseback arrangement as contemplated in section 23G) or any policy issued by an insurer as defined in section 29A.

The term "interest-bearing arrangement or debt" in para (c) encapsulates the idea of an "instrument." (Sonnenbergs, 2011, p. 5). In addition, the definition of an instrument includes any right to receive interest or the obligation to repay interest, as well as the inclusion of a repurchase or resale agreement; these are outside the scope of this research report (report) (Income Tax Act 58 of 1962, s 24J(d)-(e)). In view of that, for this report, the focus will be on whether a debtor can obtain a tax deduction under Section 24J(2) for interest on an interest-bearing arrangement or debt.

Section 24JB of the Act governs the deductibility of interest expense for specific taxpayers, such as banks and companies forming part of banking groups (ENSafrica, 2020). This section is in line with the suggestion by the OECD for countries to have specific interest rules that apply to the banking industry (OECD, 2017a, p. 80).

3.1.2 The definition of interest

The definition of the term ‘interest’ can be found in s 24J(1). Following the release of the *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update: Inclusive Framework on BEPS* by the OECD, the definition of “interest” and the rules governing the deductibility of interest have not changed in South Africa (ENSafrica, 2020). The definition of interest in s 24J(1) of the Act is not extensive enough to encompass payments that are economically equivalent to interest as per the OECD’s recommendation (National Treasury, 2020b, p. 45).

‘Interest’ according to s 24J(1) includes:

(a) gross amount of any interest or similar finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement;

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

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

irrespective of whether such amount is—

i. calculated with reference to a fixed rate of interest or a variable rate of interest; or
ii. payable or receivable as a lump sum or in unequal instalments during the term of the financial arrangement.

The interest definition's unique inclusions would not be addressed. For this research report, only the word ‘interest’ and ‘similar finance charges’ in paragraph (a) of the definition of interest will be discussed in more detail.

The definition of ‘interest’ circularly refers to the word ‘interest’, which does not define a meaning for the word in the Act (ENSafrica, 2016); for that reason, it requires further interpretation first by analysing the literal meaning of the word. In *Venter v R* 1907 TS 910 914 (Venter v R), it is noted that the literal meaning of words may be applied unless it results in ambiguity or a meaning that was not intended by the legislature. The main deciding factor is the legislature's intent when writing the provision (Venter v R). The common law meaning of the word can also be determined using relevant case law (de Koker & Williams, 2020, p. 7.34).

The courts would make use of dictionaries when attempting to interpret provisions in the legislation; according to the *Shorter Oxford English Dictionary* Sixth Edition, the word ‘interest’ is defined as ‘*money paid for the use of money or for the forbearance of a debt*’ (ENSafrica, 2016). According to common law, interest may be regarded as compensation for the provision of credit provided by a lender to a borrower (de Koker & Williams, 2020, p. 7.34). Essentially interest can be seen as the cost of borrowing money according to the OECD (OECD, 2017a, p. 33).

In *Bennett v Ogston (1930) 15 TC 374*, interest was considered to be (p. 379):

payment by time for the use of money

In *Garnett Paul Curran v HMRC [2012] UKFTT 517 (TC)*, the First-tier Tribunal established that:

> the simple test of what constitutes interest is that it is a payment for the use of money, or, taking the other side of the coin, a payment received for the deprivation of money by reference to the period of time of that use or deprivation.

In *Commissioner for Inland Revenue v Lever Brothers & Unilever 1946 AD 441 (CIR v Lever Brothers)*, Watermeyer CJ said in a majority judgement:

> one speaks of a debt carrying interest, or interest on a debt, as though interest were a sort of growth sprouting from the debt, the language used means no more than that the borrower pays interest, if that is the agreement between borrower and lender, as consideration for the benefits allowed to him by the lender

It is held in *CIR v Lever Brothers* that, where a lender supplies money to a borrower, the lender will receive consideration by way of a charge, which is normally stated as a percentage of the unsettled portion of the loan amount. This fee is the interest, and it matches the concept of interest set out in Section 24J(1) of the Act.

3.1.3 Similar finance charges

'Similar finance charges' is not defined in the Act and there is no case law attributing meaning to this term with regard to s 24J, which requires a determination of its literal meaning as per the literal approach above (Kotze, 2017). The literal meaning of the words can be found in the *Collins English Dictionary,* which defines *'*similar*'* as *'showing resemblance in qualities, characteristics, or appearance; alike but not identical*' and ***'finance charge' as*** *'fees or interest that you pay when you borrow money or buy something on credit.'* (Collins, 2021).

In determining the intention of the legislature, Kotze argues that the difference between the meaning of 'related finance charges' and 'similar finance charges' may not be discernible in practice and whether or not the interpretation of the old 'related finance charges' will now be void (Kotze, 2017). 'Related finance charges' included, among other things, bid expenses, developer fees, legal fees, insurance, start-up costs, specialist

advocate costs and lenders technical advisors' costs in ITC 1870, 76 SATC 97, Victor J allowed for the deduction of all these expenses as 'related finance charges' which amounted to a total of R 64 million. The definition of interest was amended by the *Taxation Laws Amendment Act, 2016,* published on 19 January 2017. The purpose of the amendment was to *'clarify the policy position that this applies to finance charges of the same kind or nature';* the expected result of this change was to narrow the courts' prior interpretation of what constitutes interest (Mazansky, 2016).

3.1.4 Requirements for the deductibility of interest

Once it is established that a taxpayer meets the definition of an issuer of an instrument, whether or not interest on a debt is tax deductible is determined by way of establishing the reason for incurring the interest expense and whether it is incurred during the production of income in the course of a trade (ENSafrica, 2020). To decide this, the courts in South Africa ought to consider the association between interest expense and the income-generating activities of the taxpayer (Oguttu, 2005, p. 163). If the funds relating to the interest expense are used to produce taxable income, then the interest expense is tax deductible (ENSafrica, 2020).

Section 24J(2) states that an issuer (borrower) in relation to a debt instrument will be deemed to have incurred interest expense equal to the total amount of interest incurred during any tax year or a portion of a month during that tax year and the amount of interest must be deducted from income derived from the carrying on of a trade and provided that the interest was incurred in the production of income (Income Tax Act 58 of 1962, s 24J(2)).

From the above, it can be deduced that for an amount of interest to be deductible, the following requirements must be met (Oguttu, 2005, pp. 163-166):

- 'In production of income' requirement
- 'Trade' requirement

The deductibility of interest is directed by the requirements contained in s 24J(2):

> Where any person is the issuer in relation to an instrument during any year of assessment, such person shall for the purposes of this Act be deemed to have incurred an amount of interest during such year of assessment, which is equal to—
>
> (a) the sum of all accrual amounts in relation to all accrual periods falling, whether in whole or in part, within such year of assessment in respect of such instrument; or
>
> (b) an amount determined in accordance with an alternative method in relation to such year of assessment in respect of such instrument,
>
> Which must be deducted from the income of that person derived from carrying on any trade, if that amount is incurred in the production of the income.

In order to determine the amount of interest that will be tax deductible, a formula in terms of s 24J needs to be applied.

3.1.5 The 'in production of income' requirement

In *CIR v G Brollo Properties (Pty) Ltd 1994 2 SA 147 (A),* it was stated that when attempting to determine whether interest is deductible, the purpose of acquiring the debt needs to be assessed to ascertain whether there is a direct link between the expenditure and the income-producing activities of the borrower, if the purpose of borrowing the money is to acquire the means to produce income, the interest expense on the debt is tax deductible. Loans acquired to use the funds for business activities that produce exempt income or income that does not meet the requirements of the definition of 'income' in s 1 of the Act will not be allowed as a tax deduction (*Commissioner for Inland Revenue v Allied Building Society 1963 (4) SA 1 (A), pp. 13C-G*).

In *Financier v Commissioner of Taxes 1950 (3) SA 293 (SR)*, it was held that when a taxpayer borrowed money to utilise within the business generating their income but later on they invested this money on an investment that does not generate income that is taxable the interest would still be tax deductible. The judgment in *1950 (3) SA 294(SR)* confirmed that when the money is used for non-income producing activities at a later stage is not necessarily a deciding factor in consideration of interest deductibility:

1. Where a taxpayer borrows a specific sum of money and applies that sum to a purpose unproductive of income, and not directly connected with the income-earning part of his business, then the interest paid on the borrowed money cannot be deducted as expenditure incurred in the production of income.

2. Where a taxpayer has for good and sufficient reasons borrowed money for use in the business producing his income, despite the fact that he subsequently, in pursuit of a legitimate business purpose, invested such money in an investment which does not produce taxable income, the interest is still deductible for income tax purposes.

It would seem that the test to be applied is the purpose for which the money was borrowed.

3.1.6 The 'trade' requirement

Aside from requiring that it must be established that interest expense was incurred in the production of income, s 24J(2) requires that interest expense may only be tax deductible if it was incurred for the taxpayer's trade.

The South African Revenue Service (SARS) allows expenses incurred in producing income to be deducted, although the receipt or the accrual of the income was not incorrect in the course of a trade (SARS, 1994, p. 2). SARS's practice is detailed in Practice Note 31, the applicable portion states:

> While it is evident that a person (not being a moneylender) earning interest on capital or surplus funds invested does not carry on a trade and that any expenditure incurred in the production of such interest cannot be allowed as a deduction, it is nevertheless the practice of Inland Revenue [now SARS] to allow expenditure incurred in the production of interest to the extent that it does not exceed such income. This practice will also be applied in cases where funds are borrowed at a certain rate of interest and invested at a lower rate. Although, strictly in terms of the law, there is no justification for the deduction, this practice has developed over the years and will be followed by Inland Revenue.

Practice note 31 provides guidance for what SARS would generally do in certain circumstances; it is important to note however that practice notes are not binding in South African law and Practice note 31 warns that where a taxpayer does not carry on a trade, there is no valid basis for granting an interest deduction (SARS, 1994, p. 2).

The term 'trade' in s 1 of the Act includes:

> every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent as defined in the Patents

> Act [57 of 1978], or any design as defined in the Designs Act [195 of 1993], or any trade mark as defined in the Trade Marks Act [194 of 1993], or any copyright as defined in the Copyright Act [98 of 1978], or any other property which is of a similar nature.

In *Burgess v Commissioner for Inland Revenue [1993] 2 All SA 511 (A)*, the court held that the definition of 'trade' ought to be given a broad meaning as being 'well established'. It was determined if the appellant was carrying on a business or a trade relating to s 11(a) of the Act read in conjunction with s 23(g).

In *Commissioner for South African Revenue Service v Tiger Oats Ltd [2003] 2 All SA 604 (SCA) 65 SATC 281*, the court determined if an investment holding company was indeed carrying on a trade for the application of the Regional Services Act 109 of 1985. It was held, among other things, that:

> In a very real commercial sense the respondent [was] actively involved in the business of its subsidiaries and associated companies and its making of investments in those companies which enabled it to be actively involved;… [the respondent was] not simply a passive investor in [its subsidiaries and associated companies], equitable with a member of the public who invest[ed] in listed shares on the stock exchange

3.1.7 Conclusion

Interest expense is tax deductible under s 24J(2) regardless of whether it is of a capital nature so long as the debt relating to that interest was acquired in the production of income and for the purposes of the borrower's trade. According to South African law, to determine whether the expenditure was incurred in the production of income, the purpose of acquiring the debt and consequentially the expense needs to be established by evaluating the relationship between the expense and the income-earning activities of the taxpayer's business (Oguttu, 2005, p. 163). Interest not incurred in the production of income is not tax deductible (*Commissioner for Inland Revenue v Allied Building Society 1963 (4) SA 1 (A), pp. 13C-G)*. The definition of 'trade' is not exhaustive; it requires factual analysis on a case by case basis; in this regard, no particular set of rules can be relied upon *(Burgess v Commissioner for Inland Revenue [1993] 2 All SA 511 (A))*.

Practice note 31 guides taxpayers with regard to the general practice of SARS concerning the deductibility of interest expense; however, practice notes are not enforceable by law and therefore, it is safer to rely on case law when attempting to interpret the provisions discussed in this chapter concerning s 24J (ENSafrica, 2020).

The Act does not define 'interest' except for in s 24J(1), where the definition refers to the word interest; this is why the common law meaning needs to be determined (de Koker & Williams, 2020, p. 7.34). Based on case law, interest is defined as consideration for the use of money paid by a borrower to a lender (*Bennett v Ogston (1930) 15 TC 374*). The definition of interest is not adequate to take into account payments economically equivalent to interest listed by the OECD Report (OECD, 2017a, p. 34):

- Payments made under profit sharing loans (OECD, 2017a, p. 34)
- Interest that is owed on securities like convertible bonds and zero coupon bonds (OECD, 2017a, p. 34)
- Sums financed by non-traditional means, such as Islamic finance (OECD, 2017a, p. 34)
- The finance lease payment's finance expense portion (OECD, 2017a, p. 34)
- Capitalised interest or capitalised interest amortisation included in the statement of financial position value of a related asset (OECD, 2017a, p. 34)
- Where applicable, sums calculated using a funding return in accordance with transfer pricing provisions (OECD, 2017a, p. 34)
- Notional interest amounts attributable to a company's debts under derivative contracts or hedging agreements (OECD, 2017a, p. 34)
- Some foreign exchange profits and losses on debts and instruments used to raise funds (OECD, 2017a, p. 34)
- Pledge fees for lending arrangements (OECD, 2017a, p. 34)
- Contract fees and other fees associated with obtaining debt (OECD, 2017a, p. 34)

This non-exhaustive list of payments economically equivalent to interest is important for countries to include as payments that form part of 'interest' to create more certainty for multinational groups operating in the global economy when applying the best practice approach discussed in Chapter 2 (OECD, 2017a, p. 33).

In terms of the OECD's report, the best practice approach is not intended to limit deductions on the following (OECD, 2017a, p. 34):

- Gains and losses on foreign exchange on monetary products unrelated to obtaining debt
- Sums held in financial contracts or hedging agreements that aren't linked to debt, such as oil futures or any other commodity derivatives
- Discounts relating to clauses in agreements that are not relevant to debt
- Payments on operating leases
- Royalties
- Interest accrued on fixed benefit pension schemes

3.2 Section 31: Thin Capitalisation and Transfer Pricing Rules

3.2.1 Introduction

Transfer prices are the costs for goods and services that connected/related parties charge when doing business with each other (Benetello, Undated, p. 10.1). Transfer pricing becomes an issue for tax authorities when multinational enterprises (MNEs) manipulate prices in such a way that it results in shifting of large amounts of taxable income from a high tax jurisdiction like South Africa to a low tax jurisdiction causing the erosion of the tax base (Benetello, Undated, p. 10.1). Section 31 was intended to mainly govern the relationship-based pricing of goods and services between connected parties, one which is resident in South Africa and the other which is resident outside of South Africa (Ernst & Young, 1996). Thin capitalisation, on the other hand, refers to the circumstance in which a company is financed through moderately high levels of debt compared to equity (Halka, et al., 2017, p. 189). Thin capitalisation rules were governed by s 31(3) of the Income Tax Act 58 of 1962 (the Act) (de Koker & Williams, 2020, p. 17.60).

In cases where two connected parties are within the same tax jurisdiction and have entered into loan agreements with each other, the fact that they are both subject to tax on their respective incomes in that country should not be a cause for concern (Halka, et al., 2017, p. 204). It is when the related party accepting interest payments is situated in a different country from the party paying the interest that debt and the related interest instalments are seen as a problem that could result in base erosion, particularly when the party receiving interest payments is situated in a jurisdiction with a lower tax rate (Halka, et al., 2017, p. 204). Debt funding from related parties that are non-residents to local companies was a concern for South Africa, especially when very little equity was used as an investment by the non-resident investor and additionally where high interest rates were charged on the debt that resulted in the erosion of the tax base (National Treasury, 2020b, p. 25).

In 1995, South Africa introduced thin capitalisation rules (National Treasury, 2020b, p. 25). Thin capitalisation rules are intended to constrain the deductibility of interest on what is considered excessive amounts of debt (de Koker & Williams, 2020, p. 17.60). At the time, thin capitalisation was mainly dealt with under s 31(3) of the Act (PWC, 2013, p. 202). Section 31(3) in the old legislation (prior to 1 April 2012) enabled the commissioner to refuse a deduction for any amount of interest, which arose from a cross-border loan that he believed was excessive in connection to the creditors fixed capital in the borrower (de Koker & Williams, 2020, p. 17.60).

The South African Revenue Service (SARS) makes use of practice notes and interpretation notes to give taxpayers direction on how it will administer the provisions of the Act (PWC, 2013, p. 196). Practice Note 2 provided guidance on the thin capitalisation rules and their interaction with the transfer pricing rules (PWC, 2013, p. 196). According to Practice Note 2 (PN2), excessive financial assistance was determined by applying a safe harbour ratio rule of 3:1 debt to equity (SARS, 1996, p. 4). PN2 recognised that the debt to equity ratio could be higher than the 3:1 safe harbour for certain companies depending on their circumstances and given that this higher ratio was also agreed to by the SARS (SARS, 1996, p. 6).

An advantage of having a safe harbour rule is that it makes the administration of thin capitalisation rules much easier for both the tax authorities and the taxpayers (OECD, 2017a, p. 25). The following benefits of using safe harbours are defined by the OECD's Transfer Pricing Guidelines (OECD, 2017b, p. 206):

1. Simplifying and lowering the cost of enforcement for qualified taxpayers when assessing and reporting necessary requirements for qualifying regulated transactions;

2. Assuring qualified taxpayers that the price charged or paid in qualifying managed transactions will be approved by tax administrators who have implemented the safe harbour with a selective audit or no audit beyond ensuring that the taxpayer has fulfilled the safe harbour's eligibility requirements and complied with the provisions;

3. Allowing tax authorities to divert money away from the investigation of more complicated or high-risk transactions and taxpayers.

A safe harbour would result in less difficulty for SARS compared to the arm's length principle when it comes to administering thin capitalisation rules and certainty for taxpayers (OECD, 2017a, p. 25). The OECD points out that despite these advantages, thin capitalisation rules based on debt:equity ratios still allow a lot of flexibility regarding the rate of interest that could be charged on debt and it is easy for groups to manipulate the amount of equity in a specific company to have higher amounts of debt so that they can claim excessive amounts of interest and therefore thin capitalisation rules are not considered to be effective against combating BEPS relating to interest (OECD, 2017a, p. 25).

3.2.2 Application of the old legislation's s 31 provisions

Where the debt to equity ratio surpassed the 3:1 rule, the portion above the 3:1 guideline had to be calculated and the interest rate on the non-excessive portion needed to be evaluated in terms of s 31(2) to determine whether it is at a market related rate which two independent parties transacting at arm's length would have agreed on (SARS, 1996, p. 1.2). PN2 included guidance concerning what an acceptable cost of debt would be, depending on the rand value of the loan (de Koker & Williams, 2020, p. 17.60). A rate that did not exceed the weighted average of the South African prime rate plus two percentage points was considered acceptable and not excessive (SARS, 1996, p. 2.2). Loans that were not denominated in South African rand had to be converted to rand using the spot rate or forward rate (de Koker & Williams, 2020, p. 17.60). In the case of companies, the amount of interest that was disallowed was subject to secondary tax on companies because it was deemed to be a dividend in terms of s 64C(3)(e) of the Act (SARS, 1996, p. 9).

Section 31(3) in the old legislation applied to financial assistance between connected parties only and when the foreign investor held at least a 25% interest in relation to the voting rights, dividends, capital or profits in a South African company (SARS, 1996, p.

3). The thin capitalisation rules did not apply to loans from a foreign parent company to its local branch because the rules only applied between separate legal persons (de Koker & Williams, 2020, p. 17.60). Conversely, financial assistance from an affiliate of the offshore parent to a local branch would have fallen within the ambit of the thin capitalisation rules (Ernst & Young, 1996).

South Africa is not a member of the OECD; it is however, an associate in 6 OECD Bodies and Projects and a Participant in 15 (OECD, undated). South Africa tends to follow the recommendations made by the OECD (PWC, 2013, p. 202). From 1 April 2012, s 31 was updated based on the OECD's model tax conventions to require that cross border transactions between connected parties are conducted at arm's length (National Treasury, 2020b, p. 26). In terms of the new updated legislation, there is now no longer a separate subsection dealing with thin capitalisation; instead, it is now managed under the general transfer pricing rules in s 31(2) (PWC, 2013, p. 203).

The advantage of the arm's length principle is that it recognises the unique facts and circumstances that apply to individual companies within a group of companies (OECD, 2017a, p. 24). Nevertheless, the arm's length test is cumbersome and resource-intensive based on the amount of investigation, analysis, data collection and the complexities of the circumstances applicable to individual companies (OECD, 2017a, p. 24). Even with its disadvantages, the OECD advises that the arm's length test is still a valuable rule as a complement to other rules such as the best practice approach and other specific rules to combat base erosion and profit shifting as a result of interest deductions and it should be used to determine the value of interest (OECD, 2017a, p. 24)

3.2.3 Application of the provisions of s 31 in new legislation

The transfer pricing rules apply to any transaction, operation, scheme, agreement or understanding if that transaction is considered to be an 'affected transaction' in terms of s 31(1) and one of the parties to the transactions receives a tax benefit. Section 31(2) requires the party receiving the tax benefit to calculate their taxable income as if the affected transaction was between two independent third parties based on the arm's

length principle. The rules in s 31 require the arm's length principle to apply to 'financial assistance', which is defined as any debt, security or guarantee under s 31(4).

The SARS released a Draft Interpretation Note on s 31 (IN) in 2013. The reason for this IN is to provide taxpayers with direction on the application of the arm's length principle when deciding whether a taxpayer is thinly capitalised under s 31 of the Act and, if so, calculating taxable income without claiming a deduction for the expenditure incurred on the excessive portion of finance (the portion above the arm's length portion) (SARS, 2013, p. 3). The IN withdrew PN2 for years of assessment starting on or after 1 April 2012 (SARS, 2013, p. 3).

SARS advises that the OECD's recommendations relating to how to ensure that transactions adhere to the arm's length principle should be taken into consideration (SARS, 2013, p. 6). Furthermore, a loan agreement must be evaluated from the point of view of the borrower as well as the lender to determine whether the terms and conditions are at arm's length (SARS, 2013, p. 7). As a result, it is a requirement to determine whether the borrower would have borrowed the amount of money in the loan agreement if he were acting in the best interest of his business and whether a lender would have been willing to lend the said amount taking the economic circumstances of the borrower into account. (SARS, 2013, p. 7).

An amount of zero could be deemed the arm's length amount of debt in the case of a borrower with inter alia a healthy statement of financial position and cash reserves if they borrow money from an offshore parent company when all of the available evidence shows no legitimate business requirement to do so (SARS, 2013, p. 7). Even though an independent lender would probably have lent the money to the borrower based on their ability to repay the loan, on the other hand, an independent borrower in the same position would not have borrowed money based on the arm's length principle (SARS, 2013, p. 7).

Section 102(1) in the Tax Administration Act 28 of 2011 places the burden on the taxpayer to prove that a transaction is at arm's length and that no deduction has been

sought for the portion of the loan that is considered excessive and not following the arm's length principle.

A functional and comparability analysis is needed for taxpayers to prove how correct their arm's length assessment of the debt was (SARS, 2013, p. 7). The IN provides a list of factors and information that may need to be considered when performing the analysis, including, amongst other things, the terms and conditions of the loan agreement (SARS, 2013, p. 8). The IN also requires a taxpayer to obtain comparable data to validate their arm's length decision (SARS, 2013, p. 8).

SARS is investigating whether it is feasible to obtain and maintain a database centred on South Africa that can be used to determine the validity and suitability of comparable data as well as the arm's length sum of debt (SARS, 2013, p. 8). The databases under consideration are paired with credit risk scorecard models (SARS, 2013, p. 8). The database is intended to include a variety of industry sector standard ratios based on credit scores that, when combined with other related information supplied by the taxpayer, may be used to evaluate the taxpayer's assessment of the sum it should and would have borrowed at arm's length (SARS, 2013, p. 8). A database like this might be used to make a decision on what an arm's length interest rate will imply.

The difficulty in South Africa is that comparable data is not readily available (United Nations, 2013, p. 410). The result is that the most reliable data is used by and currently SARS makes use of European data (United Nations, 2013, p. 410). Since the data is not relevant to the South African market and its unique risks, adjustments have to be made to the data to make the data relevant (PWC, 2013, p. 199). The more adjustments are required to this data, the less comparable and reliable the data becomes and the process of making the necessary adjustments is extremely challenging and complex (United Nations, 2013, p. 410).

(United Nations, 2013) states that South Africa prefers a more holistic method in determining whether the arm's length principle has been maintained by trying to understand the taxpayers' business model and gaining an in-depth understanding of

intragroup agreements, for example (United Nations, 2013, p. 411). (Beukes, 2014, p. 31) is of the opinion that historical stock market data should be accessible since the functional analysis requires the taxpayer to consider an unrelated lender's point of view when deciding on the terms and conditions of an arm's length arrangement. (Beukes, 2014, p. 31) argues that similar companies will not always have similar thin capitalisation ratios since the data may have been collected when the economy was growing and low-cost debt was easily attainable and at the time of the comparability study, there may be an economic recession resulting in high interest rates and very few borrowers willing to borrow or creditors willing to lend thus affecting what a reasonable amount for debt vs equity is in companies.

It is critical to distinguish between debt and equity instruments (SARS, 2013, p. 8). SARS believes that unrelated parties dealing at arm's length will consider an arrangement's economic substance rather than its legal form when determining if it should be debt or equity. (SARS, 2013, p. 8). The International Financial Reporting Standards rules offer guidance on the meaning of debt and equity (SARS, 2013, p. 8). To assess if the overall debt is at arm's length, not just the amount of debt but also the cost of the debt should be investigated (SARS, 2013, p. 9). The interest rate paid on the loan is the cost of the loan. There is no prescribed rate that would be considered as an arm's length rate since each case will be assessed on the basis of its own set of facts and circumstances (SARS, 2013, p. 9).

A taxpayer must determine whether they were thinly capitalised at the time that they obtained the debt to know whether an adjustment would be required under s 31 (SARS, 2013, p. 9). A taxpayer must periodically re-evaluate the amount of debt and interest (SARS, 2013, p. 9). The frequency at which a taxpayer must examine whether the volume of debt is arm's length varies from business to business, as they can operate in various sectors of the economy (SARS, 2013, p. 9). This would be the case even for taxpayers that do not prepare financial statements in line with International Financial Reporting Standards (SARS, 2013, p. 9). The IN seems to be referring to organizations other than companies or closely held corporations, such as trusts and individuals (Beukes, 2014, p. 28).

Provided that the terms and conditions of a loan are different from the terms and conditions that would have existed had the loan been between unrelated parties transacting at arm's length and the result is that the taxpayer is thinly capitalised, SARS would not allow deductions of interest on the non-arm's length portion of the debt (SARS, 2013, p. 4). An adjustment will be made to limit any interest deductions to only the arm's length portion and the non-arm's length portion will not be allowed as a deduction when determining the taxpayer's taxable income (SARS, 2013, p. 10). This is known as the primary transfer pricing adjustment as per s 31(2) (SARS, 2013, p. 10).

A secondary adjustment is also required as a result of the primary adjustment as per s 31(3) (SARS, 2013, p. 10). In addition to the primary adjustment, the disallowed portion of the interest will be deemed to be a loan from the resident borrower to the non-resident lender (SARS, 2013, p. 10). The borrower would have to, on the deemed loan, account for interest income at an arm's length rate when determining its taxable income in South Africa (SARS, 2013, p. 10). The deemed loan will need to be calculated and taxed on the interest payable until the loan is considered to have been paid off or the interest reimbursed to the taxpayer (SARS, 2013, p. 10).

Both direct and indirect funding transactions will be affected by this IN (SARS, 2013, p. 5). Indirect funding takes account of back-to-back finance arrangements, guarantees by a non-resident and the use of special purpose vehicles (SARS, 2013, p. 5). Arrangements that are economically equivalent to debt (finance leases, structured derivative financial instruments and components of hybrid instruments) will also be affected by this note (SARS, 2013, p. 9).

South Africa has no advance pricing agreements (APA's) (SARS, 2013, p. 15). An APA system allows taxpayers and SARS to pre-approve the amount of debt that is and is not viewed as arm's length; the documents are concluded before the transactions in question are taken on, or a tax return is filed (SARS, 2013, p. 15). In choosing potential thin capitalisation cases for audit, SARS uses a risk-based approach (SARS, 2013, p. 16) and an advantage of implementing an APA system would be that SARS could manage the risk of possibly overlooking taxpayers that could be thinly capitalised but fall within the 3:1 debt:EBITDA ratio and the number of audited cases would be limited to only

certain companies that do not have an APA (Beukes, 2014, p. 36). Since an APA will be initiated by a taxpayer, it can make the administration of thin capitalisation rules less resource-intensive and create certainty for taxpayers (Beukes, 2014, p. 36).

The OECD notes that since the arm's length test requires each company to be considered separately with its own facts and circumstances that the outcome of this test is uncertain, they also recognise that the use of advance pricing agreements could reduce the uncertainty for taxpayers and tax authorities alike (OECD, 2017a, p. 24).

SARS published a discussion paper on advance pricing agreements; in the paper, they note that advance pricing agreements will assist in avoiding disputes, reduce mutual agreement procedures (MAPs), and create an environment of tax certainty that investors look for before they invest (SARS, 2020a, p. 2).

Although SARS acknowledges the advantages of the APA system, it requires the necessary skills for the system to come from the current transfer pricing professionals within the SARS office (SARS, 2020a, p. 3). Uganda has APA legislation in place but has not implemented it as yet, due to their APA system having a lack of experienced transfer pricing professionals (KPMG, 2015, p. 5). It is extremely important to have sufficient capacity to successfully implement an APA programme (KPMG, 2020). SARS is currently still building the required capacity, as it is not ready to implement an APA system (SARS, 2020a, p. 5). The discussion paper includes the proposed framework for an APA system in South Africa based on, amongst other things, international benchmarking (SARS, 2020a, p. 6). Comment on this discussion paper from interested parties had a deadline for submission by 18 December 2020.

In para 9, the Commissioner explains how tax treaties and permanent establishments affect the IN. (SARS, 2013, p. 13). Given that South Africa interprets Article 7 of the OECD Model Tax Convention according to the commentary prior to the 2010 Update SARS will apply the arm's length rule when attributing earnings to a permanent establishment (SARS, 2013, p. 13). Article 7 of the OECD Model Tax Convention before

the 2020 update read that profits attributable to permanent establishments are (OECD, 2008, p. 3):

> the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.

Permanent institutions would be treated as independent bodies pursuant to the arm's length principle, but no deductions for notional costs would be allowed (SARS, 2013, p. 13). The IN states that all conditions, including the risk assessment parameters, will apply in the same way to permanent establishments that are party to affected transactions as it does to other companies (SARS, 2013, p. 13). When deciding on a case, SARS will take into account all relevant facts and circumstances to determine the portion of debt attributable to the resident or non-resident permanent establishment (SARS, 2013, p. 13).

The Act exempts certain transactions with headquarter companies from the provisions of s 31 when a transaction, operation, scheme, agreement or understanding is

- A non-resident providing financial assistance to a headquarter company, the amount of that financial assistance directly applied to a foreign company in which the headquarter company directly or indirectly owns at least 10% of the equity shares and voting rights (s 31(5)(a))

- A headquarter company providing financial assistance to a foreign company in which the headquarter company directly or indirectly owns at least 10% of the equity shares and voting rights (s 31(5)(b))

- A non-resident granting the use of intellectual property, as defined in s 23I(1), to a headquarter company that only makes use of the intellectual property for the intended purpose under the Act and that headquarter company directly or indirectly owns at least 10% of the equity shares and voting rights (s 31(5)(c))

- A headquarter company granting the use of its intellectual property to a foreign company and that headquarter company directly or indirectly owns at least 10% of the equity shares and voting rights (s 31(5)(d))

The Act exempts certain transactions with controlled foreign companies (CFC) in relation to a transaction, operation, scheme, agreement or understanding where financial assistance (s 31(6)(a)) or the right of use of intellectual property is granted to a CFC by a resident other than a headquarter company if (s 31(6)(b)):

- The resident directly or indirectly owns at least 10% of the equity shares and voting rights of the CFC,
- The CFC has a foreign business establishment defined in s 9D(1) and
- The total amount of tax payable by the CFC across all countries it operates in is at least 67,5%* of the amount of tax that would have been payable if the CFC had been a South African tax resident in any tax year

*The Draft IN because it is outdated still refers to 75% instead of 67,5%

In calculating the CFC's aggregate tax, any double tax agreement, tax credit, rebate or other rights to recoup any tax paid to any foreign tax authority must be considered and after ignoring any losses made by the CFS in relation to other years or losses from a company other than the CFC (s 31(6)(b)).

An additional from the provisions of s 31 applies where any transaction, operation, scheme, agreement or understanding has been entered into where the resident or any company in the same group as that resident company grants financial assistance to a foreign company and that foreign company is not required to redeem that debt in full within 30 years after it was incurred and the redemption is conditional on the market value of the foreign company's assets not being less than the market value of the liabilities of the foreign company and the resident company or a company in the same group as the resident company directly or indirectly owns at least 10% of the equity shares and voting rights (s 31(7)) (de Koker & Williams, 2020, p. 17.60B).

3.2.4 Conclusion

Section 31 of the Act applies where a cross-border transaction is entered into by related parties if that transaction constitutes an affected transaction as defined in s 31(1) where the terms and conditions of the transaction are not at arm's length and it results in a tax benefit to either of the parties involved in the transaction (ENSafrica, 2020). Section 31(6)

The party receiving the tax benefit is required to determine their taxable income as if the terms and conditions of the transaction were based on the terms and conditions of a similar transaction between unrelated parties at arm's length (s 31(2)). If the terms and conditions are not the same as those that may have existed in an arm's length deal, an adjustment is required under s 31(2) to bring the transaction in line with the arm's length principle; this results in the non-arm's length portion of interest on the transaction being disallowed as a tax deduction.

A secondary adjustment is required under s 31(3) based on the difference calculated due to the application of s 31(1). The draft IN refers to this secondary adjustment as a deemed loan since it is out of date; currently, the secondary adjustment deems the difference calculated in accordance with s 31(2) to be a dividend in specie declared by a South African company (that received financial assistance from a non-resident related party) to the non-resident investor and it is subject to a withholding tax rate of 15% and if the resident is a person the difference is deemed to be a donation subject to donations tax.

Section 31(3) of the Act no longer deems the non-arm's length portion of interest on an affected transaction to be a loan; the non-arm's length portion is currently considered to be a dividend in specie subject to withholding tax on companies at 15% if the resident is a company and if the resident is a person it is deemed to be a donation subject to donations tax (s 31(3)). The IN is still in draft status and needs to be redrafted and released by SARS urgently and it ought to be in line with the recommendations from the OECD to avoid possible double taxation due to differences in tax rules in different countries in which MNEs operate (Davis Tax Committee, 2018b, p. 34).

South Africa has moved away from a safe harbour ratio of debt:equity of 3:1 as per PN2 to a debt:EBITDA ratio as per IN (SARS, 2013, p. 12). This new ratio is not a “safe harbour” but purely an indication of what SARS may possibly regard as high risk, suggesting that SARS may well apply a different ratio on a case by case basis (SARS, 2013, p. 12). SARS would refer to the 3:1 debt:EBITDA ratio when considering to audit taxpayers linked to MNEs, the IN mentions that SARS will consider auditing a company in which the debt:EBITDA ratio of the taxpayer is greater than 3:1 and where the interest rate exceeds the weighted average of the South African Johannesburg Interbank Rate plus 2% for loans denominated in rand (SARS, 2013, pp. 11-12). For loans denominated in foreign currency, a rate exceeding the weighted average base rate of the country plus 2% will be considered high risk (SARS, 2013, p. 12).

3.3 Section 23N and Section 23M

3.3.1 Introduction

Section 10(1)(h) of the Act exempts interest income received by or accrued to a non-South African tax resident unless, inter alia, it is connected to a permanent establishment in South Africa. This exemption was meant to attract foreign direct investment (National Treasury, 2013, p. 2.6).

Debt is an important funding mechanism, although the exemption of interest income received by foreign investors became a concern for the tax authorities and led to excessive amounts of interest claimed by taxpayers in highly leveraged companies, which resulted in the erosion of the tax base, consequently these sorts of tax practices needed to be controlled (National Treasury, 2013, p. 2.6).

Section 23M of the Income Tax Act 58 of 1962 (the Act) was introduced, effective from 1 January 2015, to address double non-taxation in a case where debt funding comes from a non-South African tax resident that is not subject to tax in South Africa and the interest expense on that debt is claimed as a tax deduction by a South African borrower that received the funds, provided that a controlling relationship exists (National Treasury, 2020b, p. 28). Additionally, interest withholding tax of 15% became effective from 1 March 2015, payable on the interest income of foreign investors from a South African source (National Treasury, 2020b, p. 29).

Section 23M limits interest deductions on debts based on a fixed ratio rule (ENSafrica, 2020). As part of the best practice approach, the Organisation for Economic Co-operation and Development (OECD) highly recommends this type of interest limitation rule (OECD, 2017a, p. 29). In s 23M, the borrower is referred to as the debtor and the lender is referred to as the creditor.

Interest expense related to the purchase of company assets intended to generate taxable income is usually tax deductible and interest related to the acquisition of equity share is not tax deductible since equity generates tax exempt dividends (National Treasury, 2013, p. 2.7). Excessive deductions for interest on high levels of debt used to obtain control of target companies through the use of newly formed subsidiaries to purchase the income-generating assets in the target company was still achieved (Rudnicki, 2015, p. 38). Discretionary interest limitations were applied by the South African Revenue Service (SARS) for these types of business acquisition transactions under s 23K; this was just a temporary solution until s 23N came into effect from 1 April 2014 (National Treasury, 2020b, p. 26).

Section 23N limits the deduction of interest expense on debt used to fund intragroup transactions in terms of a s 45 or s 47 liquidation/deregistration transaction or the acquisition of shares in terms of s 24O (Webber Wentzel, 2020, p. 5).

3.3.2 Application of s 23N

Interest expenditure by an acquiring company in connection with debt funding is limited by s 23N(3) in the context of (s 23N(2)):

- Debt used for obtaining or funding the acquisition of any asset in terms of a reorganisation transaction by the acquiring company. The amount of debt that may be used to repay, refinance, or resolve the above debt would be limited (s 23N(3));

- Debt used to fund an acquisition transaction or the amount of debt that may be used to repay, refinance, or resolve the above debt would be limited (s 23N(3)).

Section 23N contains a formula that will apply when calculating the amount of 'interest,' as described in section 24J (1) of the Act, that will be deductible for tax purposes (Webber Wentzel, 2020, p. 5). See chapter 3.1 for a detailed discussion on 'interest'. The formula is based on an interest rate that changes as the repo rate changes.

An Acquiring company is defined in s 23N(1) of the Act as:

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

Based on the definition of an acquiring company, it is clear that it refers to the company that purchases the assets in another company within the same group of companies (s 45(1)). The definition also refers to the acquirer of all the assets by way of a liquidation or deregistration distribution from its subsidiary (s 47(1)) or the buyer of stock interests in an operating company that, as a result of the deal, joins the same group of companies, that continuously carries on a trade supplying goods or services for consideration (s 24O(1)).

'Debt' is not defined in s 23N or anywhere else in the Act and the common law meaning of the word needs to be applied (Rudnicki, 2015, p. 40). For example, in *Joint Liquidators of Glen Anil Development Corporation Ltd (in liquidation) v Hill Samuel* (SA) LTD, 1982, 1 All SA 105 (A), it was held that 'debt' means anything that is owed or due to one person which another person is obligated to pay.

A few of the definitions in s 23N(1) will be presented below before a detailed example illustrating how s 23N would apply to limit the deductibility of interest.

An acquired company is:

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

An acquisition transaction is:

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

A reorganisation transaction is:

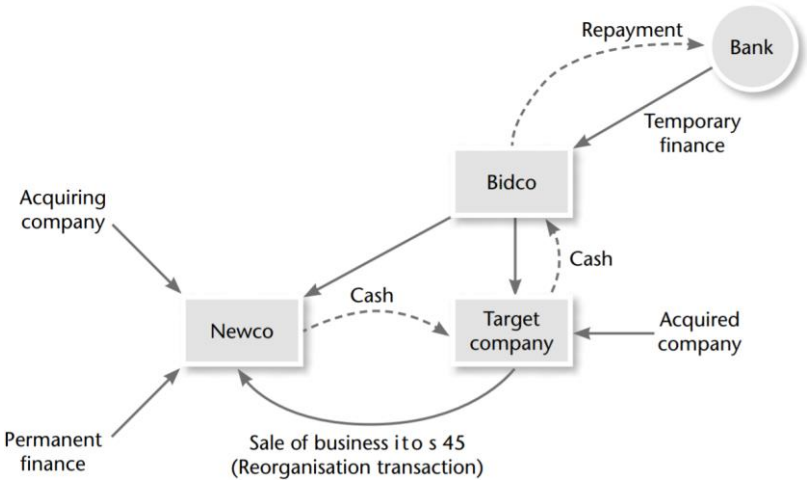
> (a) an intra-group transaction as defined in section 45(1) to which section 45 applies; or
>
> (b) a liquidation distribution as defined in section 47(1) to which section 47 applies;

Examples

Debt push down

In the below example 'Bidco' secures shares in Target Company using temporary finance; permanent finance is then utilised by a newly formed subsidiary of Bidco, called Newco, to purchase the assets and liabilities of the Target Company (Rudnicki, 2015, p. 41). The interest expense incurred by Newco is subject to limitation under s 23N since this arrangement makes use of the s 45 reorganisation transaction (Rudnicki, 2015, p. 41). Figure 3 depicts the scenario discussed above.

Figure 3: Debt push down

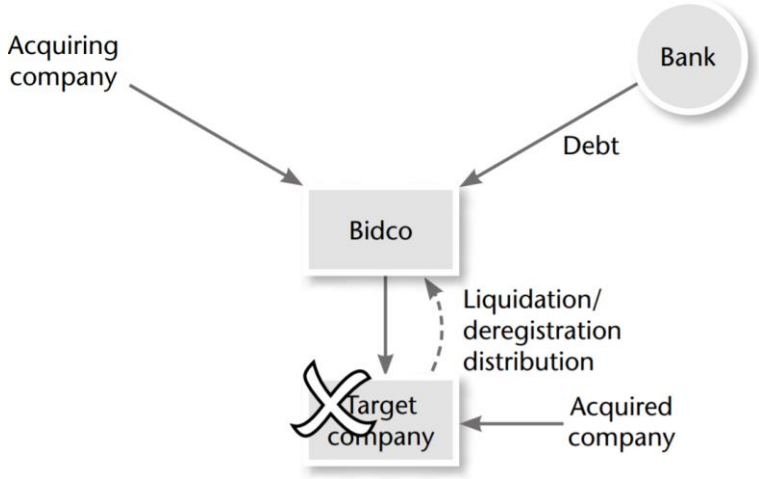


** (Source: Rudnicki, 2015, pp. 42)

Debt push up

Tax deductible interest expenditure is also realized where Bidco purchases the equity shares in a Target Company in this scenario; it would prefer to purchase the assets and liabilities instead of the shares the seller of the Target Company, on the other hand, would prefer to dispose of its equity shares (Rudnicki, 2015, p. 42). Consequently, to appease the seller, Bidco exploits debt funding to purchase the shares in Target Company, the assets and liabilities of Target Company are transferred to Bidco in a liquidation or deregistration transaction (Rudnicki, 2015, p. 42). The interest expense incurred by Bidco is subject to limitation under s 23N as this arrangement makes use of the s 47 liquidation/deregistration transaction (Rudnicki, 2015, p. 42). Figure 4 depicts the scenario discussed above.

Figure 4: Debt push up



**(Source: Rudnicki, 2015, pp. 42).

The limitation to the interest will in the tax year that the acquisition or reorganisation transaction is entered into and for five tax years from then may not exceed (s 23N(3)):

• the amount of interest received by or accrued to the acquiring company; and

• the higher of a percentage of adjusted taxable income calculated according to the formula in s 23N(4), for each tax year:

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

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

(iii) before the year of assessment as per (i) above,

reduced by any amount of interest incurred by acquiring company in respect of debts beyond the scope of s 23N(2).

The percentage in S 23N(2) should be calculated using this formula (s 23N(4)):

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

In which formula —

'A' represents the percentage to be calculated for use in s 23N(2);

'B' represents a number = 40;

'C' represents the average repo rate (currently 3.5%)[3] plus 400 basis points; and

'D' represents a number = 10,

but not exceeding 60% of adjusted taxable income of the acquiring company.

[3] Accurate as at 7 April 2021 (South African Reserve Bank, 2021).

3.3.3 Application of s 23M

When a debtor and a creditor enter into a loan agreement, the creditor has a controlling relationship with the debtor or borrowed the money lent from an entity who has a controlling relationship with the debtor, and the debtor owes the creditor interest, the interest is not taxable in South Africa and not included in the net income of a controlled foreign company in terms of s 9D of the Act, the amount of interest that will be tax deductible by the debtor must be calculated in terms of the formula in s 23M(3) (Kruger, 2015, p. 13). If the interest is prohibited as a deduction in terms of s 23N, s 23M does not apply (s 23M(2)(b)(ii)).

A controlling relationship is one in which one person owns 50% of the equity shares or voting rights in a business, either directly or indirectly. (Income Tax Act 58 of 1962, s 23M(1)). Should the average repo rate in any tax year exceed the official interest rate plus 100 basis points (s 23M(6)(a)(ii)), the deductible interest amount should be calculated using this formula in s 23M(3):

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

where

- ‘A’ is the percentage to be applied;
- ‘B’ is 40;
- ‘C’ is the average repo rate;
- ‘D’ is 10.

but not exceeding 60 per cent of the adjusted taxable income of that debtor,
reduced by so much of any amount of interest incurred by the debtor in respect of debts other than debts contemplated in subsection (2) as exceeds any amount not allowed to be deducted in terms of section 23N.

The limitation does not apply to debt that was obtained by a debtor where the creditor obtained the funds from a third party lending institution not in a controlling relationship with the debtor (s 23M(6)(a)(i)).

Section 23M also does not apply to any interest incurred by a debtor in respect of any linked unit held by a creditor where the creditor is an insurer as defined in the Long-term Insurance Act, a pension fund or a provident fund if that insurer or fund holds at least 20% of the linked units in that debtor and acquired those linked units before 1 January 2013 and at the end of the previous year of assessment 80% or more of the value of the debtor's assets, reflected in its annual financial statements for the previous year of assessment, is directly or indirectly attributable to immovable property (s 23M(6)(b)).

3.3.4 The interaction between s 23N, s 23M and s 31

Section 31 relates to limiting interest deductions regarding 'affected transactions' in a cross-border context between connected parties and s 23M relates to limiting interest deductions where a lender is in a controlling relationship with the borrower (Kruger, 2015, p. 20). There is no indication that the lender in s 23M must be a non-resident, although the requirement that the interest received is not subject to tax in South Africa may be interpreted as though the provisions of s 23M apply to cross-border parties, which is a similar requirement in s 31, South African tax residents are taxed on their worldwide income and it is safe to assume that if a lender is not subject to tax in South Africa (Republic) that they are not tax resident in the Republic (Readhead, 2017, p. 3).

A controlling relationship as per s 23M exists where the lender owns at least 50% of the equity shares or voting rights in the borrower (s 23M(1)). A connected party relationship exists in terms of s 31, where the lender or borrower owns more than 50% of the equity shares or voting rights in the other party subject to the transaction (SARS, 2020b, p. 16); these provisions are similar to those under s 23M, though those of s 23M are broader than s 31 since the threshold is higher and s 23M would, for this reason, better fulfil its purpose to limit excessive interest deductions (Kruger, 2015, p. 16).

Where both s 23N and s 23M apply to the same amount of interest in that case according to s 23M(5), s23N should be applied first, in that case, if a tax deductible interest expense is limited by s 23N of the Act, only the portion that was allowed as a tax deduction under

s 23N will be subject to the provisions of s 23M (Kruger, 2015, p. 20). It is possible that s 31, s 23N and 23M may all apply to the same amount of interest (Mandy, 2014).

Kruger argues that since taxable income is required to determine the deductibility of interest s 31 should be applied first, because the provisions of s 31 have to be applied to establish taxable income; he suggests that s 31 should apply then s 23N and lastly s 23M (Kruger, 2015, p. 20). Readhead, on the other hand, is of the opinion that specific interest limitation rules such as s 23N & s 23M should be applied to limit interest deductions first, thereby decreasing the reliance of tax authorities on the cumbersome arm's length principle in s 31 of the Act because transfer pricing rules should only be applied as a complement to specific interest limitation rules (Readhead, 2017, p. 5). Mandy seems to agree with Readhead but argues that the application of s 23M results in no tax benefit being derived per s 31 of the Act (Mandy, 2014).

3.3.5 Conclusion

According to Rudnicki, the interest incurred by an acquiring company in terms of transactions that fall within the ambit of the provisions of s 45, s 47 and s 24O may be limited by first applying the thin capitalisation and transfer pricing rules under s 31 of the Act and then only by s 23N. Where the debt funding is obtained from a lender that owns at least 50% of the equity shares or voting rights in the borrower and does not pay tax on the interest income in South Africa, that interest deduction will be limited by the provisions of s 23M of the Act (Rudnicki, 2015, p. 44). The deductible interest in terms of s 23N is calculated using a formula under that section.

Section 23M applies to limit interest deductions when the following conditions are met with regard to debt funding where (National Treasury, 2020b, p. 28):

- The lender has a controlling relationship with the borrower; or
- If the lender does not have a controlling relationship with the borrower, the lender received the funds borrowed from an individual in a controlling relationship with the borrower; or
- If the lender does not have a controlling relationship with the borrower, the loan is secured by a person in a controlling relationship with the borrower.
- The lender is not taxed in South Africa
- The interest income was not part of a controlled foreign company's net income under s 9D of the Act
- The interest has not been disallowed under s 23N of the Act
- The borrower is a South African resident for tax purposes

The relationship between s 23N and s 23M is known, s 23N is applied first before s 23M is applied, the relationship of s 31, s 23N and s 23M remains unclear and requires clear legislative provisions to put the matter to rest (Kruger, 2015, p. 21).

The amount of interest deductible under s 23M is calculated based on the same formula in s 23N, the adjusted 'tax EBITDA' is similar to that in s 23N and taxpayers are allowed to carry forward unclaimed interest deductions in terms of s 23M to future tax years (National Treasury, 2020b, p. 28). Section 23 M is in line with the OECD's recommendations for countries to adopt a fixed ratio rule to limit excessive interest deductions (Kruger, 2015, p. 21).

4 Conclusion

4.1 South Africa and the OECD's BEPS Action 4

The base erosion and profit shifting (BEPS) project undertaken by the OECD was meant to rebuild confidence in the fairness of the international tax system and creating an environment with equal opportunities for local companies and multinational enterprises (MNEs) and recommend tools to governments to increase the efficiency of their tax systems (OECD, 2016a, p. 4).

Tax rules applied by countries to combat BEPS relating to interest deductions are effective in various ways but do not deal with the core of the issues relating to BEPS from interest deductions (OECD, 2017a, p. 22). A best practice approach was necessary to streamline interest deductibility across different jurisdictions, making it easy for tax authorities to administer and creating certainty for MNEs. The best practice approach not only should apply to interest but to all payments that are economically equivalent to interest (OECD, 2017a, p. 23).

South Africa uses a form of the fixed ratio rule and also makes use of interest withholding tax and the arm's length principle, which the OECD advises are not effective in preventing BEPS with regard to interest payments (Davis Tax Committee, 2018a, p. 28). The table below illustrates how s 24J, s 31, s 23N and s 23M comply with the recommendations of BEPS Action 4.

Table 1: Comparison of s 24J, s 31, s 23N and s 23M and the recommendations of BEPS Action 4

Table 1 indicates which provisions in South African tax law comply with the OECD's guidline concerning the best practice approach.

OECD Rule (OECD, 2017a, p. 29)	**South Africa**	**Description**
Fixed ratio rule limiting net interest expense	Yes	Sections 23M and s 23N make use of a fixed ratio limitation under stipulated conditions using a specific formula (National Treasury, 2020b, p. 28).
Group Ratio Rule	No	
Carry Forward/back allowed	Yes	Unclaimed interest deductions under s 23M may be carried forward for use in future tax years (National Treasury, 2020b, p. 28).
De minimis threshold	No	
Targeted rules	Yes	• Section 23N makes use of a fixed ratio limitation under stipulated conditions using a specific formula (National Treasury, 2020b, p. 28). • Section 31 and the Draft IN make use of the arm's length principle applicable to cross-border related party transactions (SARS, 2013, p. 3) A Debt:EBITDA over 3:1 is an indication of high risk in relation to thin capitalisation (SARS, 2013, p. 11) • The difference between the interest rate at arm's length and the real rate of interest is a deemed dividend on which withholding tax is payable at 15%

		• Section 24J provides for interest to be deducted only if it is incurred in the production of income from the operation of a trade. Interest expense relating to funds used to generate tax exempt income is not deductible (s 24J(2))

In the discussion paper, released in February 2020, called *Reviewing the Tax Treatment of Excessive Debt Financing, Interest Deductions and Other Financial Payments,* the South African government proposed the following with regard to the recommendations made by the OECD (National Treasury, 2020b, pp. 45-47):

- Considering the high interest rates in South Africa and an analysis of taxpayer net interest:EBITDA ratios, the fixed ratio should be 30% which will allow approximately 75% of taxpayers to deduct their net interest expense in the tax year in which it was incurred
- The new fixed ratio rule should replace s 23M with transitional provisions for existing third party loans
- Earnings will be based on tax EBITDA, which is taxable income before net interest, depreciation and amortisation
- The list of payments economically equivalent to interest per the OECD to be included as interest since the s 24J(1) definition of interest is not wide enough to include these payments.
- The fixed ratio rule should apply to all companies operating in South Africa forming part of a multinational group
- For tax purposes, the terms 'Group' and 'MNE Group' be defined:

    - "Group" means a collection of enterprises connected through ownership or control such that it is either required to prepare Consolidated Financial Statements for financial reporting purposes under applicable accounting principles or would be so required if equity interests in any of the enterprises were traded on a public securities exchange.
    - "MNE Group" means any Group that includes two or more enterprises the tax residence for which is in different jurisdictions, or includes an enterprise that is resident for tax

purposes in one jurisdiction and is subject to tax with respect to the business carried out through a permanent establishment in another jurisdiction.

- Section 23N will remain in place as a targeted rule to address BEPS that the fixed ratio rule is unable to prevent
- Unclaimed interest deductions under the new fixed ratio rule will be carried over for use in future tax years for five years
- A *de minimis* threshold dependent on the net interest cost of a local group ranging from R2 million to R5 million to exclude smaller low risk companies

4.2 How the new fixed ratio rule will interact with other provisions in South Africa

The government recommends that the arm's length test, in s 31, should first be applied to financial transactions; once the interest has passed the arm's length test then only should the interest limitation rules be applied, a safe harbour rule is also being considered to assist taxpayers in determining whether the arm's length test should be applied to certain amounts of debt (National Treasury, 2020b, p. 47).

4.3 Interest limitation rules in BRICS countries

The below table is a comparative analysis between OCED interest limitation rules and BRICS countries

Table 2: Interest limitation rules in BRICS countries

Interest limitation rule in place (OECD, 2019b)	Year	Interest limitation rule in place	Type of rule	Financial accounting measure	Ratio value	Limit applied to gross or net interest expense	Applicable to third party debt	Applicable to related party debt	De minimis threshold	Carry forward/back	Interest characterised as a dividend	Group ratio or similar	Targeted rules
Brazil	2019	Yes	Thin cap	Debt-to-equity	0.3:1 or 2:1	Gross interest expense	No	Yes	None	No	No	No	No
China (People's Republic of)	2019	Yes	Thin cap	Debt-to-equity	2:1		No	Yes	None				
India	2019	Yes	Earnings stripping	Interest-to-EBITDA	0.3	Gross interest expense	No	Yes	INR 10 million	Yes		No	No
Russia	2019	Yes	Thin cap	Debt-to-equity	3:1		No	Yes		No		No	No
South Africa	2019	Yes	Earnings stripping	EBITDA + interest accrued - interest paid to parties falling outside the limitation rules	0.42	Gross interest expense	No	Yes	None	Yes		No	Yes

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