REVIEWING THE TAX TREATMENT OF EXCESSIVE DEBT FINANCING, INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS

national treasury

Department:
National Treasury
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Contents

1. Executive summary

Corporate debt bias can be influenced by tax policy design. When in need of capital, businesses – whether purely domestic or multinational – can choose between debt and equity financing. While many factors influence this decision, tax deductibility of interest payments (but not in respect of dividends or returns on equity) can sway the outcome, particularly in cases where tax avoidance is a primary objective. With tax deductions for interest payments being more valuable in countries with higher corporate income tax (CIT) rates, multinational companies can minimise tax liabilities further by placing the majority of their debt funding in high-tax countries.

While debt capital is an important financing source for investment, it can create opportunities for base erosion and profit shifting (BEPS) in South Africa – the CIT rate is high relative to the global average, and especially in relation to some of our key trading and investment partners. The OECD/G20 BEPS Project produced a report on *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments* in 2015, providing **a benchmark against which to assess the existing corporate tax regime in respect of its potential impact on the choice between debt and equity financing**.

The OECD/G20 Project considered all the rules in place that limit excessive debt or interest deductions – including transfer pricing rules, thin capitalisation rules, ratios that limit interest deductions and withholding taxes. The consensus recommendation is that the best means of curtailing BEPS is to limit net interest expense deductions to a fixed percentage of earnings before interest, tax, depreciation and amortisation (EBITDA). The OECD recommends using a *net interest expense / earnings (NIE/EBITDA)* ratio of between 10 and 30 per cent to limit excessive interest deductions and prevent tax base erosion. To constrain those taxpayers that pose the largest BEPS risk, the OECD recommends applying the rule to all entities of a multinational group as a minimum.

Besides the OECD, other international and regional organisations, as well as the Davis Tax Committee, have also contributed to the debate on this issue. The IMF has done a lot of empirical analysis on countries' existing rules. One of the main findings is that interest limitation rules (including thin-capitalisation rules, for example) are more effective when applied to total interest expense – i.e. interest flowing to both connected and independent parties. The *United Nations (2017) Handbook on Selected Issues in Protecting the Tax Base of Developing Countries* provides a good overview for why taxpayers use debt, as well as useful thoughts on the OECD recommendations. The African Tax Administration Forum (ATAF) has done a lot of work to assist African countries in this regard – producing a *Suggested Approach to Drafting Interest Deductibility Legislation* to assist countries in capturing the OECD recommendations in their legislation. The Davis Tax Committee has reviewed the tax treatment of debt financing – agreeing with the OECD in some areas and disagreeing in others. All of the key issues from these parties are discussed in the document.

Many countries have either implemented a version of the recommendations or reviewed their existing rules. Most countries in the European Union have implemented the OECD recommendations already or are in the process of doing so, as they are required to do so under the EU Anti-Tax Avoidance Directive. Some developing countries that have implemented the OECD recommendations include India, Botswana and Vietnam. Australia and New Zealand are retaining their thin capitalisation approaches using balance sheet ratios, rather than opting for interest limitation rules based on earnings.

South Africa's current interest limitation rules have similar design features to the fixed ratio rule recommended by the OECD, but there are differences. The existing rules are comparatively less strict than the OECD recommendations and narrower in application – they are targeted at a smaller set of transactions and the limitation for net interest expense deductions is set at a higher percentage of earnings. There are also other incumbent rules that mitigate the debt bias. In respect of cross-border loans from connected persons, SARS is able to use the arm's length test (transfer pricing rules) to question whether: (1) the quantum of debt is excessive; (2) the transaction labelled as a loan is more akin to equity; and (3) the associated interest rate charged is not excessive. Deviations from the arm's length principle result in a portion of the interest expense being permanently disallowed as a deduction. The withholding tax on interest is set at a standard rate of 15 per cent, but is substantially reduced or nullified for many key investment and trading partners.

In reviewing the existing regime, government (recognising that South Africa is primarily a capital importing country) aims to strike a balance between attracting capital and investment, and protecting the corporate tax base. This brings up the classic tax policy design trade-off between accuracy and simplicity.

National Treasury analysis of SARS administrative data from corporate tax returns reveals *NIE/EBITDA* ratios for different company types and sizes. Companies are analysed in three groups – South African subsidiaries controlled by foreign multinational companies; group companies (including both South African owned multinational companies and purely domestic groups); and other companies. The companies are also analysed on size, using sales as a proxy.

Based on the analysis conducted, government proposes to implement the OECD recommendations. Illustrative examples show that replacing the existing interest limitation rules (specifically those in section 23M of the Income Tax Act) with the OECD approach will provide a more uniform approach to all interest payments flowing out of the country (regardless of which country the loan emanates from), as well as enhance the level of base protection. Government proposes to restrict net interest expense deductions to 30 per cent of EBITDA.

Government welcomes comments from all interested parties:

Taxpayers are invited to submit comments on the proposals. Each submission should include a high-level list of the main points being made. Additional information on specific transactions / business models that may be negatively affected is requested so that comments are substantiated. Comments might be made public – please clearly mark any information that is sensitive / should not be made public.

All comments should be sent to hayley.reynolds@treasury.gov.za by 17 April 2020.

2. Introduction – why the need for a review?

When businesses require capital there are multiple factors that determine whether to use debt or equity financing (or both). Tax can be one of these factors. Empirical evidence[1] shows that corporate tax considerations can provide a strong rationale for companies preferring debt over equity. Interest payments are generally viewed as an ordinary business expense, which are deductible in determining taxable income. However, since payments with respect to equity represent an after-tax return on a capital investment, they are normally not deductible.

The international context in which multinational enterprises (MNEs) operate adds an additional dilemma for governments. Varying corporate income tax (CIT) rates across countries create an environment where an MNE can minimise its global tax burden by strategically placing debt in entities located in high-tax jurisdictions. This can generate excessive interest deductions that facilitate the shifting of profits from high-tax to low-tax countries. The higher the CIT rate, the higher the value of an interest deduction.

Debt capital is an important financing source for investment and South Africa is a predominantly capital-importing country. While a healthy business environment relies on debt, it is important to recognise that it can create opportunities for base erosion and profit shifting (BEPS). Erosion of the corporate tax base has economic consequences for any government whose role it is to generate revenue in an equitable, efficient and sustainable manner to fund public expenditure. Critical for government is determining how to strike a balance between attracting such capital (and promoting investment) and protecting the corporate tax base.

Members of the African Tax Administration Forum report that the use of third party and related party interest is one of the most simple and prevalent of the profit shifting channels used in Africa – posing a significant risk to African tax bases. Both the OECD (2015) and ATAF have argued that the fluidity and fungibility of money makes it relatively easy to alter the mix of debt and equity in a controlled entity.[2]

As the OECD states: interest expense is particularly useful for tax planners because it is so flexible. The *form* of debt is flexible – groups can structure their funding in different legal forms that have the same economic effect, but different tax consequences. The *volume* of debt is flexible – groups can easily change the mixture of debt and equity in an entity that leads to a different tax treatment with no impact on economic activity. The *location* of debt is flexible as it can be raised in any entity and moved

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[1] See, for example:
de Mooij, R. (2011, April). *The Tax Elasticity of Corporate Debt: A Synthesis of Size and Variations*. IMF WP/11/95;
de Mooij, R., & Hebous, S. (2017, January). *Curbing Corporate Debt Bias: Do Limitations to Interest Deductibility work?* IMF Working Paper. IMF;
Fuest, C., Hebous, S., & Riedel, N. (2011). *International debt shifting and multinationals firms in developing economies*. Economic Letters, 135-138;
Hebous, S., & Ruf, M. (2015). *Evaluating the Effects of ACE Systems on Multinational Debt Financing and Investment*. CESifo Working Paper No. 5360;
Huizinga, H., Laevan, L. & Nicodeme, G. (2008). *Capital Structure and international debt shifting.* Journal of Financial Economics. Vol. 88, issue 1 (pp. 80-118);
IMF. (2016). *Tax Policy, Leverage and Macroeconomic Stability*;
IMF. (2017). *Curbing Corporate Debt Bias: Do Limitations to Interest Deductibility Work?*
Reynolds, H., & Wier, L. (2016, November). *Estimating profit shifting in South Africa using firm-level tax returns*. WIDER Working Paper 2016/128. UNU Wider.

[2] ATAF has compiled a suggested approach to Drafting Interest Deducibility Legislation. Available: http://ataftaxevents.org/media/documents/21/documents/ATAF_Suggested_Approach_Orange_english_LR_print.pdf

to where the tax benefit is the greatest. Lastly, the *pricing* of debt (the interest rate) is flexible and the terms of an intra-group loan can be amended to justify a high or low interest rate.

This is not a new issue for South Africa. For example, thin capitalisation rules were introduced in 1995 in an attempt to curb the use of excessive debt in relation to equity. However, there has been heightened interest since the G20 Finance Ministers called on the OECD to find solutions for base erosion and profit shifting (BEPS). The OECD/G20 BEPS Project produced a final report on Action 4 – *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments* in 2016. Other international organisations have also conducted analyses and provided inputs into the debate – including the IMF and UN. The African Tax Administration Forum has provided guidance to African countries in this regard. More recently – within the ongoing debate on the taxation of the digital economy – the OECD is addressing the issue of base eroding payments, with interest payments being one such concern.

Within this context, it is essential to determine the most appropriate regime for addressing excessive debt financing and the associated interest deductions in South Africa. Currently, the deduction of interest payments can be limited by the following rules – transfer pricing (which incorporates an arm's length non-excessive debt element), interest limitation, and exchange control. Government agrees with the Davis Tax Committee in recognising that there is a need to review and simplify the current legislation to enhance certainty.

The review and policy proposals have been guided by three key principles – certainty, base protection and simplicity. In tax policy design, there is almost always a trade-off between simplicity and perfect targeting. Government is aiming for a balance between the two so that the corporate tax base is adequately protected and taxpayers are provided with certainty. This is important so that investment and economic growth are encouraged rather than hampered, while tax avoidance is kept to a minimum.

3. What is the problem

There is a **clear economic rationale for debt** in the economy. The *United Nations (2017) Handbook on Selected Issues in Protecting the Tax Base of Developing Countries*[3] provides a good overview for why taxpayers use debt. It argues that the availability and use of debt is widely recognised as an important element of a healthy business environment, and that the absence thereof can deter economic growth. This is evidenced by governments continually striving for a balance between increased regulation of financial institutions and the need for these institutions to lend to growing businesses. Loans are not only provided by financial institutions. In a group context, businesses can also borrow from a parent company or affiliate. For some businesses, issuing debt securities such as bonds to raise debt funding is also an option.

The Handbook argues that there are multiple potential reasons for an investor needing to borrow funds to grow a business:

- Debt could be used (in combination with equity) to capitalise a business
  - Debt provides an initial investor with the ability to increase the pool of capital and be compensated before equity investors receive a return
  - Debt enables expansion without diluting control
  - Debt can add discipline into the operation of a business which can yield long-term improved profitability and operation
- Debt may be required to purchase goods or property, where the lender would typically be entitled to the goods or property as security for the loan
- A credit line may be required to support working capital.

On the choice between debt and equity, there are numerous commercial factors that play a role in decision-making – existing loan covenants, hurdle rates of return on equity, the weighted average cost of capital, exchange control considerations, future interest rates (yield curve) and industry norms. For example, the Financial Stability Board (2015)[4] points out that industries that are capital-intensive, including energy and mining, tend to have more debt-heavy liability structures, while service-oriented firms tend to rely more on equity. Industries with a higher share of tangible assets are able to use tangible assets as collateral – making it relatively easier and more cost effective for them to borrow (de Mooij & Hebous, 2017).

A recent paper on *Transfer Pricing in Mining with a focus on Africa* (World Bank Group, 2017) discusses the choice between debt and equity in the African mining context. It provides the likely rationale for MNEs preferring debt over equity. Equity is easy to access when markets are buoyant, but this is not always the case and funding may be required when there is limited supply available. Returns on equity are often highly volatile in an environment with fluctuating exchange rates and commodity prices, as well as rising costs. In the mining context, expectations are generally only realised in the long run. The process of raising new equity through the stock market is expensive and complex. Supporters of a mining project may not want to dilute their ownership of the project with too much reliance on equity. Debt is quite different. It does not dilute ownership, financing is cheaper, funds are available when actually needed, and the financing cost is generally tax deductible.

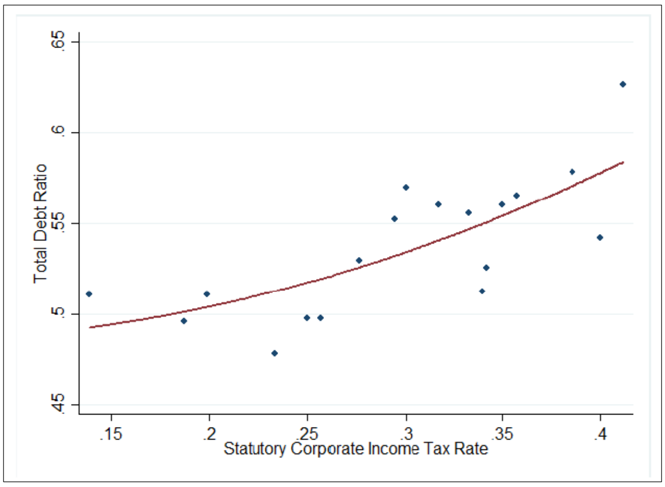
[3] See Chapter IV. Available here: https://www.un.org/esa/ffd/wp-content/uploads/2017/08/handbook-tax-base-second-edition.pdf
[4] Financial Stability Board. (2015). Corporate Funding Structures and Incentives – Final Report.

Tax policy design can influence the choice of debt relative to equity. Most countries treat debt and equity differently for tax purposes. Interest payments on debt are normally treated as an ordinary and necessary business expense – deductible for the payer and taxed in the hands of the payee. As UN (2017) points out – while these deductible payments "erode" the tax base of the enterprise, they are inherently no different from any other ordinary or necessary deductible expenses, such as wages, rents or purchases of services and raw materials. In contrast, dividends or other forms of return on equity are usually not tax deductible. However, even though most would agree the use of debt and the payment of deductible interest expense are fully appropriate, governments are concerned about the potential for these payments to become excessive and erode a country's tax base. A bias has arisen that can lead to excessive debt financing. Excessive payments can arise from two scenarios – if the amount of the debt is excessive or if the interest rate charged is unsuitable.

The choice between debt and equity is available to any business – regardless of whether there is a group of companies or cross-border context. This is commonly known as the general (external) debt bias – an incentive for businesses to prefer debt over equity financing beyond that which they would otherwise opt for (what would be justified in economic terms). This is exacerbated by intra-group debt shifting – cross-country differences in CIT rates can encourage corporate groups to conduct internal lending from low-tax to high-tax countries, or by locating external borrowing in high-tax countries.

There is a lot of empirical evidence showing how the use of debt is sensitive to CIT rates. De Mooij (2011) conducted a meta-analysis on the tax elasticity of corporate debt (i.e. how responsive corporate debt is to the corporate income tax rate). Based on 19 studies and 267 estimates, the results suggest that a one percentage point higher tax rate typically increases the debt-asset ratio by between 0.17 and 0.28, with responses increasing over time. The scatter plot constructed by Hebous and Ruf (2015) in Figure 1 shows that high corporate tax rates are associated with high debt ratios.

Figure 1: Relationship between Statutory Corporate Income Tax Rates and Debt Ratios[5]



(Source: Hebous & Ruf, 2015)

A more recent study by the IMF finds that the corporate debt bias increases debt ratios by 7 per cent of total assets on average, including for financial institutions (IMF, 2016).[6]

[5] The underlying data is taken from the German Bundesbank MiDi dataset, which includes detailed firm-level panel data on virtually all German firms investing abroad and their affiliates in other countries.
[6] This was based on the OECD average CIT rate around 25 per cent; South Africa's would be slightly higher than 7 per cent.

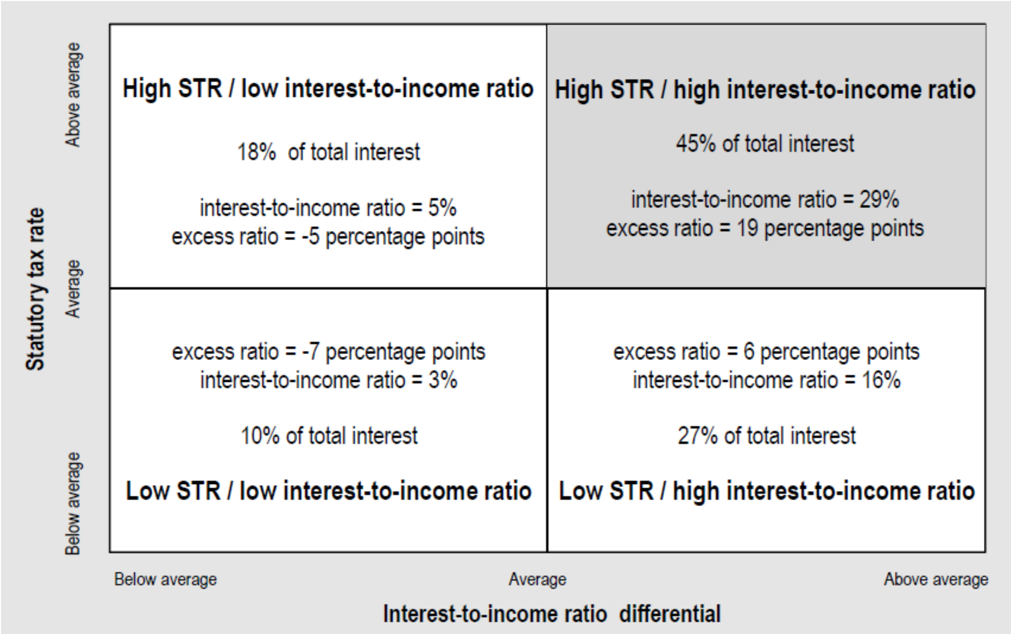
There has been more interest recently in determining the effects of BEPS on developing countries. On debt financing specifically, Fuest, Hebous and Riedel (2011) show that connected party debt in developing countries is considerably more sensitive (twice as sensitive) to changes in corporate income tax rates than developed countries.[7] Most studies relying on tax micro-data focus on MNEs that are either headquartered or have subsidiaries in Germany or the United States, given the availability of detailed tax data for research.[8]

Reynolds and Wier (2016) used South African company tax return micro-data to estimate profit- and debt-shifting responses in South Africa between 2009 and 2014. They find evidence that South African subsidiaries of multinational firms engage in profit shifting and that profit-shifting responses to tax incentives across all channels are systematically higher compared to developed countries. On debt bias specifically, the estimates imply that a 10 percentage points lower parent company tax rate is associated with a 2 percentage points higher debt-asset ratio in subsidiaries. This effect is roughly twice as large as the one estimated by Huizinga et al. (2008) for the European Union, where a 10 percentage points lower parent company tax rate implies a 1 percentage point higher leverage in subsidiaries. It is within the range of 1.7 to 2.8 percentage points estimated by de Mooij (2011). It was also found that South African subsidiaries of foreign parent companies facing lower tax rates have higher levels of net interest expense. This could be an indication of both excessive debt, but also transfer mispricing with inflated interest rates charged on the debt.

The OECD/G20 (2015b) Action 11 Report on *Measuring and Monitoring BEPS* includes indicators for identifying BEPS behaviours. One indicator focuses on interest expense-to-income ratios of multinational affiliates in countries with above average statutory tax rates. Calculations are based on affiliate-level and consolidated financial information on interest paid and EBITDA[9] for over 10 000 affiliates of the top 250 global MNEs in 2011. Figure 2 shows that 45 per cent of the total interest expense of all affiliates was attributable to affiliates with interest-to-income ratios in excess of their MNE group's worldwide consolidated ratio, and located in countries with statutory tax rates higher than the average.[10] This is evident from the grey quadrant below. The average interest expense / EBITDA ratio was 29 per cent – this is compared to an average ratio of 10 per cent for all affiliates.

[7] This empirical study was based on the German MiDi dataset and a distinction was made between MNE affiliates of German parent companies in developed and developing countries.
[8] For more information on empirical studies, there is a high level summary in Chapter 3 of the OECD/G20 (2015b) Action 11 Report.
[9] Earnings before interest, tax, depreciation and amortisation
[10] South Africa's statutory corporate tax rate is 28 per cent – higher than the OECD average of 24.7 per cent in 2016

Figure 2: OECD Indicator: Interest-to-income ratios of MNE affiliates in locations with above average statutory tax rates[11]



Source: (OECD/G20, 2015)

4. What is tax policy's role in addressing the problem?

One of the key principles of tax policy design is neutrality – taxpayer decisions should be based on economic fundamentals and not distorted by tax considerations (unless a specific tax policy objective aims to encourage a certain type of behaviour because a market failure has arisen). Achieving neutrality in corporate financing decisions would require that payments in respect of debt and equity are treated equally. Some countries have introduced an allowance for corporate equity (ACE) in an effort to do so. The challenge with this policy is two-fold – it reduces the tax base and requires determining an appropriate interest rate for the notional deduction.

The IMF (2016) makes a persuasive statement for treating debt and equity alike: "*There are no compelling reasons to treat debt more favo[u]rably than equity for tax purposes. The original rationale for allowing a deduction only for interest was that this is seen as a cost of doing business whereas equity payments are business income, a view also reflected in international accounting principles. In economic terms, however, both are a return to capital and there is no a priori reason to tax them differently (De Mooij 2012). From a legal and administrative perspective too, differential treatment is problematic as distinguishing debt from equity can be complicated. For instance, hybrid financial instruments (debt for tax purposes, but with equity-like characteristics) increasingly blur the distinction between the two*."

In the absence of allowing a deduction akin to an ACE, the other option is to limit the amount of interest a business can deduct. Hypothetically, if a government wanted to impose complete tax neutrality, it could remove interest deductibility in its entirety. This would be a drastic departure from

[11] Important caveats to note is that the analysis uses gross interest expense from financial accounting information.

the current design and would be more in line with concepts such as a cash flow tax where immediate expensing of capital purchases is allowed (rather than depreciation allowances).

Within the current corporate tax system, it is more appropriate for governments to determine an acceptable level of debt (and interest expense) and impose a limit on any resulting deductions in excess of this level. This is common practice globally – most countries have rules that limit the amount of interest that can be deducted. These typically include one (or more) of thin capitalisation rules, earnings stripping rules and transfer pricing rules.

The UN (2017) Handbook includes a well-written piece on governments exercising their prerogative when it comes to public policy making:

> *Tax laws in a country generally do not—indeed, cannot—forbid an enterprise from having an excessive level of debt, however, that limit may be defined. Rather, other government agencies may impose (and measure whether an enterprise exceeds) acceptable levels of debt.*
>
> *Tax rules, however, frequently limit the amount of interest that may be deducted by an enterprise in determining its taxable income. These limitations are valuable, because they backstop and help enforce non-tax rules that restrict excessive debt. Moreover, they prevent taxpayers from incurring so much debt that the relevant tax base is eroded.*
>
> *Taxpayers may argue that the tax law should not limit interest deductions; as long as the taxpayer is compliant with non-tax rules establishing the level of debt that can lawfully be incurred (and any prudential limitations imposed by lenders or others), then the interest expense incurred is a reasonable business cost and should be deductible in determining taxable income. But **tax laws often set limits on deductible expenses as a matter of tax or public policy**; examples include deduction limitations for entertainment, advertising and highly compensated personnel. In similar fashion, tax laws sometimes allow exceptional deductions (for research and development or the purchase of capital equipment) as a statement of policy.*
>
> ***It is consistent with the use of tax rules as an instrument of policy to impose limitations on the deductibility of interest when that interest is determined to be "excessive".** These tax rules work in parallel with the non-tax rules that limit the amount of debt an enterprise may incur when the company is formed or at particular times after formation.*

5. To what extent should the tax system intervene?

This question was evaluated by the OECD in the G20/OECD Project on BEPS. Other organisations, including the IMF and UN have also provided analysis and their views. In addition, ATAF has provided guidance to assist African countries in implementing the OECD recommendations.

The following section sets out the OECD main findings and recommendations, and includes other organisations' views on each element.

OECD (focused on BEPS)

The OECD published its final report on Action 4 – *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments* – in 2016, setting out its recommendations for a best practice approach to the design of rules to prevent base erosion through the use of interest expense. The OECD Project focused on the use of debt to achieve BEPS in the international context, rather than the general debt bias. The report identifies three basic scenarios in which BEPS involving interest and payments economically equivalent to interest can arise – where groups:

- Place higher levels of third-party debt in high-tax countries
- Use intra-group loans to generate interest deductions greatly in excess of the group's actual third-party interest expense
- Use third party or intragroup financing to fund the generation of tax-exempt income

Figure 3 shows an illustrative example for placing higher levels of third-party debt in high-tax countries. In this example, L Co (located in high-tax jurisdiction) borrows from a bank and uses the proceeds to return surplus funds to F Co in the form of a dividend or share buyback. F Co (located in a low-tax jurisdiction) uses the funds to acquire a building. The rental income is subject to a low rate of tax, while the interest expense on the loan used to fund the purchase of the building reduces the taxable income of L Co in the high-tax country.[12]

Figure 3: Location of third-party interest expense

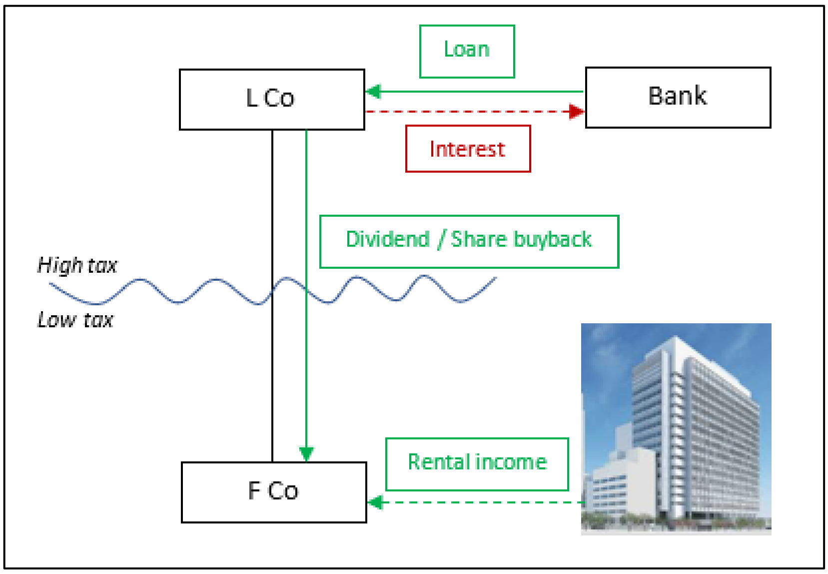


Figure 4 provides an example of how groups use intragroup interest expense to shift profits to low-tax jurisdictions. L Co borrows from a group company, F Co. The group uses interest expense on the internally generated loan to reduce the tax base in country L. This transaction has generated additional interest expense for a group company even though the group has no debt.

[12] The examples illustrated in Figures 3, 4 and 5 are taken from an OECD presentation to SARS.

Figure 4: Intra-group interest expense

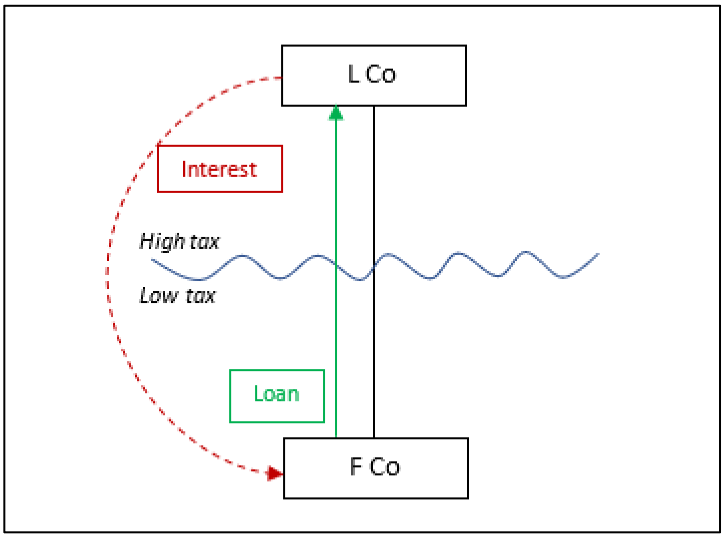
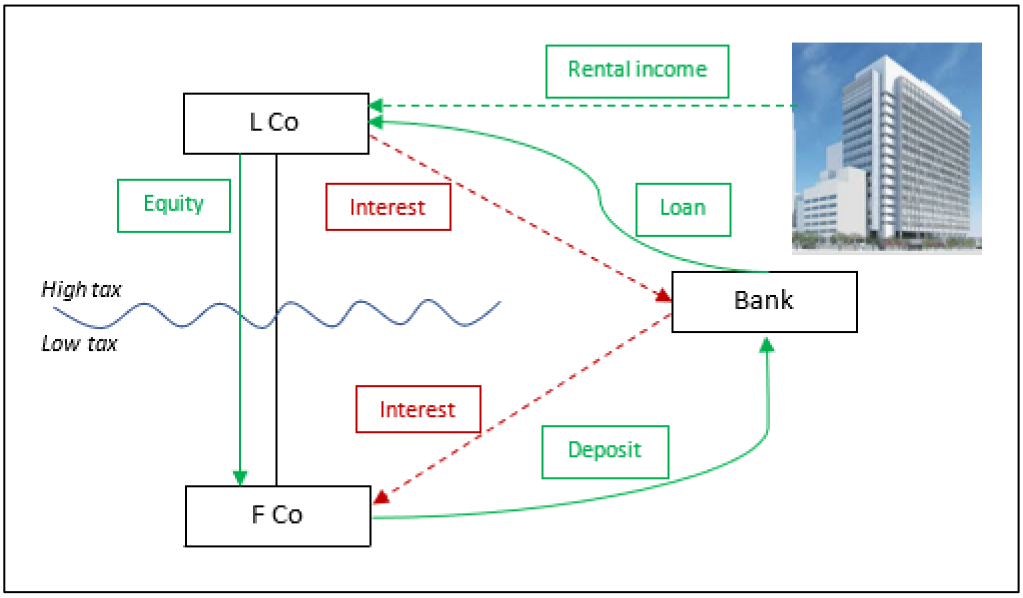


Figure 5 shows an example where an independent bank is used by a group to reduce the tax base in a high-tax country using interest expense. L Co injects surplus funds by way of an equity investment into its subsidiary (F Co) located in a low-tax jurisdiction. F Co puts this on deposit with a bank, which lends the money to L Co to buy a building. L Co effectively lends its own money to acquire the building and income from the investment is being shifted to the low-tax jurisdiction.

Figure 5: Back-to-back loans



The following **six existing approaches to tackle base erosion and profit shifting** involving interest deductions or other financial payments were identified:

- Arm's length tests that compare the level of interest or debt in an entity with the position that would have existed had the entity been dealing entirely with third parties
- Interest withholding taxes
- Rules that disallow a specified percentage of the interest expense of an entity

- Rules that limit the level of interest expense or debt in an entity with reference to a fixed ratio, such as debt/equity
- Rules that limit the level of interest expense or debt in an entity with reference to a group's overall position
- Targeted anti-avoidance rules that disallow interest expense on specific transactions.

The **report considers and rejects the first three approaches**. The arm's length tests are considered too resource intensive and uncertain – for taxpayers and tax authorities. While the report acknowledges that interest withholding taxes can reduce the benefit of base erosion, unless the rate of withholding tax matches the corporate rate, there is still a benefit available. On the other hand, imposing or increasing interest withholding taxes may be difficult, especially given the number of bilateral treaties that reduce the interest withholding tax rate. Finally, a rule that disallows a specified percentage of the interest expense of an entity is not seen as effective at tackling base erosion, but rather imposing an additional cost on debt.

The recommended approach is a combination of the final three approaches above – a "fixed ratio rule" based on the level of net interest expense relative to "tax EBITDA", not the level of debt, in an entity. This is an income statement approach (that includes tax adjustments) where affected companies are able to deduct their net interest expense up to a specified percentage of EBITDA.

The OECD argues that an earnings-based rule is preferable for the following reasons:

- Using earnings to measure economic activity should be the most effective way to match a net interest expense deduction with the activities that generate taxable income and drive value creation
- It is more robust against planning – a group can only increase net interest deductions in a country by increasing earnings in that country (any restructuring to move profits out of a country will also reduce net interest deductions in the country)
- Definition of earnings can be adapted to exclude income which is subject to favourable tax treatment (e.g. exempt dividend income)
- Base erosion and profit shifting is driven by the level of tax deductible expenses in the entity, not the level of debt
- a fixed ratio based on debt/equity (the basis for thin-capitalisation rules) will need an additional mechanism to prevent base erosion by charging high interest rates
- the level of debt can fluctuate in the period and averages can be manipulated

The report also considered the most appropriate method of calculating earnings and concludes that EBITDA is the appropriate measure of earnings in this context, as it is the best guide as to whether an entity can meet its interest commitments. In relation to the choice between EBITDA and EBIT, the following was discussed in the report:

> *"EBITDA is the most common measure of earnings currently used by countries with earnings-based tests. By excluding the two major non-cash costs in a typical income statement (depreciation of fixed assets and amortisation of intangible assets), EBITDA is a guide to the ability of an entity to meet its obligations to pay interest. It is also a measure of earnings which is often used by lenders in deciding how much interest expense an entity can reasonably afford to bear. On the other hand, using EBITDA potentially favours entities operating in sectors with*

> *high levels of fixed asset investment. This is because EBITDA does not include the write-down of capitalised costs such as investment in plant and machinery, whereas it does take into account revenue costs which are the majority of the cost base for entities in other sectors."*

Discussion

The main disadvantage of this approach (which the OECD recognises) is that an entity's earnings may be relatively volatile (and there is a limit to the extent this can be controlled by a group). It may be hard to anticipate the level of net interest expense that will be permitted from year to year. Without knowing the extent to which interest cost will be deductible, it could be difficult to calculate the cost of debt for long-term projects. It may also be the case that a large interest deduction in year 1 may only generate matching EBITDA in year 3.

The other challenge with applying the same ratio across the board is that companies have different financing needs – due to the size, stage or industry specific needs, for example. The IMF (2019)[13] considers such a rule to be an arbitrary quantitative limit.

The UN (2017) considers an income statement (earnings-based) and a balance sheet approach to test for excessive interest deductions, and emphasizes that there are strengths and weaknesses in each approach. It argues that there is an admittedly arbitrary element in using net interest expense/EBITDA and debt/equity ratios as there is no "correct" ratio for businesses, but that standards can be identified by observing ratios found in a broad range of businesses.

With respect to debt/equity ratios, the UN raises the following challenges:

- determining whether interest is deductible based on compliance with a debt/equity limit has an often-overlooked shortcoming – it doesn't consider the interest rate charged on the debt. The interest rate is a key component in determining whether interest is excessive.
- With financial accounting, the equity of a business is generally based on historical measures, which could undervalue the asset side of the business. However, if businesses are permitted to revalue equity on a fair market basis, it can be costly and complex – potentially creating controversy with tax authorities. This is why the Australian thin-capitalisation rules have recently been amended and equity will be valued using historical cost going forward. The government experienced a significant increase in the use of asset revaluations by taxpayers to generate additional debt capacity under the safe harbour debt amount, enabling taxpayers to claim larger debt deductions. Concerns have been raised about the rigour and accuracy of some of these asset revaluations.[14]
- A sometimes-challenging issue is how to determine the amount of interest that should be disallowed in the event a taxpayer exceeds a permissible debt/equity ratio. A form of proration (where interest is disallowed based on the degree to which the enterprise exceeds the debt/equity limitation) is likely to be best, but that test may be easier to describe than to apply.

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[13] *Corporate Taxation in the Global Economy*, available: https://www.imf.org/en/Publications/Policy-Papers/Issues/2019/03/08/Corporate-Taxation-in-the-Global-Economy-46650

[14] See the Australian Treasury Explanatory Memorandum here: https://treasury.gov.au/sites/default/files/2019-03/Explanatory-Memorandum_2.pdf

The UN agrees with the OECD that an earnings-based approach (where interest deductions are limited to a percentage of earnings) has one primary virtue – it directly limits base erosion. A debt/equity ratio only limits base erosion indirectly. Two businesses with the same debt/equity level could have substantially different levels of interest expense. An earnings approach does not ensure every business will have positive income and pay taxes – interest deductions may be limited but the business could have other expenses that generate a low taxable income or loss. However, if the concern is that businesses could have excessive debt and excessive interest expenses that improperly reduce or erode the tax base, the UN argues this approach tackles the concern directly. It is also argued that an earnings ratio automatically causes taxpayers to adjust their behaviour as interest rates fluctuate. When interest rates are rising, this approach effects positive incentives to reduce debt and associated interest expense. In doing so, it reinforces non-tax regulatory objectives that would generally seek to encourage businesses to reduce their debt levels in such a situation. It is also a simple method to apply.

Many African countries link the deductibility of interest to the level of equity in an entity, often through thin capitalisation rules based on a debt/equity ratio. ATAF points out that the main advantage of such a test is that it is relatively simple for tax administrations to obtain relevant information on the level of debt and equity in an entity. Secondly, it provides a reasonable level of certainty to groups in planning their financing. However, two important disadvantages are highlighted – (1) similarly to the UN's view, a rule which limits the amount of debt still allows significant flexibility in terms of interest rate payable on that debt; and (2) given that an equity test enables entities with higher levels of equity capital to deduct more interest expense, it is relatively easy for a group to manipulate the outcome of a test by increasing the level of equity in a particular entity.

ATAF views the earnings-based approach recommended by the OECD as a straightforward rule to apply, ensuring that an entity's interest deductions are directly linked to its economic activity. Furthermore, these deductions are directly linked to an entity's taxable income, which makes the rule reasonably robust against planning. It has published a *Suggested Approach to Drafting Interest Deductibility Legislation.*

It could be argued that transfer pricing is the best means of restricting excessive debt and interest rates. In contrast to balance sheet and income statement approaches where one ratio applies across the board, it uses a facts and circumstances approach which is much more specific to each business' needs. However, its effectiveness is often challenging in practice. In addition to the OECD Action 4 Report acknowledging that the arm's length test is often resource intensive and uncertain, the OECD outlined the following flaws in a presentation recently provided to SARS – it is difficult to determine an arm's length level of debt for a given entity; the terms of intragroup debt can be manipulated to justify a higher arm's length interest rate; and it does not address instances where interest funds non-taxable income.

There is global debate on whether the arm's length principle is the most optimal solution to the challenges MNE's and tax authorities face in a global business environment with rapidly evolving technology. The current debate on the digital economy has highlighted this. The recent IMF (2019) paper on *Corporate Taxation in the Global Economy* included some responses from a survey they conducted on the BEPS Project. Many respondents felt that the BEPS Project was useful, but it had two serious flaws – one of them being the continued reliance on the arm's length principle "*which was very widely seen as no longer suited to modern economic structures; as relying on the "economic* *fiction" of separate entities; as increasingly complex; and as inappropriate, disadvantageous to, and hard to implement by LICs*[15]".

The outcome of potential consensus on the digital economy is still uncertain, but it is likely that the arm's length principle will remain. On 11 February 2020, the OECD published a revised version of the transfer pricing guidelines in respect of financial transactions, which sets out how tax authorities can think about auditing the validity and scope of transactions.[16]

The Davis Tax Committee's[17] main concern with a ratio based on earnings is uncertainty for potential investors as to what level of interest deductibility would be available in any particular year. The Committee recommended that a "*proper analysis be made to determine whether reliance on deduction limitation rules is appropriate*". It agrees with the OECD that the arm's length principle should be used for testing the interest rate, but added that it may be preferable to retain it for evaluating the extent of debt. In addition, the DTC recommended introducing a "safe harbour" with a fixed balance sheet (debt/equity) ratio to provide non-residents that are funding local entities with guidance as to reasonable levels of debt versus equity.

Government recognises that the potential volatility of earnings is the biggest drawback of a ratio based on earnings. Businesses prefer upfront certainty when deciding whether to raise capital and invest. While a debt/equity ratio may be a more stable measure, governments are rightly concerned that this can be manipulated and has no bearing on what interest rate is charged. Aiming for a holistic approach to the tax treatment is important – recognising that businesses require certainty, but equally that government has the right to protect its corporate tax base against what is deemed to be excessive deductions stemming from debt financing.

The OECD report includes a number of options for countries to deal with volatility in earnings, including averaging EBITDA or allowing the carry-forward and carry-back of disallowed interest, as well as carry-forward of unused interest capacity. The need for including these options depends to some extent on the percentage for the "fixed ratio rule". A carry-forward provision can help entities that incur interest expenses on long-term investments that are expected to generate taxable income only in later years, and will allow entities with losses to claim interest deductions when they return to profit. The challenge with this option is that businesses are ultimately allowed a deduction for interest expense that is considered to be excessive. Mitigating this could be achieved by capping the number of years that the deductions can be carried forward for (which has been implemented in some countries). There is a risk that the carry forward of unused interest capacity or the carry back of disallowed interest would otherwise permit excess capacity to build up in the economy over time.

Using average EBITDA over 3 or 5 years, for example, also has challenges. What about start-ups or new projects with no history, or loss-making entities where the average would be very low. A *de minimis* rule (although intended to reduce unnecessary administrative requirements for smaller businesses) could be a potential solution for these difficulties.

The OECD report includes an optional "group ratio rule" that also has the potential to mitigate the volatility problem. The report highlights that a fixed ratio rule does not consider that groups in different sectors may be leveraged differently and that some groups within the same sector may be

[15] Low-income countries
[16] Available here: https://www.oecd.org/tax/beps/oecd-releases-transfer-pricing-guidance-on-financial-transactions.htm
[17] The Davis Tax Committee recommendations are included in Box 1

more highly leveraged. To address these concerns, the best practice approach includes a group ratio rule. This will allow an entity that exceeds the entity fixed ratio rule to deduct net interest expense up to the group's third party (external borrowing) net interest to EBITDA ratio. This could be aligned with the fixed ratio rule, using the same calculation of entity EBITDA based on tax numbers, and the same carry forward or carry back provisions.

A number of countries currently apply a fixed ratio rule in combination with a group ratio rule using an assets-based ratio. For example, Germany has an 'equity escape' rule whereby the fixed ratio rule based on net interest/EBITDA does not apply if a company can show that its tax-adjusted equity/total assets ratio is equal to or exceeds that of its group. Under the OECD's recommendations, a country may also apply a group ratio rule based on asset values. By far the biggest challenge with introducing this option is complexity.

While the commercial reality makes some sense, auditing the ratio would be difficult as SARS would not have access to much of the required information. South Africa does not have group taxation. In summary, the feasibility of introducing such a ratio successfully is questionable – it would be complex to design, comply with and administer.

The Netherlands, Sweden and India have also opted out of a group ratio approach.

The UN (in its commentary on the OECD Action 4 Report) agrees with this summation:

The challenge for both taxpayers and tax administrators is how to assemble and audit the global group financial information required to apply a group ratio rule. Necessarily, the group ratio is likely to be determined on the basis of financial accounting data, rather than tax data. The Final Report recognizes that no country currently adopts a rule like the one proposed and states that further work will be necessary to provide guidance to countries; that additional work is now under way.

The difficult consideration lies in how this group rule should affect the limitations, if any, of a wholly domestic taxpayer. If an entity is allowed to leverage itself up to the level of its global group, then an entity that is either a stand-alone company or a member of a wholly domestic group would always qualify under this rule since the leverage ratio of the entity would be identical to its group ratio.

Limitations on interest expense generally are proposed for two reasons: to prevent erosion of the tax base and to discourage excessive leverage in a company for prudential reasons unrelated to tax. Therefore, it may be prudent to provide for some cap on the allowable leverage, even if the leverage of an entity in a specific country is at or below its group level.

The choice on the best approach highlights the classic tax policy design trade-off – finding a middle ground between a complex and potentially non-administrable (but tailored, case-by-case) approach, and a simple (but potentially blunt) approach.

6. What should be restricted?

The OECD report recommends that the restriction should cover interest on all forms of debt, payments economically equivalent to interest, and expenses incurred in connection with the raising of finance. These could include, but are not restricted to:

- payments under profit participating loans
- imputed interest on instruments such as convertible bonds and zero-coupon bonds

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

ATAF has included this list in its *Suggested Approach to Drafting Interest Deductibility Legislation.* Botswana has recently introduced the OECD recommendations and included the list above in its legislative definition for interest to be limited according to a fixed ratio of 30 per cent.[18] The Report does not view foreign exchange gains and losses (on instruments to hedge or take on a currency exposure connected with the raising of finance) as generally economically equivalent to interest[19]. But adds that countries may wish to treat some or all foreign exchange gains and losses on these instruments as economically equivalent to interest, in line with local tax rules and to reflect the economics of the currency exposure.

The best practice approach does not apply to payments which are not interest, economically equivalent to interest or incurred in connection with the raising of finance. As a guide, it suggests not limiting deductions for items such as:

- foreign exchange gains and losses on monetary items which are not connected with the raising of finance
- amounts under derivative instruments or hedging arrangements which are not related to borrowings, for example commodity derivatives
- discounts on provisions not related to borrowings
- operating lease payments
- royalties
- accrued interest with respect to a defined benefit pension plan.

Two further considerations include whether the rule should apply to: (1) gross or net interest expense, and (2) total or connected person (net or gross) interest expense. The report states that it would be appropriate to use a net interest amount (i.e. interest and economically equivalent expenses paid to external and related parties net of any interest income) to prevent inappropriate double taxation

[18] Article available here: https://www.ataftax.org/botswana-passes-new-transfer-pricing-legislation-and-interest-deductibility-legislation;
2018 Finance Act available here: https://irp-cdn.multiscreensite.com/a521d626/files/uploaded/ITA%20Amendment%20Act.pdf

[19] This statement is debatable as the pricing of instruments to hedge currency exposure is priced taking into account the interest differential of interest rates in the two countries.

outcomes. However, it is recommended that a specific integrity rule be enacted to ensure that a company cannot disguise other income as interest income to defeat the operation of the limitation.

On the second issue, the OECD recommends that total net interest expense (including that paid to related and unrelated parties) should be subject to the fixed ratio rule. This is preferable given the results of empirical analyses that have tested the success of measures to curb the debt/equity bias. Thin capitalisation and interest limitation rules have been shown to reduce leverage, but rules targeting solely related party interest expense are generally ineffective.

Blouin et. al (2014) studied affiliates of U.S. multinationals subject to thin capitalisation rules that restrict interest deductions. They found that rules targeting internal leverage have an indirect effect on the overall indebtedness of affiliate firms. Similar effects were found for Germany where a related-party restriction was implemented (Buettner et. al., 2012).

However, there are important behavioural responses to note. While both studies find that rules restricting interest deductions have an effect, Buettner et. al. (2012) find that even though companies reduced their internal debt, they increased their external debt. For the U.S., Blouin et. al. (2014) show that rules restricting internal leverage do have an impact on total leverage – so that shifts to third-party debt might not completely offset reductions in related-party debt.

A recent IMF paper tested whether limitations to interest deductibility work. It suggests that thin-capitalisation rules applying only to related-party debt have no significant impact on the external borrowing of corporate groups. On average, rules limiting interest deductibility that target a broader corporate debt base are estimated to reduce the consolidated debt ratio by about 5 percentage points, while the impact of rules solely restricting related party interest deductions was substantially lower. Companies can circumvent related party rules by raising external debt with “back-to-back loans” using a third-party financial institution. The main conclusion (recommendation) for countries is that neutralising tax systems with respect to financing decisions requires broadening the scope of their rules to cover all debt. (IMF, 2017)

Applying interest limitation rules to connected person net interest expense only would require additional complex anti-avoidance legislation.

7. Who should the rules apply to?

According to the OECD Action 4 Report, companies in large multinational groups pose the main base erosion and profit shifting risk. This is defined as all of the entities that are commonly controlled (directly or indirectly) where the group operates in more than one jurisdiction, including through permanent establishments. The report recommends that, as a minimum, the best practice approach should apply to such entities. The fixed ratio rule could also apply to members of domestic groups and standalone entities. In these circumstances, the rules may be applied for other tax policy reasons, e.g. to prevent a tax bias in favour of debt or to prevent a more favourable treatment of domestic over foreign controlled entities.

As mentioned, the OECD Report also recommends a *de minimis* threshold based on net interest expense to exclude low-risk entities from the scope of these rules. Anti-fragmentation and grouping rules are recommended to ensure that the *de minimis* thresholds are not abused.

Discussion

In the cross-border context, ATAF holds the view that debt funding of inbound and outbound investment by groups is the main tax policy concern surrounding interest deductions. This is due to parent companies commonly being able to claim relief for interest expenses whereas the return on equity holdings is taxed on a preferential basis – benefiting from a participation exemption, preferential tax rate or taxation only on distribution. They also argue that subsidiary entities may be heavily debt financed, using excessive deductions on intragroup loans to shelter local profits from tax. The conclusion is that these opportunities surrounding inbound and outbound investment can create competitive distortions between groups operating internationally and those operating in the domestic market. This suggests that the OECD recommendation to focus on MNE groups is rational.

Many countries do not have a specific definition for an MNE. In a different context (discussing residual profit allocation by income), Deveraux (2019)[20] discusses the boundaries of a multinational. He argues that it is necessary to trade-off two competing objectives – a clear and simple definition (based on the parent's ownership of, or voting rights in, a business) or recognising that a subsidiary that is 50% owned is not that different from one that is 49% owned. He refers to the former as arbitrary bright-line tests and notes that they tend to encourage businesses to arrange their affairs to be on the favourable side of the line for tax purposes. This can distort business decisions (sometimes with real economic repercussions) and also lead to greater complexity. Practically, he suggests following the 50% ownership test as per accounting treatment as it is unlikely that an MNE would want to adjust its financial statements significantly to manipulate the bright line for tax purposes. This is in line with the OECD best practice. However, government is hesitant to accept this conclusion as it has witnessed adjustments in ownership percentages previously in respect of the Income Tax Act.

The South African regulations specifying the Country-by-Country Reporting Standard for MNEs provide the only existing tax-related definition of an MNE Group.[21] It starts by defining a group:

The term "Group" means a collection of enterprises related 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.

The term "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.

8. How did the OECD determine the 10% - 30% corridor for the fixed ratio rule?

Under the best practice approach, interest will be deductible to the extent that the net interest expense to EBITDA does not exceed the allowable cap.

To be effective, the OECD recognised that a benchmark fixed ratio needs to be set at a level appropriate (low enough) to tackle BEPS. But it is also understood that countries differ in economic environment and in the tax rules that target the deductibility of interest expense. There was a fear

[20] Available: https://eml.berkeley.edu/~auerbach/WP1901_0.pdf
[21] Available: https://www.sars.gov.za/AllDocs/LegalDoclib/SecLegis/LAPD-LSec-Reg-2016-07%20-%20Regulation%20R1598%20GG40516%20-%2023%20December%202016.pdf

that competitiveness concerns would drive countries to adopt a ratio too high to effectively tackle BEPS. The aim was to identify a range of ratios that:

- Allows groups to deduct an amount equivalent to their net third party interest expense, and
- Limits the extent to which groups can use intragroup interest expense to claim total net interest deductions in excess of net third party interest expense

The OECD relied on PWC's analysis using Standard & Poor's GlobalVantage database to inform the 10% - 30% range. An extract from Annex B of the Action 4 Report is included below. The net interest expense (NIE) / EBITDA ratios were calculated using consolidated financial accounting figures from a sample of 12 000 multinational groups. This is important for two reasons. The best practice approach recommends using tax figures for calculating the NIE/EBITDA ratio, so including tax adjustments could yield ratios that are different to those based on accounting figures. Secondly, because the ratios are based on consolidated accounts, all connected party interest payments would be netted out for consolidation purposes. Table B.3. (below) from the OECD Report's Annex suggests the percentage of companies that would in principle be able to deduct an amount *equivalent to their net third party interest expense.* It shows that 87 per cent of MNCs would be able to deduct an amount equivalent to their net third party interest expense with a 30 per cent fixed ratio rule in place. The PWC analysis also showed that, at a fixed ratio above 30 per cent, the share of groups that can deduct all their net third party interest expense increases very slowly. But, the concern at this level was that a significant portion of groups may have an incentive to use intra-group debt to claim net interest deductions in excess of their actual third-party interest expense.

88 – ANNEX B. DATA ON COMPANIES AFFECTED BY A BENCHMARK FIXED RATIO AT DIFFERENT LEVELS

Table B.2 Tabulations for multinational and non-multinational companies, excluding companies with negative EBITDA, average for 2009-2013

Percentage of companies affected by interest deduction limitation

Percent of EBITDA limit on net interest deductibility	Average 2009-2013	
	Non-MNC	MNC
5%	57%	53%
10%	45%	38%
15%	35%	28%
20%	28%	22%
25%	23%	17%
30%	19%	13%
35%	16%	11%
40%	13%	9%
45%	11%	8%
50%	9%	7%
55%	8%	6%
60%	7%	5%
65%	6%	4%
70%	6%	4%
75%	5%	4%
80%	5%	3%
85%	4%	3%
90%	4%	3%
95%	4%	3%
100%	3%	3%

Source: OECD Secretariat calculations based on data in Table B.1.

Table B.3 Tabulations for multinational and non-multinational companies, excluding companies with negative EBITDA, average for 2009-2013

Percentage of companies that would in principle be able to deduct an amount equivalent to their net third party interest expense

Percent of EBITDA limit on net interest deductibility	Average 2009-2013	
	Non-MNC	MNC
5%	43%	47%
10%	55%	62%
15%	65%	72%
20%	72%	78%
25%	77%	83%
30%	81%	87%
35%	84%	89%
40%	87%	91%
45%	89%	92%
50%	91%	93%
55%	92%	94%
60%	93%	95%
65%	94%	96%
70%	94%	96%
75%	95%	96%
80%	95%	97%
85%	96%	97%
90%	96%	97%
95%	96%	97%
100%	97%	97%

Source: OECD Secretariat calculations based on data in Table B.1.

Table B.2 includes the companies affected by a particular fixed ratio. Table B.3 includes the companies that in principle are not affected. Taken together, numbers from these tables for a particular ratio should add to 100%. Table B.3 assumes that net interest expense is spread around a group in accordance with EBITDA. In practice there may be barriers which prevent a group achieving this.

Source: OECD (2015)

In addition to the fixed ratio and group ratio rules, a best practice approach would include targeted anti-avoidance rules to prevent groups undertaking planning to reduce the impact of the fixed ratio and group ratio rules. The key risks identified in the report include planning to convert items from interest into non-interest amounts, entering into arrangements to increase group debt (and consequently the group ratio) and entering into arrangements to split an economic group for the purposes of the group ratio rules.

The OECD's report recognises that **there are some large-scale highly-geared projects which are privately owned but result in provision of a public benefit**. The OECD also acknowledges that due to the close relationship with the public sector, these projects present little or no risk of base erosion and profit shifting. As a result, the OECD's best practice approach includes an option for countries to exclude from the general rule the interest expense incurred on third-party loans linked specifically to projects which deliver a public benefit.

The OECD report recognises that the **recommended best practice approach is unlikely to address BEPS in the banking and insurance sectors** for a number of reasons. In particular, banking and insurance groups are important sources of debt funding for groups in other sectors, hence many are net lenders by a significant margin. This means that the main operating companies in these groups, and the group overall, will often have net interest income rather than net interest expense. The fact that interest income is a major part of a bank or insurance company's income means that EBITDA may not be a suitable measure for economic activity across a group in these sectors. The OECD report also suggests that the restrictions imposed by regulatory requirements lower the BEPS risk in banking and insurance groups. However, not all companies within banking and insurance groups are regulated, and there can be BEPS risks from borrowing involving non-regulated entities.

There were some countries who disagreed that the financial sector should be excluded and, as a result, countries were encouraged to decide what is most appropriate for their circumstances. Currently, government is not convinced that the financial sector should be excluded, but encourages companies in this sector to provide information should they disagree.

According to the report **a country may also apply transitional rules** which exclude interest on certain existing loans from the scope of the rules, either for a fixed period or indefinitely. The report recommends that these transitional rules are primarily restricted to interest on third party loans entered into before the rules were announced, and that interest on any loans entered into after the announcement of the new rules should not benefit from any transitional provisions.

9. What have other countries done?

The box below shows some countries' stances on excessive debt financing since the OECD BEPS Project.

Country	**Fixed Ratio rule**	**Who**	**What**	**Group Ratio rule**	**Equity escape**	**Carry forward**	**De minimis threshold**
UK	30% tax EBITDA	MNE groups	Internal & external	Y	Companies can choose to use a debt cap	Disallowed interest indefinitely; Unused interest 5 years	NIE > €2.3m
Norway	25% EBITDA	Consolidated groups	Internal & external		Y	Disallowed interest 10 years	NIE > €2.6m

EU (ATAD) (countries can be stricter)	30% EBITDA	MNE groups		Y			NIE > €3m
Netherlands	30% EBITDA	MNE groups	Internal & external	N	N	indefinite	NIE > €1m
France	30% tax EBITDA	Standalone and MNE groups	Internal & external	Y		Indefinite	NIE > €3m
Sweden	30% EBITDA	MNE groups	Internal & external	N		6 years	NIE > €500 000
Finland	25% tax EBITD	MNE groups (50% direct/ indirect control), general & limited partnerships & real estate companies		Y		indefinite	NIE > €500 000
United States	30% EBITDA before 2022 & 30% EBIT from 2022	An affiliated group of corporations that files a consolidated U.S. federal income tax return applies at the consolidated level					$25 000 of average gross receipts for the prior three years
India	30% EBITDA	Associated enterprises of Indian co or PE of foreign company	Internal (related party borrowings)	N		8 years	NIE > €130 000
Botswana	30% tax EBITDA	MNE groups	Internal & external			3 years (general) 10 years (mining)	
Argentina	30% EBITDA (does not apply to interest s.t. WHT)					5 years	NIE > €20 000

Vietnam	20% EBITDA	MNE groups	Internal & external	N			No
Japan	20% Adjusted Taxable Income					7 years	NIE > €80 000
Australia	Retaining thin-cap (1.5:1)		D/E				AUD 2m
New Zealand	Restricted TP approach (inbound debt)	Inbound debt "high BEPS risk"					

Sources: International Tax Review; EY; PWC; Deloitte; Inland Revenue, New Zealand, 2017; HM Treasury (2017); International Fiscal Review (2019)

Moat of the countries in the table have followed the OECD's "best practice" approach. Australia has not – the current approach relies on a debt to equity ratio, which was tightened in 2014. The changes placed the focus on larger businesses as the de minimis threshold was increased from AUD 250 000 to AUD 2 million per year. The thin capitalization safe harbour gearing limits have been reduced from 75% (3:1 debt to equity) to 60% (1.5:1) for general investors, and from 20:1 to 15:1 for Australian financial entities that are not deposit taking institutions.

New Zealand released a discussion document in 2017. It is of the view that the current rules serve the country well and has proposed measures to strengthen the existing rules that limit interest deductions of companies with international connections (the inbound and outbound thin capitalisation rules together with the transfer pricing rules). Thin capitalisation rules have been strengthened previously, such as reducing the safe harbour for debt/assets from 75 per cent to 60 per cent in 2011, and by extending the rules so they apply to New Zealand firms controlled by non-residents who act together in 2015. A special thin capitalisation regime also applies to registered banks operating in New Zealand.

10. South African history

South Africa has introduced several tax policy measures to mitigate the debt/equity bias over the past 25 years.

Thin-capitalisation and transfer pricing

In 1995, South Africa introduced specific thin-capitalisation rules where a 3:1 debt-to-equity ratio was used to determine excessive debt. These rules were intended to address situations where a South African taxpayer was funded (directly or indirectly) by a non-resident connected person with excessive intra-group, intra-group-guaranteed or back-to-back debt. Such debt could lead to excessive interest deductions that reduce the corporate tax base and section 31 of the Income Tax Act empowered the Commissioner to consider whether the international financial assistance rendered was excessive. If excessive, the interest, finance charges or other consideration relating to the excessive financial assistance was disallowed and deemed to be dividends subject to the secondary tax on companies.

Following the stance of the OECD Model Tax Convention, specific thin capitalisation rules were repealed and only transfer pricing rules applied with effect from 1 April 2012. These rules determine non-excessive debt and arm's length finance charges. Section 31 requires taxpayers to:

- determine whether the actual terms and conditions of any transaction, operation, scheme, agreement or understanding differ from the terms and conditions that would have existed if the parties had been independent persons dealing at arm's length;
- if there is a difference which results or will result in a tax benefit for one of the parties to the affected transaction, to calculate their taxable income based on the arm's length terms principle and conditions (functions performed, assets utilised and risks assumed by each party) of the affected transaction; and
- instead of the discretion previously given to the Commissioner, to make a transfer pricing adjustment, the new rules place an obligation on each party to the transaction to make a 'voluntary' transfer pricing adjustment.

Although often referred to as a disallowance of excessive interest, the denial of a deduction is not limited to excessive interest. Any interest, finance charges or deductions / inclusions in taxable income arising in relation to or on that portion of the non-arm's length debt (for example, foreign exchange gains and losses) is disallowed as a deduction (or inclusion, as appropriate) in determining taxable income. The disallowed deduction / inclusion (the primary adjustment) is a permanent difference and may not be carried forward to a later year of assessment.

A secondary adjustment used to require that the excessive interest expenses be deemed to be a loan bearing a market interest rate. As of 1 January 2015, the amount of the secondary adjustment is deemed to be a dividend in specie paid by the resident company to the other person. Because it is a deemed dividend *in specie* and the recipient is generally not the beneficial owner, the taxpayer does not benefit from reduced dividend withholding tax rates in tax treaties.

Temporary measures to limit interest deductions

Until mid-2011 section 45 was used in the context of leveraged asset acquisitions to ensure the tax deductibility of interest that would otherwise not have been available if the parties to the transaction had structured the transaction as the sale of shares.[22] The specific concerns to government in this respect related to instances where a new operating subsidiary company acquired the business assets of the existing "target company". In such transactions, debt was 'pushed-down' by the acquirer into the target company to facilitate the deduction of 'excessive' acquisition-related interest costs, thereby reducing the returns to the fiscus.

In light of this, instead of suspending the use of section 45, section 23K was introduced with effect from 3 June 2011 as an 'interim' measure to stem losses to the fiscus while a more permanent solution was formulated.[23] In terms of section 23K, deductions for interest associated with debt used by an acquiring company directly or indirectly for the purpose of procuring, enabling, facilitating or funding the acquisition of any asset under so-called re-organization transactions would be disallowed unless

[22] Interest on debt used to buy assets is deductible, while interest on debt used to acquire shares is not deductible.
[23] Taxation Laws Amendment Act 24 of 2011

a specific directive was obtained from SARS.[24] This was the case regardless of whether such interest expenditure would otherwise have been deductible under the general principles of deductibility or any other specific provision.

Where an application was made, section 23K required the Commissioner to take into account the amount of interest incurred, received or accrued by parties to the transaction, including the lenders, and only issue a directive allowing the deduction of interest in the event that the Commissioner was satisfied that the issuing of the directive would not lead to a significant reduction of the aggregate taxable income of the parties involved in the transaction and therefore pose a threat to the tax base.

Permanent measures to limit interest deductions

Section 23N

With effect from 1 April 2014, section 23N was introduced – to replace the subjective section 23K with objective rules.[25] While section 23N, like section 23K, serves to limit the deduction of interest incurred in respect of debt used to fund reorganisation and acquisition transactions, the net effect of these changes was to provide partial relief to taxpayers by allowing the deduction of a portion of interest expenditure in prescribed circumstances. Section 23N specifically limits deductions in respect of interest payable on debt used to finance, or refinance, any transaction carried out under section 45 or section 47 (i.e. reorganisation transactions), as well as acquisition transactions (as defined under section 24O).

The amount of interest that may be deducted in such circumstances is currently limited to:

- The amount of interest received by or accrued to the acquiring company for a specific year of assessment.
- *Add:* An amount arrived at by multiplying the taxpayer's adjusted taxable income[26] by a percentage determined by applying a specified formula (42 per cent[27]).
- *Less:* Any amount of interest incurred by the acquiring company on debts other than debts contemplated in the section 23N.

The percentage referred to above was initially introduced at 40 per cent of '"tax EBITDA"', but was amended to be flexible in that it responds to changes in the repo rate, recognising that fluctuations have an effect on the cost of debt financing. Companies are able to deduct interest (excluding interest not linked to such transactions) to the extent that it does not exceed the sum of 43 per cent of 'tax EBIDTA' and net interest income.

The disallowed deduction is a permanent difference and may not be carried forward to a later year of assessment.

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[24] Re-organisation transactions are those catered for by section 45 (as well as under section 44 (*amalgamation transactions*) and section 47 (t*ransactions relating to liquidation, winding-up and deregistration*))

[25] Taxation Laws Amendment Act 31 of 2013

[26] Adjusted taxable income refers to the taxable income of the acquirer determined in the normal manner, reduced by interest received or accrued; controlled foreign company net income; and recovered or recouped amounts in terms of capital allowances. This is further adjusted by the addition of any interest incurred; all capital allowances; and 75 per cent of the acquirer's rental income.

[27] Based on SARS repurchase rate if year of assessment ends on 30 June 2019

Table 1 shows that section 23N has denied interest deductions totalling R1.76 billion since inception. Assuming an effective tax rate equal to the headline corporate income tax rate, this has realised a saving for the fiscus of almost half a billion rand. Assuming the same level of denied deductions in 2018 and 2019 as in 2017 – denied deductions are estimated to have reached almost R3 billion since introduction. It would appear that only a small number of companies have been affected by the rule. However, it is important to note that this table excludes 'lost deductions' resulting from behavioural change of companies to fall within the interest limitation.

Table 1: Total deductions and number of taxpayers in respect of section 23N

TaxYear	Total_23N	Estimated Total_23N	Stand-alone	Local group	Foreign group
	Rands		*Count*		
2014	20 209 394	20 209 394	4	3	1
2015	227 374 460	227 374 460	10	12	6
2016	595 582 636	595 582 636	11	12	12
2017	717 460 655	717 460 655	37	3	-
2018	201 805 680	717 460 655	14	-	-
2019	-	717 460 655	-	-	-
	1 762 432 825	2 995 548 455			
28%	*493 481 191*	*838 753 567*			

Section 23M

To attract foreign debt capital to South Africa, interest income of non-residents from a South African source is generally exempt from normal tax unless that foreign person has a South African permanent establishment. However, it is important to strike a balance between attracting capital and protecting the tax base. Many transactions entered into between a resident company and a foreign person or domestic pension fund, for example, result in double non-taxation as the interest paid from South Africa is deductible while the recipient is not taxed on the interest income under the normal tax or interest withholding tax system. This is an attractive tax result for companies that are naturally inclined to minimise the group's tax liability and maximise shareholder returns.

Excessive interest deductions pose a recurring risk if the debtor and creditor form part of the same economic unit. In such instances, the parties can freely change the terms of the funding instrument to serve the interest of the group. Consequently, the debt label for these instruments is frequently driven by tax and other regulatory factors, when the substance is more akin to equity.

Broadly, section 23M, which took effect on 1 January 2015, limits interest deductions in respect of loan funding where the creditor (i) is not subject to tax on the interest income or the interest has not been included in a CFC's net income under section 9D, (ii) is in a 'controlling' relationship with the debtor and (iii) the interest has not already been disallowed under section 23N. The rule also applies if a creditor that is independent from the debtor obtained the funding for the debt advanced from a person that is in a controlling relationship with that debtor.

The method of restricting the interest deductibility in section 23M is based on the same formula as that for section 23N. The adjusted '"tax EBITDA"' is similar to that in section 23N. The disallowed deduction may be carried forward to a later year of assessment, which is not the case for section 23N.

Table 2 shows the impact of section 23M. It is estimated that up to R4.3 billion in interest expense has been denied a deduction, potentially saving the fiscus around R1 billion in tax revenue since inception.

Table 2: Total deductions and number of taxpayers in respect of section 23M

TaxYear	Total_23M	Estimated Total_23M	Stand-alone	Local group	Foreign group
	Rands		*Count*		
2015	513 908 125	513 908 125	45	7	27
2016	791 485 671	791 485 671	93	5	50
2017	1 003 538 227	1 003 538 227	143	3	5
2018	15 959 545	1 003 538 227	80	-	-
2019	-	1 003 538 227	-	-	-
	2 324 891 568	4 316 008 477			
28%	*650 969 639*	*1 208 482 374*			

Withholding tax on interest

The tax system used to provide a blanket exemption in respect of interest payable to non-residents. However, it became evident that the blanket exemption was overly generous compared to other developed and emerging economies, many of which exempt cross-border interest on mobile portfolio debt, but tax other forms of cross-border debt (typically at a flat withholding tax rate).

As mentioned above, it became apparent that a careful balance was needed between attracting foreign debt capital and protecting the tax base from potential erosion. The exemption of cross-border interest led to cycle schemes purely designed to undermine the tax base. It became apparent that some South African companies were paying interest to a foreign subsidiary or affiliate located in countries where no tax is imposed on the interest income. The payment was routed through a facilitator to another foreign related party and ultimately paid back to the South African company in the form of a foreign dividend, which would escape normal tax due to the 10 per cent participation exemption. As a result, South African companies benefitted from the interest deduction and exemption of foreign dividend income, i.e. double non-taxation. If the company paying the dividend was situated in a country that allows deductions for dividends, the tax benefit was further increased. These schemes are no longer effective since the amendment to section 10B(4), which would deny the participation exemption in this situation.

Other concerns arose in the context of closely-held cross-border situations, as the interest exemption could provide foreign investors with an incentive to fund businesses with a disproportionate amount of debt as opposed to equity. Specific thin capitalisation rules in place prior to 1 April 2012 only acted as a partial remedy.

A withholding tax on interest paid to foreign persons was introduced on 1 March 2015, so that a foreign person that receives or accrues interest from a South African source is liable to pay 15 per cent on the amount of interest that is paid to that person. The withholding tax rate is reduced to as low as zero per cent in tax treaties with some key trading and investment partners.

Exchange control

The Davis Tax Committee raised the misalignment of interest rate caps for exchange control and transfer pricing purposes and included the table below.[28] The Committee raised this as a source of misalignment and uncertainty, which has been aggravated by the draft transfer pricing interpretation note from 2013 that has not been finalised.

The most recent Manual for Authorised Dealers[29] states that the following criteria must be strictly applied by 'Authorised Dealers' when adjudicating applications for inward foreign loans. In respect of:

- Third party foreign-denominated loans, the interest rate may not exceed the base lending rate plus 3 per cent
- Shareholders' foreign-denominated loans, the interest rate may not exceed the base lending rate as determined by commercial banks in the country of denomination
- Third party rand-denominated loans, the interest rate may not exceed the base lending rate plus 5 per cent
- Shareholders' rand-denominated loans, the interest rate may not exceed the base rate.

Table 3: Davis Tax Committee overview of exchange control and transfer pricing differences[30]

Loan obtained from	SARB	SARS Draft IN on Thin Cap (indicative interest rates only)	Comment
Shareholder loan, foreign currency denominated	Prime or base rate of the country of denomination	Weighted average of the base rate of the country of denomination plus 2%	Current interest rate cap from SARB should prevent non-arm's length interest rates
Non-shareholder loan, foreign currency denominated	Prime or base rate of the country of denomination + 2%	Same as above	Same as above
Shareholder loan, ZAR denominated	SA prime	JIBAR plus 2%	SARS considers interest exceeding JIBAR plus 2% to be of higher risk. JIBAR plus 2% is higher than SA prime. A taxpayer could therefore have an interest rate approved by SARB that is not viewed as arm's length from a TP perspective. This is not helpful.
Non-shareholder loan, ZAR denominated	SA prime + 3%	JIBAR plus 2%	Same as above, except that the gap between what SARB allows and SARS views as high risk is greater

[28] This information can also be sourced from the Reserve Bank's website. Available: http://www.resbank.co.za/RegulationAndSupervision/FinancialSurveillanceAndExchangeControl/FAQs/Pages/Inward%20loans.aspx
[29] South African Reserve Bank, Currency and Exchanges: Manual for Authorised Dealers (2019-07-02)
[30] The comment in the fourth column, third row is no longer applicable as JIBAR is currently 3.2% lower than prime. The JIBAR rate changes daily and is not as stable as repo or prime rate.

Box 1: Davis Tax Committee Recommendations

- **Current legislative environment is complex and unclear**. Having several differing sections all serving to limit interest deductions is cumbersome and needs to be addressed. Taxpayers need certainty and simplification to be compliant. Need balance between base protection, certainty and stimulating economic growth.
- **Consider a holistic review of rules applicable to inbound debt considering:**
  - Safe harbours as a viable option
  - Interaction of excessive debt rules and thin cap rules
  - Alignment of thin cap rules with exchange control
  - Having overly-complex rules which negatively impact on how projects in capital intensive sectors are funded is counterproductive and discouraging of these sorts of initiatives (limiting capital-intensive industries by regulating their funding is of concern).
- **Effectiveness of arm's length principle** – While OECD recommended that the arm's length test only be used for the pricing of debt, the DTC found that it may be preferable to retain it for evaluating the extent of debt (thin capitalisation) and debt pricing (interest rate) separately. Guidance from SARS should be changed to be in line with that of OECD and international thinking as a matter of urgency.
- **Introduce a safe harbour** with a fixed ratio in section 31 or Interpretation Note to provide non-residents funding local entities with guidance on reasonable levels of debt vs equity
- **Draft Interpretation Note (2013) creates uncertainty**. Issuing of a final Interpretation Note on thin capitalisation should be deferred until a holistic evaluation of all the rules has been performed. Following should be considered:
  - Simplification
  - Consistency with OECD recommendations and international precedent
  - Transfer pricing rules for interest rate should factor in the GE and Chevron outcomes with respect to relevance of parent ratings
  - Reducing admin burden for low-BEPS-risk taxpayers (safe harbour or de minimis)
  - Consider how to treat start-up operations where loan funding required
  - Compliance cost for investors
- **Align exchange control** and transfer pricing interest caps. Interest rates allowable from a SARB perspective are potential indicators of risk from a South African transfer pricing perspective. A taxpayer should determine what interest rate would be acceptable from a transfer pricing perspective. If acceptable, then it should be allowed by SARB. Alternatively, SARS should indicate what interest rates it would allow, and then those should be allowed from an exchange control perspective.
- **Reconsider effectiveness of the withholding tax on interest** to ensure that source right to tax protected, e.g. renegotiate zero-rate treaties.
- **Analysis needed to determine whether reliance on deduction limitation rules appropriate** (recognising complexities and uncertainties for potential investors as to what level of interest deductibility would be available in any particular year).
- **Targeted rules may be required** for to address BEPS risks posed by entities which are not subject to the general interest limitation rules:
  - A group is restructured to place an unincorporated holding entity at the top of the structure, to create two groups. This may be to prevent a fixed ratio rule applying (e.g. in a country where the rule does not apply to stand alone entities) or to separate the original group into two parts for the group ratio rule purpose.
  - "structured arrangements" also need to be dealt with – e.g. those incorporating a third party with back-to-back arrangements, often using non-interest payments in one leg of the structure.
  - Definitions of "related parties" should be made clear to address risks set out.

Government's response on some of the points raised by the Davis Tax Committee

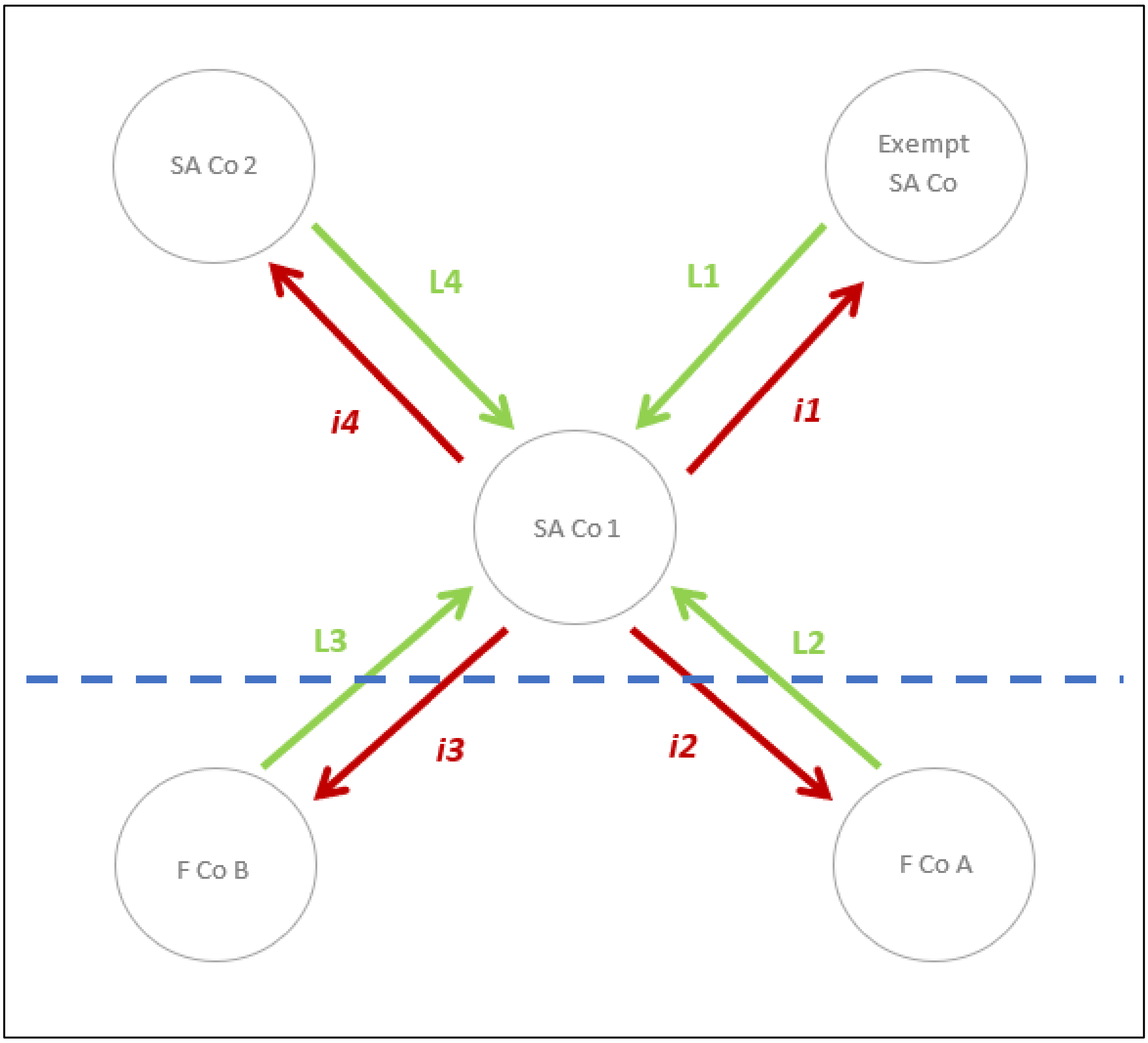
Government agrees that achieving a balance between base protection, certainty, simplicity and stimulating economic growth is key. These key principles are the drivers that underpin this discussion document, which serves as a holistic review of the tax treatment of debt funding.

With respect to recommendations on specific policy areas and choices, the document provides government's thinking in each of these areas. These include, for example, the effectiveness of the arm's length principle and the suitability of a fixed ratio rule. A revised draft interpretation note will be issued following public consultation and the legislative process following from this discussion document. Commentators will again have an opportunity to provide comments.

11. Examples

It is useful to take a high-level view of the current regime aimed at mitigating the debt/equity bias by considering a simple example (see Figure 6). Each transaction (L1, L2, L3, L4) involving a loan should be viewed in isolation (as it is impossible for SA Co 1 to have a collective shareholding of more than 100 per cent).

Figure 6: Example



L1 – SA Co 1 borrows from a tax-exempt South African company:

- Section 31 is not applicable as there is no cross-border transaction between connected persons, and therefore no "affected transaction" against which to test the arm's length principle under transfer pricing.
- Section 23N is not applicable as there is no "reorganisation transaction" or "acquisition transaction".
- If there is a 50%+ shareholding (or if the funding is sourced from a third party that received funding from a creditor in a controlling relationship (50%+) with SA Co 1), section 23M will limit the amount of interest that SA Co 1 can deduct.
- If there is no relationship or the shareholding is not more than 50%, there will be no limitation on the amount of interest that can be deducted in terms of 23M.
- There is no withholding tax on the interest payment as no interest is paid or due and payable to or for the benefit of a foreign person.

L2 – SA Co 1 borrows from F Co A (51 per cent shareholding) that is situated in a country where the tax treaty reduces the WHT on interest to zero per cent:

- Section 31 applies because there is a cross-border affected transaction between connected persons (holding of at least 20 per cent of the equity shares or voting rights). The arm's length principle is used to test both the validity of the interest rate and whether SA Co 1 has excessive debt (in relation to equity).
- Section 23N is not applicable as there is no "reorganisation transaction" or "acquisition transaction".
- Because F Co A is not subject to withholding tax on the interest flowing out of South Africa, section 23M applies to limit the amount of interest that SA Co 1 can deduct (because the interest income is not taxed in the hands of the recipient).
- There is no withholding tax on the interest payment as the tax treaty reduces the rate to zero.

L3 – SA Co 1 borrows from F Co B (51 per cent shareholding) that is situated in a country where the tax treaty reduces the WHT on interest to 5 per cent:

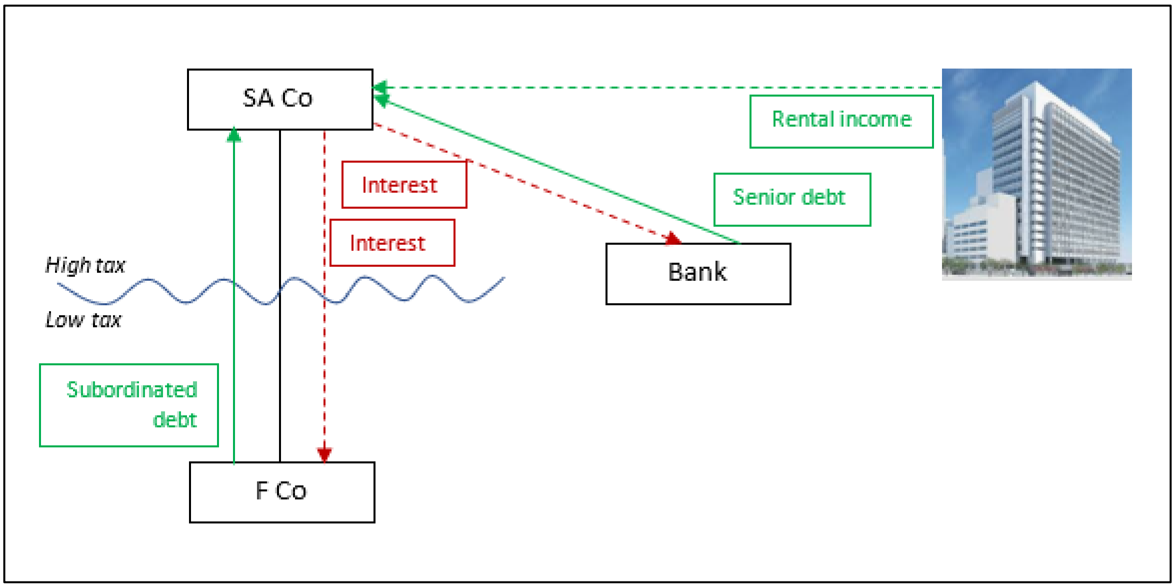
- Section 31 applies because there is a cross-border affected transaction between connected persons (holding of at least 20 per cent of the equity shares or voting rights). The arm's length principle is used to test both the validity of the interest rate and whether SA Co 1 has excessive debt (in relation to equity).
- Section 23N is not applicable as there is no "reorganisation transaction" or "acquisition transaction".
- Because F Co A is subject to withholding tax at a rate of 5 per cent on the interest flowing out of South Africa, section 23M does not apply (the interest income is taxed in the hands of the recipient).
- A withholding tax of 5 per cent is applied to the total amount of interest flowing out of South Africa (even if a portion was permanently disallowed as a deduction for transfer pricing purposes under section 31).

L4 – SA Co 1 borrows from SA Co 2:

- Regardless of whether there is a relationship between the two parties, the interest income is included in the South African tax base as the recipient is a resident. Sections 23M, 23N and 31 are not applicable.

While it may appear that there is already a robust approach to addressing BEPS resulting from excessive levels of debt and inflated interest rates charged on debt between connected persons, the current interest limitation rules do not apply uniformly to interest flowing out of South Africa, and the example in Figure 7 shows there is room for improvement.

Figure 7: BEPS driven by interest deductibility



Facts:

- SA Co borrows money from a bank to buy a building. Being senior debt, the bank has first claim on repayments should SA Co experience financial and liquidity problems.
- SA Co borrows an additional amount from its parent company in a low-tax country. In the event of a default, sub-ordinated debt holders will only be paid after the senior debt holders, since they are second in line. The risk of not getting their money back is bigger, so the intra-group interest rate charged is inflated to reflect the higher risk premium and the interest payments are used to strip profits out of South Africa.
- The subordinated debt may constitute a hybrid financial instrument so that F Co is not taxable on the interest.

Under the current rules, the following would happen:

- Transfer pricing rules (section 31) would not be applicable for the loan from the bank as it is a transaction entered into with a third party.
- Section 31 would be applicable to the intra-group loan. It is considered an “affected transaction” so SARS can test whether the amount of the loan and the interest rate is in line with the arm’s length principle (any outcome can be tested in court).

- SARS would need to go through the terms of the loan contract and prove whether the same amount would have been lent to SA Co by a third party based on the facts and circumstances.
- This is a resource intensive exercise and if the amount is proved excessive, SARS would need to determine what portion of associated interest expense should be permanently disallowed as a deduction.
- With respect to the interest rate charged, SARS would need to try and prove that there was no reason to subordinate the debt, which may be difficult to do.
- If SARS fails to prove that the interest rate is higher purely because the MNE can take advantage of its group structure, SA Co can artificially reduce its profits in South Africa, which puts it on an unlevel playing field with respect to purely domestic companies.

- If F Co was situated in a country where the tax treaty with South Africa reduces the withholding tax on interest from 15 to 5 per cent, the existing interest limitation rules (section 23M) would not apply as the interest income is being taxed through withholding, even though the WHT is low.
- However, if F Co was situated in a country where the tax treaty with South Africa reduces the withholding tax on interest from 15 to 0 per cent, the existing interest limitation rules (section 23M) would apply as the interest income is not being taxed through withholding.

This shows the possibility of both transfer pricing and existing interest limitation rules failing to limit excessive interest deductions that erode the South African tax base. The example highlights what the OECD has raised as the drawbacks of existing measures that attempt to tackle BEPS involving interest deductions. These are taken from a recent OECD presentation to SARS and are listed below:

The arm's length test:

- Resource intensive for entities and tax authorities
- Difficult to determine an arm's length level of debt for a given entity
- Terms of intra-group debt can be manipulated to justify a higher arm's length interest rate
- Does not address the issue of interest funding non-taxable income

Withholding taxes:

- WHT rates are typically too low to remove BEPS risk completely and may be further reduced under tax treaties
- May be difficult to apply to substitutes for interest (e.g. payments under swaps)
- Tax is only levied on payment, which can be deferred
- Exemptions may apply (e.g. on interest paid to banks)
- WHT can also give rise to BEPS opportunities, such as multiple claims for credit

Thin-capitalisation rules:

- Groups can manipulate the rule by injecting enough equity into an entity to support the desired level of interest deductions
- Do not prevent an excessive rate of interest on intra-group debt, so additional rules are needed
- Do not address interest expense funding non-taxable income

- Typically only apply to intra-group debt, leaving scope for BEPS using third party debt (whether "real" third party debt or third-party debt indirectly funded by the group)

Targeted anti-avoidance rules:

- Requires a tax authority to identify new risk areas and develop a targeted response, which takes time
- May drive groups to adopt different BEPS arrangements, rather than reducing BEPS behaviour
- Further targeted rules can be required to address emerging risks (a good analogy here is if a balloon is squeezed on one side, it will pop out somewhere else)
- This can result in a more complex system which is costly to apply and administer.

This example, as well as the limitations of existing rules, provide a rationale for introducing interest limitation rules based on the OECD recommendations that apply to all cross-border transactions within MNE groups – to ensure that excessive interest deductions are not used to strip South Africa's tax base.

12. Analysis – What our ratios look like

The administrative tax data from SARS, which is captured in the ITR14 forms, allows for an analysis of companies' income statement and balance sheet ratios – providing some insights into what is the most appropriate policy response in the South African context. Table 4 provides an overview of all the companies captured in the dataset. The tax years 2013-2016 appear to be the most complete when considering the number of businesses from tax year to tax year. In total, there are more than 800 000 companies that file annually with SARS. The later years have less companies accounted for as assessments have not been completed. Companies have been divided into four groups – depending on how they responded to two questions on the ITR14 form:

- Q1 – Is the company a subsidiary of a group of companies as defined in section1? (From 2017 onwards, the ITR14 form was changed to instead ask: Is the company part of a group of companies that prepares consolidated financial statements?)
- Q2 – Is the ultimate holding company resident outside South Africa?

Based on the answers to these questions (either "Y" or "N"), companies were divided into four groups:

Q1	Q2	Company type	Additional information
N	N	Stand-alone	A taxpayer in this category is not part of a group and is assumed to be domestic stand-alone company.
Y	N	Local-held group	A taxpayer in this category is part of a group that may consist of a few or many other South African and non-resident companies. The company is directly or indirectly controlled by a South African company. For indirect control, there may be other intermediary South African holding companies or other group companies that in aggregate control the taxpayer, but not individually. This category would also include a South African parent of an MNE.
Y	Y	Foreign group	A taxpayer in this category is part of a group. They are South African companies that are either owned directly or indirectly by an ultimate holding company in a foreign country.
N	Y	Other	There are no occurrences of "N" and "Y" up to and including the 2016 tax year. Because the question was changed in 2017, there are a number of companies that

			fall into this group for 2017 and 2018. While they indicate having a foreign parent, it does not appear that they are part of a group that prepares consolidated financial statements. Some taxpayers only test this in relation to being a group together with their immediate parent. Intermediate parents are not required to prepare consolidated accounts.

Companies were divided into nine sales groups – a proxy for size. Given the potential for anomalies or unexpected entries in the ITR14 forms, group 1 was created for negative sales. However, no negative figures were found to be captured in this field. It would appear that many companies are not actively trading – given the large number reporting zero sales (group 2). This was tested by looking at the 2016 tax year – the most recent tax year where assessment levels are suitably high in the dataset. Of the 780 127 companies with zero sales, 43 per cent of them indicated that they are dormant.

Table 4: Number of businesses in the SARS database – by type, sales group and tax year

Q1	Q2			2012	2013	2014	2015	2016	2017	2018	2019
N	N	Stand-alone	2_R0	767 570	748 614	773 289	769 522	775 807	690 180	285 852	7 514
			3_R0-R20m	6 756	19 470	14 639	15 661	16 619	17 420	7 938	3
			4_R20m-R50m	4 338	15 051	15 961	16 810	17 647	18 219	7 920	-
			5_R50m-R100m	1 712	6 072	6 595	7 022	7 204	7 754	3 292	-
			6_R100m-R500m	1 247	4 008	4 559	4 894	5 144	6 314	2 530	-
			7_R500m-R1bn	132	343	382	425	412	679	217	-
			8_R1bn-R4bn	76	172	206	225	239	513	113	-
			9_R4bn+	25	48	41	41	39	148	19	-
		Total		*781 856*	*793 778*	*815 672*	*814 600*	*823 111*	*741 227*	*307 881*	*7 517*
Y	N	Local-held	2_R0	1 806	3 339	3 443	3 378	3 326	958	-	-
			3_R0-R20m	720	1 353	1 218	1 231	1 240	425	-	-
			4_R20m-R50m	485	1 132	1 157	1 244	1 279	436	-	-
			5_R50m-R100m	354	829	846	913	855	267	-	-
			6_R100m-R500m	529	1 234	1 329	1 358	1 398	418	-	-
			7_R500m-R1bn	107	229	254	291	320	77	-	-
			8_R1bn-R4bn	134	226	246	256	269	52	-	-
			9_R4bn+	65	93	102	102	105	15	-	-
		Total		*4 200*	*8 435*	*8 595*	*8 773*	*8 792*	*2 648*	*-*	*-*
Y	Y	Foreign-held	2_R0	611	859	939	1 014	994	143	-	-
			3_R0-R20m	268	377	373	410	361	49	-	-
			4_R20m-R50m	290	430	463	494	507	64	-	-
			5_R50m-R100m	251	369	419	444	450	46	-	-
			6_R100m-R500m	535	730	797	834	864	75	-	-
			7_R500m-R1bn	122	175	206	214	229	7	-	-
			8_R1bn-R4bn	143	186	201	217	236	11	-	-
			9_R4bn+	43	70	73	78	92	5	-	-
		Total		*2 263*	*3 196*	*3 471*	*3 705*	*3 733*	*400*	*-*	*-*
N	Y	Other	2_R0	-	-	-	-	-	610	96	-
			3_R0-R20m	-	-	-	-	1	153	16	-
			4_R20m-R50m	-	-	-	-	-	217	23	-
			5_R50m-R100m	-	-	-	-	-	203	17	-
			6_R100m-R500m	-	-	-	-	-	445	24	-
			7_R500m-R1bn	-	-	-	-	-	120	9	-
			8_R1bn-R4bn	-	-	-	-	-	174	5	-
			9_R4bn+	-	-	-	-	-	65	2	-
		Total		*-*	*-*	*-*	*-*	*1*	*1 987*	*192*	*-*
TOTAL				**788 319**	**805 409**	**827 738**	**827 078**	**835 637**	**746 262**	**308 073**	**7 517**

The rest of the analysis only includes the 2013-2016 tax years given the change in corporate income tax forms between 2012 and 2013, and the lower levels of assessment for 2017-2019. Table 5 shows the EBITDA range for the business categories for each year. All companies that have indicated being dormant have been excluded. Businesses that appear to be stand-alone companies are more likely to have negative or zero EBITDA than companies identified as part of a group. At least 75 per cent have EBITDA of zero or less. At least half of all companies in a group scenario have positive EBITDA. Based on the number of companies in a group scenario, companies that have a foreign parent have higher levels of EBITDA (on average and in absolute terms) than their locally-held counterparts.

Table 5: "Tax EBITDA" – Descriptive statistics

					Percentiles					
Q1	**Q2**	**TaxYear**	**count**	**max**	**10th**	**25th**	**50th**	**75th**	**90th**	**95th**
N	N	2013	500 619	21 028 918 191	- 959 163	- 308 347	- 39 212	-	344 323	1 612 067
N	N	2014	499 380	26 466 354 552	- 1 068 195	- 346 526	- 44 933	-	328 482	1 690 571
N	N	2015	495 863	19 982 813 743	- 1 120 457	- 363 323	- 46 785	-	393 343	1 895 384
N	N	2016	489 080	43 236 176 819	- 1 151 680	- 375 202	- 47 749	-	468 648	2 114 775
Y	N	2013	8 390	32 784 248 700	- 2 638 382	- 5 760	2 069 136	10 500 347	41 695 001	106 653 986
Y	N	2014	8 518	36 928 684 678	- 2 852 136	- 1 132	2 333 630	11 263 396	44 167 384	108 518 664
Y	N	2015	8 726	32 121 801 645	- 2 514 511	-	2 520 860	11 934 883	43 961 741	108 297 919
Y	N	2016	8 754	20 246 351 901	- 2 428 758	-	2 602 188	12 781 550	48 748 694	112 129 378
Y	Y	2013	3 184	65 467 176 291	- 11 922 874	- 720 578	2 827 894	16 646 351	61 170 913	152 794 949
Y	Y	2014	3 440	72 030 247 503	- 11 200 414	- 464 093	2 805 623	17 123 504	63 548 148	155 552 156
Y	Y	2015	3 689	79 961 374 273	- 13 455 964	- 715 360	2 794 057	17 758 419	65 093 165	154 924 571
Y	Y	2016	3 714	97 013 116 975	- 11 503 853	- 392 351	3 740 038	21 038 836	84 814 034	203 013 367

Table 6 shows the range of total net interest expense for all active businesses (all dormant companies excluded). Only the top 5 per cent of stand-alone companies have interest expense exceeding interest income. For companies in a group scenario, at least 25 per cent have positive net interest expense i.e. the absolute value of net interest expense after taking into account interest income.

If a *de minimis* rule based on net interest expense of R10 million was introduced, for example, less than 10 per cent of group companies would be affected.

Table 6: Total net interest expense (NIE) – Descriptive statistics[31]

					Percentiles					
Q1	**Q2**	**TaxYear**	**count**	**max**	**10th**	**25th**	**50th**	**75th**	**90th**	**95th**
N	N	2013	500 619	6 246 905 063	-	-	-	-	-	60 047
N	N	2014	499 380	14 839 375 237	-	-	-	-	-	50 795
N	N	2015	495 863	6 076 038 978	-	-	-	-	-	75 232
N	N	2016	489 080	24 212 953 552	-	-	-	-	-	95 697
Y	N	2013	8 390	1 538 905 726	- 1 750 636	- 166 122	-	889 940	5 096 360	14 616 393
Y	N	2014	8 518	2 160 466 914	- 1 530 993	- 156 761	-	1 026 509	5 917 805	16 398 691
Y	N	2015	8 726	2 172 001 614	- 1 703 351	- 181 831	-	1 000 911	6 167 659	16 996 339
Y	N	2016	8 754	4 931 103 550	- 1 964 520	- 209 872	-	1 118 385	6 689 151	18 521 361
Y	Y	2013	3 184	26 369 828 163	- 3 264 254	- 588 873	- 7 280	579 421	6 007 817	18 469 089
Y	Y	2014	3 440	28 799 700 655	- 3 506 982	- 627 085	- 2 918	707 445	7 433 651	20 853 574
Y	Y	2015	3 689	33 294 352 973	- 4 017 293	- 663 371	- 4 397	858 209	8 894 105	24 494 421
Y	Y	2016	3 714	40 747 921 290	- 5 610 490	- 870 893	- 8 334	931 353	10 253 277	29 267 259

[31] NIE is calculated by taking the difference between total interest expense and total interest income, including tax adjustments.

Table 7 presents the average NIE/EBITDA ratios for companies with positive net interest expense and positive EBITDA for the 2013-2016 period. Percentiles are shown to indicate the distribution of ratios for sales groups. Using the top of the OECD-recommended corridor of 30 per cent of NIE/EBITDA that applies to total net – internal and external – interest expense, it is evident that most (roughly 75 per cent of) groups with positive tax EBITDA would be able to fully deduct their net interest expenses without being affected by the rule.

Although difficult to compare, this figure is relatively close to the OECD analysis (conducted by PWC) on MNCs. In their analysis, they found that 87 per cent of MNCs would be able to deduct all third-party interest expense. As explained earlier, their analysis is based on consolidated accounting figures and cannot be directly compared with analysis using SARS data. NIE/EBITDA ratios using consolidated accounts are expected to be lower than those based on unconsolidated information (which is the case with SARS data as companies are taxed on an entity, not group basis) as all related party interest payments would be netted out. Besides consolidation, net interest expense and EBITDA would be slightly (or potentially materially) different depending on whether accounting or tax figures are used. Because the South African rules would be based on tax figures and an individual entity basis, the SARS' data is most instructive for policy decisions.

Table 7: Average (2013-2016) NIE/EBITDA ratios, by sales groups[32]

							Percentiles					
Q1	**Q2**	**Sales_grp**	**count**	**mean**	**median**	**max**	**10th**	**25th**	**50th**	**75th**	**90th**	**95th**
N	N	2_R0	19 165	107%	40%	382634%	7%	22%	40%	51%	100%	127%
N	N	3_R0-R20m	34 796	62%	27%	345082%	3%	11%	27%	46%	68%	104%
N	N	4_R20m-R50m	34 061	33%	12%	175437%	1%	4%	12%	24%	41%	57%
N	N	5_R50m-R100m	14 398	33%	12%	79940%	1%	4%	12%	24%	40%	54%
N	N	6_R100m-R500m	9 878	72%	12%	464767%	1%	5%	12%	24%	40%	54%
N	N	7_R500m-R1bn	874	24%	13%	1635%	2%	6%	13%	26%	41%	54%
N	N	8_R1bn-R4bn	478	23%	14%	990%	2%	6%	14%	27%	41%	52%
N	N	9_R4bn+	101	26%	17%	174%	5%	7%	17%	34%	51%	64%
Y	N	2_R0	4 142	65%	46%	21710%	9%	27%	46%	51%	100%	115%
Y	N	3_R0-R20m	2 260	55%	32%	7503%	2%	14%	32%	50%	82%	119%
Y	N	4_R20m-R50m	1 994	69%	13%	63369%	1%	4%	13%	33%	59%	92%
Y	N	5_R50m-R100m	1 544	30%	13%	2631%	1%	4%	13%	30%	52%	79%
Y	N	6_R100m-R500m	2 753	26%	13%	3819%	1%	5%	13%	28%	48%	67%
Y	N	7_R500m-R1bn	639	44%	16%	5392%	3%	7%	16%	30%	45%	79%
Y	N	8_R1bn-R4bn	632	35%	18%	1985%	3%	7%	18%	34%	50%	73%
Y	N	9_R4bn+	283	21%	16%	177%	2%	6%	16%	27%	46%	56%
Y	Y	2_R0	732	113%	48%	14384%	5%	23%	48%	56%	103%	174%
Y	Y	3_R0-R20m	368	59%	29%	5003%	1%	6%	29%	52%	109%	176%
Y	Y	4_R20m-R50m	484	52%	12%	4937%	0%	2%	12%	34%	74%	161%
Y	Y	5_R50m-R100m	470	34%	13%	1056%	1%	4%	13%	34%	57%	111%
Y	Y	6_R100m-R500m	1 171	40%	13%	10199%	1%	4%	13%	33%	55%	98%
Y	Y	7_R500m-R1bn	359	43%	16%	2720%	2%	6%	16%	36%	73%	165%
Y	Y	8_R1bn-R4bn	390	34%	16%	865%	2%	6%	16%	35%	66%	122%
Y	Y	9_R4bn+	207	25%	17%	220%	2%	6%	17%	33%	52%	65%

There are a significant number of companies reporting zero sales, but positive EBITDA and net interest expense amounts. These companies also have higher NIE/EBITDA ratios on average than other sales

[32] Net interest expense is calculated by taking the difference between total interest expense and total interest income (including tax adjustments). EBITDA also includes tax adjustments and is essentially "tax EBITDA". Only businesses that have positive amounts for both the numerator and denominator have been included in this table.

groups. As suspected, the majority of these companies' main income source code indicates that they operate in the financial, insurance, real estate and business services sectors. While they report zero sales, they have other forms of income, including interest (from financial institutions and connected persons), rental income, etc. In 2016, there were 6 103 companies that reported zero sales, but positive EBITDA and positive net interest expense.

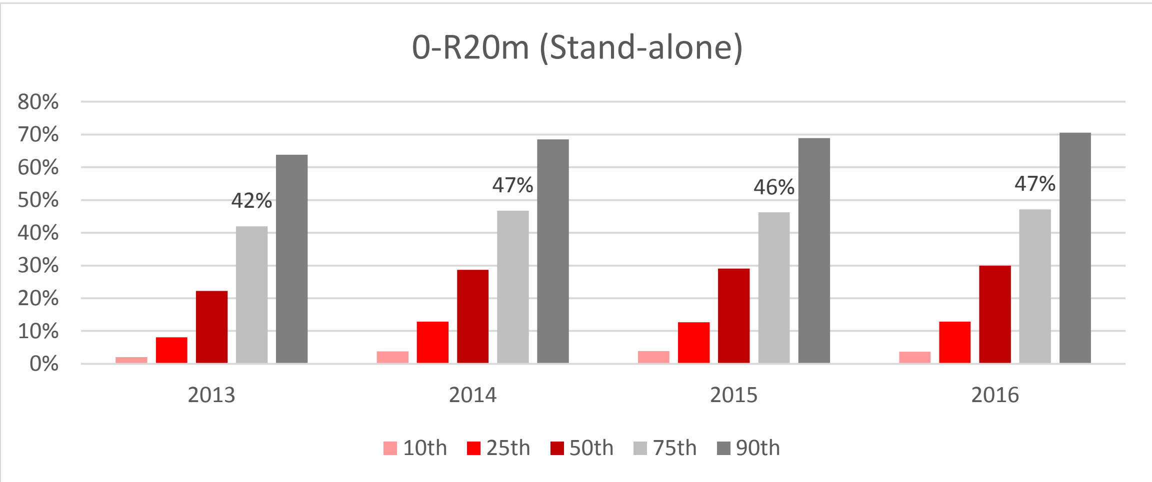
The top five income source codes are as follows:

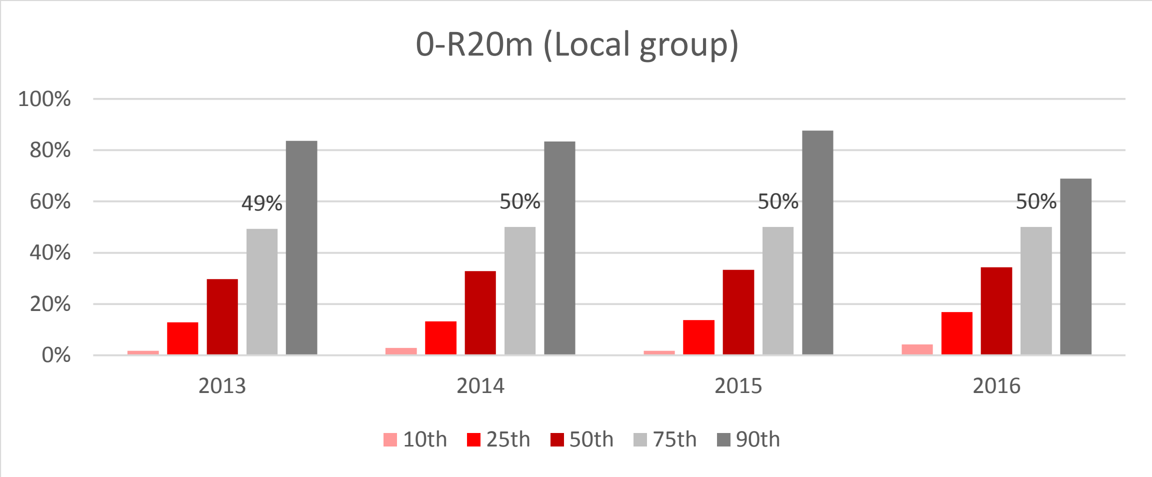
Number	Percentage (of 6 103)	Main income source code
3 214	53%	*Property, letting & business premises*
1 147	19%	*Financial, insurance, real estate & business services – other (not specified)*
461	8%	*Property letting – residential accommodation*
189	3%	*Financial services*
162	3%	*Agencies & other services - other (not specified)*

The companies in the R0-20 billion sales group also have higher ratios on average than larger companies (measured by sales).

Figures 8 and 9 present the ratios by tax year for the smallest and largest companies. The coloured bars represent the 10th, 25th, 50th, 75th and 90th percentiles for companies' NIE/EBITDA ratios. Sales is used as a proxy for size. It is evident that smaller companies have relatively higher ratios. This provides some evidence that a *de minimis* rule may be appropriate in the South African context. The figures also show that there is not too much variation in average NIE/EBITDA ratios across tax years.

Figure 8: NIE/EBITDA ratio ranges for smallest companies (proxied by sales)





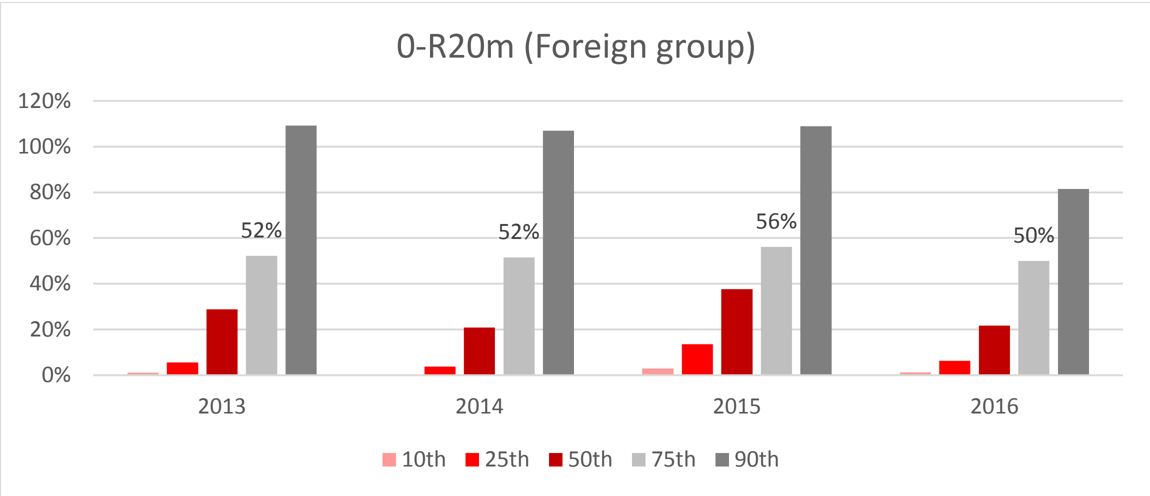
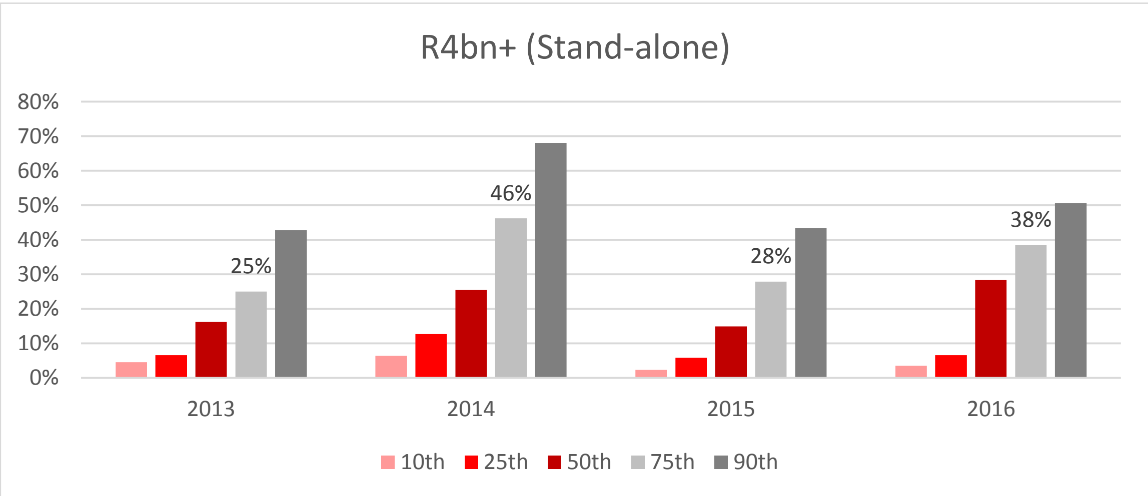
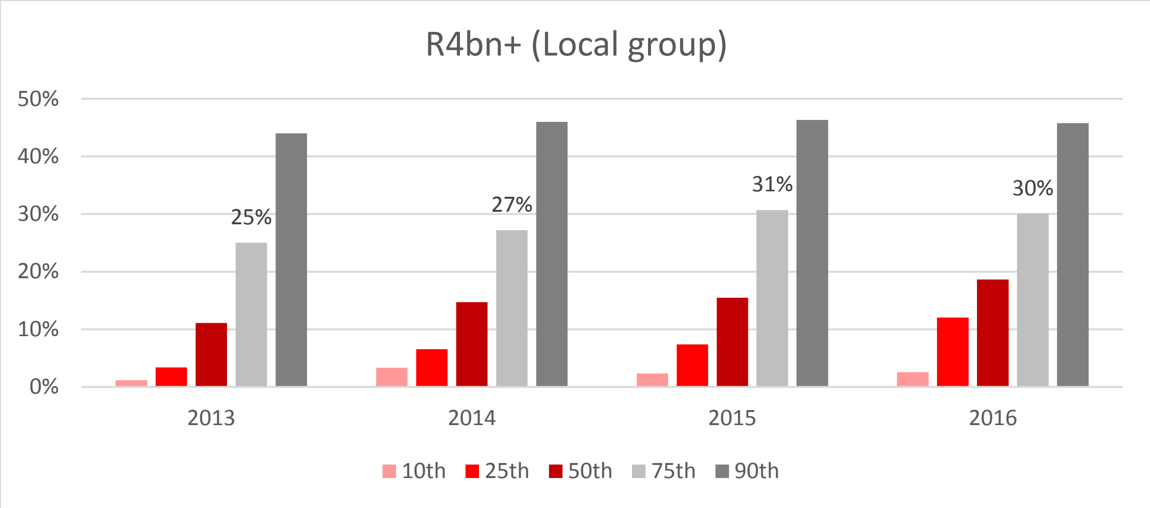
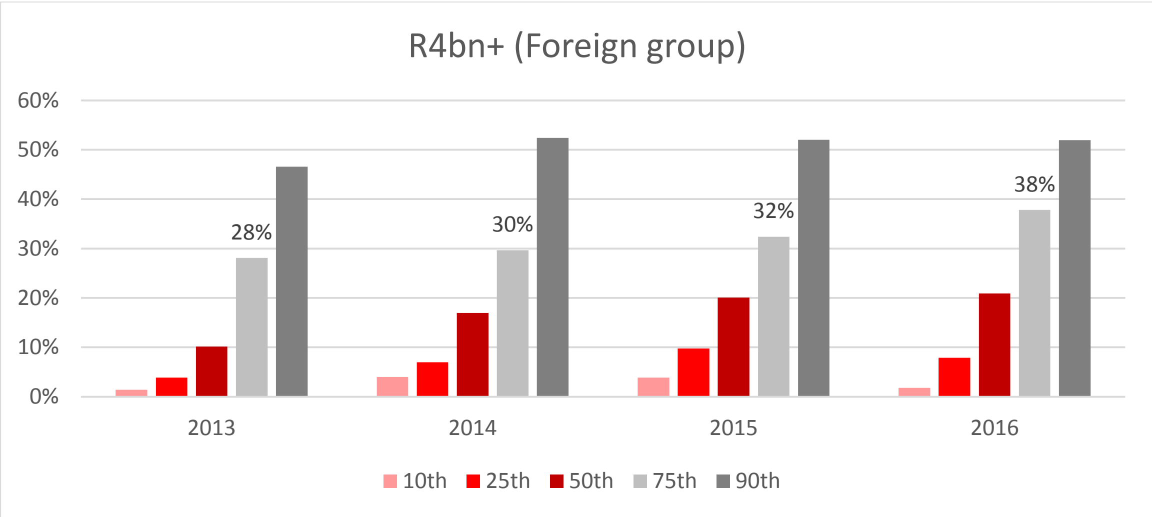


Figure 9: NIE/EBITDA ratio ranges for largest companies (proxied by sales)







With respect to excluding smaller companies that do not pose a BEPS risk, the OECD recommends implementing a *de minimis* rule based on net interest expense as an option. Of the companies with positive EBITDA and positive NIE captured in Table 7, a smaller percentage of these would be subject to a fixed ratio rule if a de minimis based on net interest expense were included. Table 8 shows that only 25 per cent of local-held group companies and 35 per cent of foreign-held group companies would be subject to the rules using a de minimis of R5 million. Of those companies subject to the rules, only those with NIE/EBITDA ratios exceeding the proposed fixed ratio threshold would be affected by the rule. It is predominantly the largest companies that would remain subject to the rule after applying a *de minimis* rule.

Table 8: The effect of a de minimis rule - how many companies would be subject to the fixed ratio rule

				Number of companies subject to the rule			
Q1	**Q2**	**Sales_grp**	**count**	**R2m de minimus**		**R5m de minimus**	
				number	*%*	*number*	*%*
N	N	2_R0	19 165	3 795	20%	1 658	9%
N	N	3_R0-R20m	34 796	3 074	9%	719	2%
N	N	4_R20m-R50m	34 061	1 407	4%	534	2%
N	N	5_R50m-R100m	14 398	1 162	8%	319	2%
N	N	6_R100m-R500m	9 878	2 455	25%	923	9%
N	N	7_R500m-R1bn	874	528	60%	310	35%
N	N	8_R1bn-R4bn	478	379	79%	303	63%
N	N	9_R4bn+	101	97	96%	94	93%
			113 751	12 897	11%	4 860	4%
Y	N	2_R0	4 142	1 855	45%	1 131	27%
Y	N	3_R0-R20m	2 260	557	25%	197	9%
Y	N	4_R20m-R50m	1 994	352	18%	189	9%
Y	N	5_R50m-R100m	1 544	376	24%	175	11%
Y	N	6_R100m-R500m	2 753	1 351	49%	724	26%
Y	N	7_R500m-R1bn	639	506	79%	388	61%
Y	N	8_R1bn-R4bn	632	576	91%	519	82%
Y	N	9_R4bn+	283	275	97%	263	93%
			14 247	5 848	41%	3 586	25%
Y	Y	2_R0	732	358	49%	261	36%
Y	Y	3_R0-R20m	368	86	23%	38	10%
Y	Y	4_R20m-R50m	484	103	21%	55	11%
Y	Y	5_R50m-R100m	470	138	29%	60	13%
Y	Y	6_R100m-R500m	1 171	610	52%	339	29%
Y	Y	7_R500m-R1bn	359	283	79%	219	61%
Y	Y	8_R1bn-R4bn	390	350	90%	310	79%
Y	Y	9_R4bn+	207	204	99%	196	95%
			4 181	2 132	51%	1 478	35%

The OECD and the Intergovernmental Forum on Mining, Minerals, Metals and Sustainable Development (IGF) released a draft practice note (for consultation) testing the OECD Action 4 recommendations for the mining sector in developing countries.[33] They analysed the net external debt position (for the group) of several mining companies under different average interest rate assumptions. The results suggest that "*even with external average interest rates of up to ten percent (a conservative assumption given the investment grade credit rating of many mining companies), the firms examined would almost all be below a ratio of 25 percent, even if their interest expense was at an average interest rate of 10 percent*."

The overall finding in this regard is that "*a fixed ratio of 20-25 percent may be sufficient for most mining MNEs to accommodate their legitimate financing activities and avoid double taxation*."

[33] Available: http://www.oecd.org/tax/beps/limiting-excessive-interest-deductions-discussion-draft.pdf

Government recognises that 10 per cent may not be a conservative estimate in the South African environment. Table 8 provides a summary of concerns raised by mining companies and responses by the OECD and IGF.

Table 9: Issues and company concerns

Issue	Proposed response
Large sunk costs associated with investments and risk of adverse changes in fiscal settings post-investment.	• Planned changes be clearly explained and MNEs given reasonable time to restructure financial arrangements before rules apply (transitional arrangements).
Exploration companies don't generate income, so will always have negative EBITDA	• Loans are not usually provided to these entities by external lenders, because they do not generate income. • It may therefore be appropriate to not afford any special treatment that would allow these entities to borrow internally. • Internal loans capitalised for deduction could be disregarded.
Timing mis-matches between when a mine is built and when production begins (income is received), resulting in entities with negative/no EBITDA	• Allowing the carry-forward of excess interest expenses to later years is most appropriate response (so long as the loans would have actually occurred at arm's length). • Allowing the grouping of local entities could limit this effect, but risks undermining local ring-fencing provisions – any grouping would need to remain consistent with overall ring-fencing policy.
Mining company earnings fluctuate with commodity prices (reflected in reduced EBITDA).	• Interest expenses exceeding the ratio can be used in subsequent years (integrity measures will be needed around any carry forward). • Some additional leeway be added in setting the interest/EBITDA limit.
Relatively higher interest rates in developing countries.	• No action proposed. MNE interest rates to third parties appear to be below 25 per cent of EBIDTA.
Use of joint venture arrangements and apportionment of earnings, expenses.	• Depends on whether group taxation system is operating (consolidated taxation of all local entities) – these rules may already cover this situation. • Otherwise, simplest approach is apportionment based on ownership percentages or appropriate control test.
Use of shareholder debt to prioritise private investors where the host government has been afforded an equity stake in the mine without having to pay the MNE to finance that acquisition.	• No response proposed.

(Source: IGF-OECD, 2018, Limiting the Impact of Excessive Interest Deductions on Mining Revenues)

13. Government proposes the following as a suitable policy response for South Africa

In the South African context, it is proposed that the policy set out below is the most appropriate stance – achieving a balance between the legitimate investment and funding needs of business, and the need for government to adequately protect its tax base from excessive debt and associated interest deductions that are not in line with genuine economic activity taking place in the country.

A. What the new interest limitation rules should apply to

As per the OECD recommendation and as endorsed by ATAF, it is proposed that the rules apply to total (external and connected) net interest expense and equivalent payments. Given that that the section 24J definition of interest is not wide enough to include payments economically equivalent to interest, the rules are proposed to apply to a wider concept of interest – including the examples listed by the OECD Report and contained in this discussion document.

Net interest expense is preferred over gross interest expense given the potential for double taxation. Net interest expense in respect of debt from both external and connected persons is included so that any attempts to circumvent the rules with back-to-back loans, for example, are ruled out and there is no need for complex anti-avoidance rules. There is enough empirical evidence showing that rules that only target connected person interest are ineffective. The analysis using SARS data is based on total net interest expense and shows that the majority of companies will be unaffected. This is also in line with what most countries have done so far. The EU Directive requires the rules to apply to external and internal interest net expense. Botswana has also followed this approach. India is an exception – applying their rules to only internal interest expense.

B. Who the new interest limitation rules should apply to

As per the OECD recommendation, it is proposed that the new interest limitation rules apply to all entities operating in South Africa that form part of a foreign or South African multinational group. That is, total net interest expense paid by entities in South Africa forming part of a multinational group (whether domestic or foreign) would be subject to the rules.

The South African regulations specifying the Country-by-Country Reporting Standard for MNEs provides the only existing tax-related definition of an MNE Group.[34] It is proposed that a group and MNE group be defined as follows:

- *The term "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.*
- *The term "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.*

It is envisaged that this approach is the most appropriate means of ensuring that debt funding used by South African entities is appropriate for the level of economic activity multinational groups are

[34] Available: https://www.sars.gov.za/AllDocs/LegalDoclib/SecLegis/LAPD-LSec-Reg-2016-07%20-%20Regulation%20R1598%20GG40516%20-%2023%20December%202016.pdf

conducting in the country, and not driven by strategies to minimise global tax liabilities. This is also in line with what other countries have done – including India, Botswana, the UK, Netherlands, Sweden and Finland. Norway applies the rule to all consolidated groups and France includes stand-alone companies.

There was a lot of discussion in previous engagements on joint ventures. Government does not consider it necessary to grant different treatment to joint venture arrangements.

C. Measuring economic activity with earnings

a. Defining earnings

It is proposed that economic activity be proxied by earnings, which will be based on "tax EBITDA", meaning the sum of:

- taxable income;
- net interest expense; and
- deductions in respect of capital assets (depreciation and amortisation)

b. The level of the fixed ratio

Using the OECD's guidance to setting the rule within the corridor of 10-30 per cent, multiple factors were considered. The most important considerations are the relatively higher interest rate environment in South Africa and the analysis examining the range of taxpayer's NIE/EBITDA ratios from 2013-2016. At a ratio of 30 per cent, the majority of taxpayers (roughly 75 per cent) with positive "tax EBITDA" will be able to deduct all of their net interest expense in the year of incurral. Government proposes to set the limit at 30 per cent.

This is in line with government's thinking set out in the 2014 Draft Response Document from National Treasury and SARS, as presented to the Standing Committee on Finance (with respect to the 2014 Tax Laws Amendment Bill): "*There are indications that the 40 per cent might be too high as illustrated by the three graphs below. The 40 per cent will be reviewed…"*[35]

Most other countries have applied the same ratio. Norway and Finland have opted for 25 per cent.

c. Smoothing the volatility in earnings

It is recognised that earnings have the potential to fluctuate and that the capacity to deduct net interest expense can be reduced by negative or low "tax EBITDA" in a particular year. If a taxpayer is not able to fully deduct net interest expense in a particular tax year, it is proposed that the excess amount be carried forward. However, because the 30 per cent limit essentially sets the bar for what is determined to be excessive, it would be counterintuitive to allow taxpayers to carry forward excessive net interest expense indefinitely. It is proposed that the carry forward be limited to 5 years on an annual FIFO basis, which is deemed to be a fair period for enabling smoothing of earnings. Many countries have limited their carry-forward periods, including India and Botswana.

[35] For the rest of the response, see page 13: http://www.treasury.gov.za/legislation/bills/2014/TLAB-TALAB/2014%20October%2016%20-%20Response%20document%20TLAB%20and%20TALAB.pdf

D. De minimis rule

As per the OECD Report, government agrees that it would be overly burdensome and unfair for smaller companies to comply with these rules. Smaller companies often face funding constraints already and these rules would exacerbate the problem. However, small stand-alone companies could be quite different from small companies that are part of an MNE when it comes to funding constraints. It is tentatively proposed that a de minimis rule be included at between R2 million and R5 million. This is in line with India's approach.

E. Existing interest limitation rules and transitional measures

It is proposed that the new rules replace section 23M. Transitional measures for existing loans will be considered for third-party loans.

The OECD has recommended countries retain targeted rules that are in place to curtail base erosion. Section 23N is an existing targeted rule, which will remain in place.

F. Interaction with other provisions in the Income Tax Act

Transfer pricing rules contained in section 31 also have the potential to limit interest deductions based on the arm's length test. This test determines whether an affected transaction entered into between connected persons would have essentially been the same in all respects as if that transaction had been entered into with an independent third party. For example, a loan can be questioned in terms of whether it is larger than what would have been provided by a bank based on the credit rating of the debtor. The interest rate is also subject to this test. The OECD Transfer Pricing Guidelines on financial transactions (published on 11 February 2020) are instructive in this regard.

While transfer pricing rules aim for transactions to be in line with the arm's length principle, the interest limitation rules reflect government's right to protect its tax base from what it deems to be excessive interest deductions. The example illustrated in Figure 7 shows why interest limitation rules are required in addition to transfer pricing legislation.

Government proposes that companies first apply the arm's length test to financial transactions, followed by the interest limitation rules, i.e. the interest limitation rules should apply to net interest expense that has already passed the arm's length test.

The draft 2013 interpretation note, *Determination of the Taxable Income of Certain Persons from International Transactions: Thin Capitalisation,* has been a source of uncertainty for taxpayers. Many taxpayers have requested a safe harbour and the Davis Tax Committee has recommended the same. To enhance certainty, government is considering a safe harbour approach to determine whether taxpayers would need to apply the arm's length principle to the quantum of financing provided (but still remain subject to transfer pricing on the interested incurred, as well as the interest limitation rules). Taxpayers are encouraged to send their views on a safe harbour in their comments.

REVIEWING THE TAX TREATMENT OF EXCESSIVE DEBT FINANCING, INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS

national treasury

Department:
National Treasury
REPUBLIC OF SOUTH AFRICA