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Dear Ms Reynolds

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

1. We herewith take an opportunity to present our comments on behalf of the South African Institute of Chartered Accounts' (SAICA) Transfer Pricing sub-committee (a sub-committee of the SAICA National Tax Committee) on the report entitled "Reviewing the existing tax treatment of excessive debt financing, interest deductions and other financial payments" released on 26 February 2020 proposing changes to curb potential excessive interest deductions claimed by member entities of Multinational Enterprises ("**MNE's**") operating in South Africa.

2. Our submission includes a discussion of some of the most pertinent matters, which we believe require the most urgent attention.

COMMENTS

Definitions – "Group" and "MNE Group"

3. National Treasury proposes introducing two additional definitions into the Income Tax Act; notably the definition of "Group" and the definition of "MNE Group". The Income Tax Act already has a definition for "group of companies" and "connected person" which are applicable to the existing transfer pricing rules in Section 31. In addition, National Treasury is considering extending the transfer pricing rules to transactions between "associated enterprises" requiring this to be defined.

4. Submission: It is submitted that including these additional definitions creates confusion with the existing and proposed definitions included or already proposed to be included.

5. It is further submitted that the existing definitions should be updated/aligned if required to avoid further confusion.

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The ratio to be applied

6. The OECD recommendation in BEPS Action 4[1] proposed a net interest expense ("**NIE**") to EBITDA ratio to determine the excessive portion of interest. SARS is proposing a Tax EBITDA calculated as the sum of:

   6.1 Taxable income;

   6.2 Net interest expense; and

   6.3 Deductions in respect of capital assets (depreciation and amortisation).

7. The ratio corridor proposed by the OECD in its final BEPS report on Action 4 was 10%-30%. It is understood that the majority of countries adopting the proposed approach selected the upper end of the range, i.e. 30%. SARS is also proposing a 30% cap. The OECD did, however, propose that countries which have a high interest rate environment and which are adopting the fixed ratio on a stand-alone basis, may consider if a higher ratio should be applied. This was also supported by ATAF in its suggested approach to drafting interest limitation legislation[2]. A comparison of interest rates for those countries identified as adopting a 30% threshold is included in Table 1 below.

Table1: Comparison of interest rates for countries adopting a 30% fixed ratio

Country	Base inter-bank lending rate (Aug 2020 data)[3]	Base lending rate (based on July/Aug 2020 data)[4]
ATAF report		
Germany	(0.48%)	1.94%
Greece	(0.33%)	3.62%
Italy	(0.48%)	1.70%
Norway	0.27%	0.0%
Portugal	(0.33%)	2,07%

[1]OECD/G20 Base Erosion and Profit Shifting Project: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments - Action 4: 2015 Final Report

[2]Suggested Approach to Drafting Interest Deductibility Legislation - ATAF

[3] Source - Trading Economics.com

[4] Source - Trading Economics.com

Country	Base inter-bank lending rate (Aug 2020 data)[3]	Base lending rate (based on July/Aug 2020 data)[4]
Spain	(0.38%)	2.31%
National Treasury report		
UK	0.05%	1.1%
Netherlands	(0.33%)	0.41%
France	(0.36%)	0.86%
Sweden	0.03%	0.2%
US	0.23%	3.25%
India	3.23%	9.0%
Botswana	5.75%	4.25%
South Africa	3.50%	7.0%

8. With the exception of India, all the other countries electing to adopt a 30% ratio have significantly lower base lending rates than the comparable South African prime lending rate.

9. Submission: The cost of capital for borrowers in South Africa is significantly higher than other countries, warranting consideration of a higher ratio to account for this. In addition, as it is proposed to apply the limitations to all debt (both third party and related party debt) it will have a very broad application further impacting the ability of borrowing entities in South Africa to secure interest deductions. This will significantly increase the cost of capital in South Africa for businesses already borrowing funds and potentially detract from foreign investment into the country.

10. The effect of the Moody's downgrade of South Africa to "junk" status on 27 March 2020 and the announcement of a national lockdown by President Ramaphosa on the same day due to coronavirus pandemic have had a huge impact on the indebtedness of companies.

11. The cost of debt going forward will most likely be substantial, as taxpayers have taken on debt to try and save their companies from shutting down. The tax system in some respects will now penalize taxpayers for this. Furthermore, SARS' limitation on losses carry forward will also have a negative impact on these already distressed companies.

12. All of this only adds to the concerns mentioned above and strengthens the argument that a higher percentage should be considered in the South African context. It is noted that the report mentions in two areas that applying a 30% cap results in the majority of groups being able to fully deduct their net interest expense. This, however, has only been tested at the group level. National Treasury is suggesting a fixed ratio test on a stand-alone basis therefore; it is not possible to rely on these conclusions for South African borrowing entities.

Group ratio

13. National Treasury dismisses the use of a "group ratio" rule as complex to design and difficult to comply with and administer. The basis for this being that SARS would not have access to the relevant information. We disagree with this view on the basis that large MNE's are now required to complete a Country-by-Country Report and Master File Transfer Pricing Document on an annual basis, which can be shared with other Tax Administrations. These documents would provide SARS with a starting point for collecting the information required to determine/apply a group ratio.

14. Submission: To ensure a fair and just result, National Treasury should consider applying a group ratio rule for large multinational groups, notwithstanding the perceived difficulties in respect of the correct application of this rule.

Carve-outs for specific industries/circumstances

15. In certain industries, it is common to lend funds on a multiple of revenue. These companies can make huge losses initially and will not get to the stated EBITDA to debt levels in the short term – as is the case for many intellectual property development companies and start-ups where the aim is to create something that is of great value and then to sell, rather than have a continuing business for years to come.

16. Submission: Providing an industry specific carve out (such as for IP development) to these rules should be considered. Property companies also have higher net interest expense/EBITDA ratios than other sectors and this should also be taken into consideration as well.

17. Real Estate Investment Trusts (REITs), due to their flow-through nature, should not be subject to the interest limitation rules as this would undermine their purpose and result in them being subject to tax as their interest incurred would not be deductible and their tax EBITDA would be lower than other companies due to their qualifying distributions.

18. Banks and insurance companies should also be excluded from the ambit of these rules as they are already governed by the regulated capital rules and are also unlikely to have a net interest expense.

19. In line with the OECD recommendations, an exclusion should also be provided in respect of interest paid on loans from third party providers used to fund public benefit projects such as water, electricity and road infrastructure. Considering the state of the current essential infrastructure in South Africa, this exclusion is considered essential.

Application to both related party and third party debt

20. The OECD recommended that the fixed ratio approach be applied to total debt of a MNE. SARS also proposed to apply the ratio to total debt and not just related party debt.

21. The report notes on page 5 that: "*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*."

22. This implies that arrangements between related parties are more susceptible to manipulation resulting in the artificial mix of debt and equity.

23. Submission: South Africa has thin capitalisation provisions, which currently require the amount of debt to be arm's length, thereby removing or limiting the ability of MNE's to manipulate this. Section 31 also applies the test to total debt.

24. We are of the view that it is unnecessary to apply the limitation rules to third party debt and note that should it be decided to apply the rules to third party debt, any limitation should be restricted to cases where debt is indirectly provided by a related party through a third party financial institution.

25. National Treasury also recommends that the rules should apply to all forms of debt payments economically equivalent to debt. As the intention of the revised Section 23M together with the application of Section 31 is to limit deductions on related party debt, this may be too restrictive.

26. Submission: It is recommended that detailed guidance be provided as to the mechanics of how the sections will apply where there is a combination of third party and related party debt to ensure taxpayers are not disadvantaged by interest on third party debt being limited.

27. We recommend that the definition of "interest" for the purposes of the revised Sections 23M and 23N be aligned with the definition of "financial assistance" in Section 31 for consistency purposes and recommend that additional guidance be adopted as indicated in the OECD final report on Transfer Pricing and Financial Transactions[5] and should also be considered in defining "financial assistance" for the purposes of Section 31, notably the delineation of the transaction and also when the arrangement is more akin to a service than a financial transaction.

28. We refer National Treasury to ATAF's suggested approach to drafting interest deductibility legislation[6], which provides guidance on what constitutes interest.

[5] Transfer Pricing Guidance on Financial Transactions - Inclusive Framework on BEPS: Actions 4, 8 & 10 - OECD February 2020

[6] Suggested Approach to Drafting Interest Deductibility Legislation - ATAF

Foreign exchange gains and losses

29. National Treasury further recommends that the rules should apply to all forms of debt payments economically equivalent to debt as discussed in the paper. This includes foreign exchange gains and losses relating to debt financing. The proposed rules will thus apply to the total (external and connected) net interest expense and equivalent payments. It is, however, not clear, whether this includes interest relating to a loan arrangement between two domestic entities.

30. Submission: Clarification is required on the mechanics of the foreign exchange gains and losses from both a "Tax EBITDA" perspective as well as the limitation perspective. Will the exchange gains and losses be included in the "Tax EBITDA"? This is of particular importance given that foreign exchange losses could be incurred for an extended period with a weaker exchange rate that may be subject to the limit while the gains arising from the same loan may be taxable in full.

31. Clarification is also required as to whether loan arrangements between two domestic parties will be included - even where there is no link with any foreign loans.

Thin capitalisation considerations

32. SARS notes in its report that certain countries are retaining their existing thin capitalisation rules in addition to a fixed ratio approach to limit interest deductions. South Africa currently has a complex thin capitalisation test relying on the arm's length principle.

33. The OECD has identified that the use of an arm's length test is both complex and difficult to administer. The Davis Tax Committee also recognised that a fixed balance sheet ratio would be easier and create more certainty when considering what constitutes a reasonable level of debt. SARS has suggested that a more formulaic approach be used for thin capitalisation purposes.

34. Submission: SAICA agrees with the Davis Tax Committee suggestion and recommends a formulaic approach to determine the excessive portion of debt and to align to the current approach adopted in many other African countries.

35. In a similar manner to paragraph 6 of Practice Note 2 (now withdrawn), we would also overlay this with the ability of a taxpayer to support a higher ratio of debt where the industry or business can justify it. The formulaic approach would therefore represent a safe harbour amount of debt, which would be accepted with a higher portion being supported through a robust comparable arm's length analysis. Thus, if the debt to equity fell within a certain ratio, the taxpayer would not need to perform a benchmarking study and this would be an acceptable level. For higher ratios, the arrangement would still need to be arm's length as supported by a benchmark study.

36. In assessing the valuation of the equity, we do not necessarily agree with the Australian view that historical cost should be used. This also does not align with the arm's length test. A third party lender would not use historical cost when determining

the relative value of a business seeking loan funding, rather it would use the current market value of equity to assess the solvency and creditworthiness of a company.

37. Submission: A safe harbour rule should be inserted, however, this rule should be allowed to be overwritten if a benchmarking analysis supports a higher gearing (rebuttable presumption).

Interest disallowed: Carry-forward limited to five years

38. The report provides for any excess portion of interest disallowed, to be carried forward for five years. The OECD BEPS Action 4 also supported a need for a carry forward provision where a portion of the interest is excessive. In high interest rate environments, the non-deductible carried forward portion could be high.

39. Capping the carry forward period to five years is conservative bearing in mind the high level of South Africa's interest rates and the difficulty in monitoring this carry forward. The limitation on the carry forward period will also significantly extend the time frame companies carry forward the unused interest costs as a result of poor trading results under the current economic conditions.

40. Submission: We suggest that no cap be put on the carry forward period as is adopted by many other countries quoted in the National Treasury document.

41. Alternatively, should a cap be imposed, the cap should be extended to a minimum of 8 years as is done in India, that also has high interest rates. Should this not be accepted, then consideration should be given to providing flexibility around pinning the carry forward to a limit beyond the end of the loan term (for instance 8 years).

Unused interest capacity: Carry-forward

42. The OECD has provided a number of options that deal with volatility of earnings which includes the carry-forward of disallowed interest and carry forward of unused interest capacity. Whilst it is acknowledged that National Treasury has considered one of the options, we suggest that National Treasury also consider the option of carrying forward of unused interest capacity in an effort to encourage investment activities for the current fragile South African economy.

43. Submission: It is recommended that the carry forward of unused interest capacity be considered in addition to the carry forward of disallowed interest for smoothing the volatility whilst encouraging much-needed investment activities.

44. Measures can be put in place to avoid the accumulation of significant excess capacity being created. For example, the unused interest capacity can be carried forward for a period of 3 years on a FIFO basis and a cap of the maximum amount or percentage can be introduced. This will encourage continued investment activities of South African resident entities that may have unused interest capacity for a period of time.

Foreign investment considerations

45. The report recognises the need to encourage foreign investment and promote growth. National Treasury should be seeking to make South Africa more attractive to investors. This can be achieved by implementing simplified and certain rules

46. Submission: Retaining the complexity of an arm's length test to limit interest deductibility, both in terms of excessive debt funding and interest cost as the primary test with the revised Section 23M only applying to the arm's length portion of the interest, will not assist investors in determining an acceptable level of debt and interest cost with relative ease.

47. To ensure simplicity and certainty, a simple safe harbour rule should be introduced as mentioned above. Carve outs for certain industries such as manufacturing and technology companies should be considered.

Interaction with other Sections of the Act – Section 31

48. The provisions of Sections 31 and 23M can apply to the same loan and there has been uncertainty as to which section needs to be applied first. The definition of “adjusted taxable income” in section 23M(1) of the Act refers to an amount of interest incurred that has been allowed as a deduction from income. It is our understanding that SARS interprets this definition as the tax position after application of Section 31, and before the application of Section 23M.

49. The difficulty of SARS’s interpretation is encountered most often in the secondary adjustment calculation. SARS is of the view that Section 31 must be applied in isolation to calculate the difference between the taxable income in the absence of Section 31(2). A difference would result in a deemed dividend.

50. It would be logical to apply Section 23M to the secondary adjustment calculation in the absence of Section 31(2) only. However, SARS appears to levy the secondary adjustment whenever there is a primary adjustment.

51. In terms of the current document under consideration, National Treasury is proposing that Section 31 be the primary test to establish an arm's length interest amount using transfer pricing principles and then apply the proposed revised Section 23M to the arm's length interest.

52. This does not assist taxpayers in making the determination of the allowable interest easily. Undertaking an arm's length test to establish the allowable interest amount is complex and often expensive for taxpayers. National Treasury indicates that reliance on an arm's length test is both uncertain and too resource intensive. In addition, the interpretation note that is meant to provide guidance as to the application of the arm’s length principle is still in draft, and by National Treasury’s admission, contradicts some of the SARB rules.

53. As indicated above, the Davis Tax Committee recommended that the rules relating to limiting interest deductions be simplified to create certainty. Retaining Section 31 in its current format does not address the concerns of the Davis Tax Committee nor the concerns raised by the National Treasury in its report.

54. Submission: We recommend a two-step approach to simplifying the application of Section 31 to intra-group loan funding.

55. If the arm's length test in Section 31 is to be retained, we recommend two safe harbours be introduced. The first being a formulaic approach to determine the excessive portion of debt to equity. The second being a safe harbour interest rate.

56. The South African Reserve Bank typically accepts the South African base lending rate plus 5% for Rand denominated inbound loans[7]. A complete alignment with the SARB table (page 3) which distinguishes between inbound and outbound and ZAR denominated and foreign denominated loans would offer a reasonable and commercial basis for determining the arm's length amount.

57. This rate could be adopted as a safe harbour interest rate for Section 31 but we do suggest that a safe harbour for outbound loans also be considered (prime rate for instance, using a conservative approach).

58. We also recommend clear guidance be provided as to the hierarchy of applying Section 31 and the new interest limitation rules. It would make sense to apply the interest limitation rules as a specific section before the application of a general anti avoidance provision such as the transfer pricing rules. From a practical perspective this may also prove a cost effective approach for many companies, avoiding the need for expensive transfer pricing analyses.

Interactions with other sections of the Act – Section 23M

59. The current Section 23M clearly takes into account any interest income that is subject to CFC imputation in terms of Section 9D. It is, however, not clear how the proposed interest limitation provisions will take into account interest that is subject to the CFC imputation. Whilst the interest expense is subject to the limitation, the gross interest received by the CFC from a South African resident is imputable in full to the extent that such interest is not subject to the interest withholding tax in South Africa.

60. This is may result in a double taxation for the MNE group to the benefit of the fiscus. For example, a CFC receives interest income from a South African resident, the treaty between the country of the CFC and South Africa exempts the interest paid from the South African interest withholding tax. This then results in the imputation of the gross interest income in terms of Section 9D in the hands of the shareholder of the CFC. On the other hand, the South African resident who has incurred the interest expense

[7] Section 23.1 of the SARB Currency and Exchanges Guidelines for Business Entities 2019-08-13

is subject to the interest limitation that may result in the permanent disallowance of the interest expense should it be carried forward beyond the 5-year period.

61. Submission: We recommend that, similar to the current provisions of Section 23M, any interest income subject to CFC imputation should be taken into account to avoid double taxation of the MNE group.

62. Alternatively, we recommend that the “tax EBITDA” take into account the taxable income plus any CFC imputation to ensure that the MNE group is not adversely impacted by the double taxation.

63. The current Section 23M clearly takes into account any interest income that is subject to the South African withholding tax on interest. It is, however, not clear how the proposed interest limitation provisions will take into account interest that is subject to the withholding tax on interest and notably how the limitation provided in Article 11(6) will apply.

64. Whilst the interest expense is subject to limitation, the gross interest paid by the South African resident is subject to the interest withholding tax in South Africa. This is may result in a double jeopardy for the taxpayer and a benefit to the fiscus.

65. Submission: We recommend, similar to the current provisions of Section 23M, that the new provisions clarify the treatment of any interest expense subject to South African interest withholding tax so as to avoid any double taxation of the MNE group.

66. Some jurisdictions such as the USA, have introduced a limitation to the portion of the interest that is subject to a reduced or exempt tax treaty rate to avoid any loss to the fiscus and the taxpayer.

Interactions with other sections of the Act – Sections 11(a), 8F, 8FA and 23N

67. The interaction with other Sections such as Section 11(a), 8F, 8FA and 23N has not been clarified. It is not clear whether the interest limitation only applies to interest that would have been deducted under Section 11(a).

68. It has also not been made clear that the dividends classified as interest in terms of sections 8F and 8FA will not be included in the fixed ratio or any group ratio calculation and that these amounts will not be taken into account in the determination of the adjusted taxable income amount.

69. Alignment between section 23N and the new section 23M and the interest limitation rules has also not been expressly clarified.

70. Submission: It is proposed that clarity is provided for the interaction of the proposed changes in the discussion document with the other Sections in the Income Tax Act mentioned above.

Certainty and simplification

71. The Davis Tax Committee recommended that the National Treasury consider an approach to simplify the current legislation and enhance certainty. It is argued that adjusting the provisions of Section 23M in line with the proposed report whilst retaining a burdensome arm's length test under Section 31 and a targeted anti avoidance provision in Section 23N does not meet this objective. The OECD also proposes a *de-minimis* threshold based on net interest expense. National Treasury proposes applying a *de-minimis* threshold of between R2m and R5m.

72. Submission: SAICA recommends that this threshold be increased to account for the high interest rates applicable to South Africa and consideration be given to aligning the threshold with that of the related party transaction threshold of R5m outlined in Section 29 of the Tax Administration Act and the Government Gazette No. 40375, 28 October 2016.

73. It is thus submitted that *de-minimis* threshold should be at least R5m but preferably higher taking into account the volatile and mostly weak exchange rate for foreign denominated loans as well as the high interest rates applicable to ZAR denominated loans.

Deferral for implementation of the interest limitation rules

74. It is stated that the excessive interest limitation proposals are aimed at addressing base erosion by MNEs of excessive interest and similar payment deductions relating to debt financing. The effective date of the proposed legislation is applicable to years of assessment commencing on or after 1 January 2022.

75. Submission: In light of the unprecedented impact arising from the of the Covid-19 pandemic and the financial hardships being faced by all companies alike, it is proposed that the effective date of the proposed legislation is changed from the years of assessment commencing on or after 1 January 2022 to years of assessment commencing on or after 1 January 2023.

76. This change would provide some financial relief since many companies are likely to be forced into legitimate debt financing positions post the lockdown due to the hardship experienced in the short to medium term while the economy stabilises.

77. In the interim, details on the transitional rules would be appreciated, especially with regard to their effective date. We suggest that these rules only become effective from the date that the legislation is issued for comment.

SAICA believes that a collaborative approach is best suited in seeking actual solutions to complex problems.

Should you wish to clarify any of the above matters please do not hesitate to contact us.

Yours sincerely

Christian Wiesener
Chairperson: Transfer Pricing Sub-Committee

Dr Sharon Smulders
Project Director: Tax Advocacy

The South African Institute of Chartered Accountants