

Budget proposals – interest limitation rule

By Karen Miller – Webber Wentzel and member of the SAICA Transfer Pricing Committee

The Minister of Finance, Mr Tito Mboweni, delivered the 2020 Budget Speech on Wednesday, 26 February. The National Treasury is recommending the following:

- The interest limitation rules will apply to total (external and connected) net interest expense and equivalent payments. This will include a wider concept of interest as identified in the Organisation for Economic Cooperation and Development's (OECD) reports. National Treasury considers that there is sufficient empirical evidence to suggest that restricting the rules to connected party debt interest is ineffective.
- The rules will apply to net interest expense as opposed to gross interest expense.
- The limitation test will be net interest / Tax EBITDA, being the sum of taxable income, net interest expense and depreciation/amortisation.
- The proposed ratio is 30% being at the upper end of the ratio proposed by the OECD in BEPS Action 4. National Treasury considers that at this rate, 75% of taxpayers with positive Tax EBITDA will be able to deduct all of their net interest expense in the year it was incurred. However, the ratio does not take into account the OECD suggestions that a higher ratio should be considered where a fixed ratio is proposed on a stand-alone basis without the overlay of a group ratio rule, or where the country implementing the rule has high interest rates compared to other countries. Both of which apply in South Africa. National Treasury considers that the previous limitation of 40% included in Section 23M to be too high.
- The proposal does allow for a carry forward of the excessive interest, but limited to 5 years on a FIFO basis.
- Finally, National Treasury heeded the Davis Committee recommendation and proposed a *de-minimis* rule of between R2 million to R5 million net interest expense. What this amount ends up at is still to be confirmed.

The rules will also require a definition of "Group" and "MNE Group" to be brought into the Act. Interestingly, the proposed definition of "Group" differs from the existing definition of "Group of Companies" already contained in the Act and it will be interesting to see how the proposed definition of "MNE Group" interacts with the existing "Connected Person" definition for the purposes of Section 31 and the proposed introduction of an "Associated Enterprises" definition.

The rules will replace the existing Section 23M rules, but Section 23N will remain in force as a targeted anti-avoidance rule. The new Section 23M will also be subject to the transfer pricing rules in Section 31, thus the limitations under the new Section 23M will apply to the arm's length portion of the interest determined under Section 31. This suggests there is an intention to retain the arm's length test for determining the interest amount under the transfer pricing rules, although National Treasury is considering a safe harbour possibly using a fixed ratio for testing the quantum of the debt funding. This will at least provide some certainty from a thin capitalisation perspective.

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