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Submission File

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Dear Mr Nevhutanda

TREATMENT OF INTEREST ON FOREIGN INBOUND LOANS

The South African Institute of Chartered Accountants' (SAICA) Exchange Control and Transfer Pricing Sub-Committees hereby take the opportunity to make a submission to the Financial Surveillance department of the South African Reserve Bank (SARB) on the interest rate requirements on a foreign inbound loan.

We set out below the background and our comments in this regard.

Background

1. In terms of section I3(b)(iv)(bb)/(cc) of the SARB Currency and Exchanges Manual for Authorised Dealers (the Manual), an Authorised Dealer is only permitted to approve an inward foreign loan if certain terms, amongst others, apply, and specifically with regard to the interest rate these terms are:

   - *In the case of foreign currency denominated connected party loans (e.g. shareholder or group treasury loans), the interest rate may not exceed the base rate and in the case of third party loans the base rate plus 3%.*

   - *In the case of ZAR denominated connected party loans (e.g. shareholder or group treasury loans), the rate may not exceed the South African prime rate and in the case of third party loans the prime rate plus 5%.*

2. It is well known that when South African companies need capital their shareholders can choose between debt and equity financing. While many factors influence this decision (including exchange control approval), tax deductibility of interest payments can sway the outcome. It is also well known that South Africa has introduced several tax policy measures to mitigate the aforementioned debt/equity bias over the past years. These are listed and

briefly described below. It is appreciated that The Income Tax Act serves to restrict the deduction claimed for tax for interest paid and not the amount actually remitted, however, alignment would ensure that both government agencies are striving to meet the same objective whereby taxpayers claim and remit the appropriate amount of interest (and in any event if the interest is not tax-deductible, it can increase the effective borrowing costs to uneconomic levels, so that it is unlikely that a borrower will lightly take on a loan where the interest is not deductible).

3. *Section 31* of the Income Tax Act sets out the transfer pricing and thin capitalisation rules. These rules *inter alia* determine non-excessive, i.e. 'acceptable' or 'market-related' debt and arm’s length finance charges. For example, any interest, finance charges or deductions from taxable income arising in relation to or on the excessive portion of the non-arm’s length debt or any excessive interest paid on the debt, is disallowed as a deduction in determining taxable income. The disallowed amount is also deemed a dividend, subject to dividend tax.

4. *Section 23M* of the Income Tax Act applies to limit the deduction of (mainly) cross-border interest where the amount of interest so incurred is not in the year of assessment subject to tax in the hands of the person that earns the interest, and if the interest is incurred by a debtor during a year of assessment in respect of a debt owing to:

   - *a creditor that is in a “controlling relationship” with the debtor; or*

   - *a creditor that is not in a “controlling relationship” with the debtor, if that creditor obtained the funding for the debt from a person that is in a “controlling relationship” with the debtor.*

5. A “controlling relationship” is defined in section 23M(1) to mean “*a relationship where a person directly or indirectly holds at least 50 per cent of the equity shares in a company or at least 50 per cent of the voting rights in a company is exercisable by a person*.”

6. Amendments to section 23M passed by Parliament last year bring South Africa’s interest limitation rules in line with the OECD BEPS Action 4 recommendation on interest deductions. In short, these changes will result in the interest paid being disallowed as a deduction if the amount of interest (together with other interest) exceeds 30% of EBITDA as calculated for tax purposes.

7. *Sections 50A – 50H* of the Income Tax Act, provide for a withholding tax on interest paid to foreign persons which 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% on the amount of the interest that is paid to that person.

8. *Sections 8F and 8FA* could also apply which causes interest to be non-deductible if the loan or the interest has any of the equity-like characteristics listed in section 8F or section 8FA.

9. It is thus clear that there are now ample provisions contained in South Africa’s tax legislation to address the risk associated with excessive interest costs, especially in a related party, cross-border scenario, being the scenario that concerns both SARB and SARS.

Further considerations

10. South Africa has entered into a number of *double tax agreements* (DTAs) with various countries. All of these agreements contain a provision that effectively requires residents of the contracting countries to conduct business with associated person in the other country on an arm’s length basis. In this regard, many residents are unable to do so because of the restrictions enforced by SARB on rates of interest. For example, when debt carrying mezzanine terms are advanced, the rates that should be applied cannot be applied under current SARB policy.

11. It is well known that there is a direct correlation between the level of long-term interest rates and *South Africa’s downgrading* to non-investment grade status. The further South Africa falls below investment grade status, the more long-term interest rates will tend to rise. Accordingly, investors will most likely demand a higher rate of interest for lending. In this regard we note that the Manual, and the interest rates applicable to inward foreign loans as referred to in the Manual, have not been updated to take the aforementioned into account.

12. Submission: Considering the above, we request that the limitation on the interest rates, as set out in the SARB Manual, be removed and that the SARB accordingly no longer sets parameters in respect of the same.

13. Reliance should be placed on SARS to police the allowable levels of interest using the powers at their disposal, for instance, the transfer pricing rules, the existing interest limitation rules and the requirement for taxpayers to support their interest levels under the transfer pricing documentation rules contained in the Tax Administration Act.

14. If SARB still believes there is a need to curb the remittance of excessive interest, SARB can determine that the amount of interest that can be remitted aligns to the amount which is allowable as a deduction in terms of the Income Tax Act or would be deductible if the interest was able to be claimed as a tax deduction.

Conclusion

15. Considering all the above, we submit that it is very important that the SARB and SARS requirements align to prevent confusion and to streamline the processes involved.

16. We thank SARB for the ongoing opportunity to provide constructive comments in this regard. SAICA continues to believe that a collaborative approach is best suited in seeking solutions to complex challenges and should you wish to clarify any of the above matters please do not hesitate to contact us.

Yours sincerely

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The South African Institute of Chartered Accountants