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Proposed new interest deductibility limitation rules

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Interest payments are generally viewed as an ordinary business expense which are deductible in determining taxable income. Varying corporate income tax rates across countries create an environment where a multinational enterprise (MNE) can minimise its global tax burden by advancing interest-bearing debt in group companies located in high-tax jurisdictions. South Africa is a high-tax jurisdiction and a predominantly capital-importing country and so government needs to strike a balance between (a) attracting capital and promoting investment, and (b) protecting the corporate tax base.

Currently, insofar as is relevant here, section 23M of the Income Tax Act, 1962 (the Act) limits interest deductions in respect of loan funding where the creditor is not subject to tax on the interest income and either (i) the creditor is a controlled foreign company and the interest received by it is not included in the income that is imputed to the South African shareholder, or (ii) the creditor is in a controlling relationship with the debtor. Since its introduction in 2015, it is estimated that up to R4.3 billion in interest expense has been denied as a deduction, potentially saving the fiscus around R1 billion in tax revenue.

In the National Budget in February, the Minister of Finance announced that a new rule will be introduced that will prevent taxpayers from deducting net interest expenses (NIE) in excess of 30% of their "tax EBITDA". National Treasury released an extensive document entitled "*Reviewing the Tax Treatment of Excessive Debt Financing, Interest Deductions and Other Financial Payments*" (Review Document). This document sets out, among other things, the proposed amendments and how they were decided upon.

The Review Document is based primarily on the Organisation for Economic Co-operation and Development's (OECD) final report on Action 4 of the Base Erosion and Profit Shifting Project, "*Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*".

Approximately 800 000 companies file tax returns annually in South Africa. The data from the tax returns has been analysed and, together with the work and recommendations of the OECD, has formed the basis of the proposed amendments.

The new interest limitation rule will apply to all entities operating in South Africa that form part of a foreign or South African multinational group. It is proposed that a group and an MNE will be defined as follows:

- Group: a collection of enterprises connected through ownership or control such that it is either required to prepare Consolidated Financial Statements or would be required if to if equity interests in any of its enterprises were traded on a public securities exchange.
- MNE Group: any Group that includes two or more enterprises the tax residence of which is in different jurisdictions, or includes an enterprise that is resident for tax purposes in one jurisdiction and has a permanent establishment in another jurisdiction.

The Review Document concludes that "tax EBITDA" is the most appropriate method of calculating earnings. By excluding the two major non-cash costs (depreciation of fixed assets and amortisation of intangible assets), EBITDA is the best guide as to whether an entity can meet its interest commitments. The "tax EBITDA" is the sum of the taxable income, net interest expense and deductions in respect of capital assets.

Rules that only target related party interest expense are generally regarded as ineffective because companies can circumvent related party rules by raising external debt with "back-to-back" loans using a third party. Including the total net interest expense (ie interest paid to connected and third parties) in the NIE/EBITDA ratio, negates the need for additional complex anti-avoidance provisions.

Importantly, the new rule will apply to interest and all payments economically equivalent to interest, such as payments under profit participating loans, certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance,

guarantee fees and arrangement fees and similar costs related to the borrowing of funds.

The Davis Tax Committee has previously raised concerns with a ratio based on earnings as it creates uncertainty for potential investors as to what level of interest deductibility would be available in any particular year. 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. Accordingly, the taxpayers will be allowed to carry forward excessive net interest expense for five years on a FIFO basis.

In order to alleviate the burden of compliance with the new rules for small companies who already face funding constraints, a *de minimus* rule is proposed (currently between R2 million – R5 million) such that companies with a net interest expense of less than this *de minimis amount* will not be required to comply.

Based on the data that was analysed, using a NIE/EDBITDA ratio of 30% approximately 75% of taxpayers with a positive "tax EBIDTA" will be able to deduct all of their net interest expense in the year of incurral.

The new rule will replace section 23M of the Act, with transitional measures being implemented for existing third-party loans.

There is at present uncertainty as to the interplay between the current interest limitation provisions and the transfer pricing rules in section 31 of the Act. The Review Document proposes that companies should first apply the transfer pricing arm's length test to financial transactions and thereafter the interest limitation rules, in other words, the interest limitation rules should apply to net interest expense that has already passed the arm's length test. Government is considering implementing a safe harbour approach to determine whether taxpayers would need to apply the arm's length principle to the quantum of the financing provided and invites comments in this regard. It would not make sense if the safe harbour rules in both sections were not the same.

All interested parties are invited to submit comments to National Treasury on the proposals contained in the Review Document by 17 April 2020. Werksmans has already submitted comments. The Review Document specifically encourages companies in the financial and insurance sectors to submit motivations as to why the new provisions should not apply to this sector.



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