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Treasury modifies the interest limitation proposals

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Proposed interest limitation rules

In 2019 Treasury released a discussion document dealing with the proposed interest limitation rules that would apply where a South African company with foreign group members has borrowed money. This kind of proposal is very common throughout the world, especially as part of giving effect to the OECD's and G20's initiative to curb Base Erosion and Profit Shifting (BEPS). This occurs inter alia by means of payment of, what is considered to be, excessive amounts of interest that legitimately rank as deductions, but where the interest is taxed at lower rates in a foreign country.

It was intended that, following assessment of the responses to the discussion document, the legislation would be passed last year to take effect this year. However, because of COVID 19 and the lockdown, it was decided to defer the legislation for a year, and also give additional time for response to the discussion document.

On 28 July 2021 a draft of the Taxation Laws Amendment Bill, 2021 was published for comment, which inter alia dealt with proposed amendments to the Income Tax Act, 1962 (the Act) in relation to interest limitation. At the outset, it must be said that the approach as evidenced by the proposed amendments – assuming that the final amendment is substantially the same as this – is to be welcomed, as it represents a considerably softer touch than was originally proposed, and adopts a far more sensible and practical approach. The fact is that the original approach in the discussion document followed too closely the approaches of more developed and capital-exporting countries in Europe and North America, as opposed to considering the more unique requirements of the South African economy.

The discussion document

It does not serve any purpose to go into a detailed analysis of the discussion document at this time. Suffice it to say that there were a number of key issues contained therein, some of which were, in the view of many in the private sector, problematic.

The following were the core issues:

- The default position was that, in qualifying circumstances, a company's interest deduction would be limited to 30% of EBITDA for tax purposes (Tax EBITDA).
- The discussion document proposed a de minimis deduction of R5 million, so that if the amount of interest was, say, R8 million, and 30% of Tax EBITDA was, say, R2.5 million, a deduction of R5 million would still be allowed, with the excess of R3 million being carried forward.
- The limitation of 30% of Tax EBITDA applied whenever there was a cross border element involving a foreign group company and there was cross border borrowing. Moreover, the 30% limitation was to apply to ***all*** interest paid, whether paid to affiliated parties or to South African independent third parties. This could give rise to an anomaly where, for example, a South African group which had borrowed money from the banks and had also a subsidiary in a foreign country to which it had lent money, which was very small in comparison to the South African group, the local group could nevertheless find itself with a 30% interest limitation on its borrowings (even though those borrowings were funding assets completely unrelated to the foreign subsidiary). The real BEPS problem in a capital importing country like South Africa is where the South African taxpayer is a subsidiary of a foreign group and has borrowed money – not where a South African group has lent money to its foreign subsidiaries and fellow subsidiaries.

- Section 31 of the Act, dealing with transfer pricing, also affects the amount of interest that can be deducted, first, because of the requirement not to be thinly capitalised (ie not to have a large debt: equity ratio), and, secondly, because the rate of interest on loans from connected persons must be arm's length. It was (wisely) indicated in the discussion document that the legislation would take into account the interaction of the two provisions, including the possibility of introducing safe harbour provisions in section 31 of the Act (for example a safe harbour debt: equity ratio and interest rate).

Existing legislation

Currently, apart from section 31, there are two specific interest limitation provisions contained in the Act, being sections 23M and 23N. The latter applies purely domestically in relation to borrowed funds being used to acquire new subsidiaries or their businesses, and nothing further needs to be said in this section.

Section 23M, however, was designed to limit deductibility of interest where a company had borrowed abroad from a person who directly or indirectly holds 50% or more of the equity shares or voting rights, such person being in, what is defined as, a "controlling relationship". The provision applies where the interest received is not subject to South African tax in the hands of the recipient, and, as far as foreign lenders are concerned, this would occur only if, under a relevant double tax agreement with the foreign country, no withholding tax in South Africa is payable on that interest. (It should be noted, however, that section 23M does not apply only in respect of interest paid tax-free to a foreign lender – it can apply even where the lender is in South Africa but does not pay tax, for example, a pension fund or a PBO.)

Section 23M also limits interest to a percentage of Tax EBITDA, but the percentage was somewhat more generous, in that it was based on 40% of the repo rate plus 400 basis points. So, for example, if the repo rate was at 5%, the interest was effectively limited to (40% of 9%) * 10 = 36% of Tax EBITDA.

The proposed amendments

Rather than introducing a completely new section into the Act, the decision has been taken to amend section 23M.

The main features of the amendments are as follows:

- Instead of the formula basis for determining the percentage of Tax EBITDA, there will now be a flat 30% that is used.
- Whereas previously the amount of interest to be limited was calculated based on "ordinary" interest as defined in section 24J of the Act, now the amount to be limited includes (a) amounts incurred or accrued under interest swap agreements, (b) the finance cost element included in lease instalments in a finance lease (the finance cost element to be determined based on IFRS16), and (c) amounts taken into account as realised foreign exchange gains and losses under section 24I.
- Certain anti-avoidance provisions have been included which enabled parties to avoid the application of section 23M.
- Where interest is paid to a foreigner and there is withholding tax deducted, that interest will be taken into account in determining whether section 23M should apply, but the interest paid to be taken into account for the interest limitation is adjusted to recognise that a portion of the interest has been taxed (so that, for example, if 15% withholding tax has been deducted, and having regard to the South African tax rate of 28%, only 13/28 of the interest paid will be brought to account in calculating the 30% of Tax EBITDA).

It is evident that some of the more unfortunate proposals have not been included in the legislation, including the fact that it would apply even where the South African company has not borrowed from a foreign affiliate but has merely invested abroad. There is also no de minimis exemption, but given the fact that the scope of the limitation has been reduced so dramatically, the absence of a de minimis exemption is not that serious.

What is a little disappointing is that there is no indication of any further legislation to harmonise the interaction between this interest limitation rule and the transfer pricing rules under section 31 of the Act.

Click here to read the South African chapter of the 2012/13 PLC Multi-Jurisdictional Guide on Taxation.

Click here to read the South African chapter of the "2012 Financier Worldwide Global Tax Annual Review".

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