I. Introduction

The annual tax proposals announced by the Minister of Finance in the Budget are given effect by a series of tax bills expected to be tabled during the year, including the Tax Laws Amendment Bill, 2013 (“2013 TLAB”) and the Rates and Monetary Amounts and Amendment of Revenue Laws Bill, 2013.

The purpose of this Media Statement is to elicit a first round of public comment on proposed rules to limit excessive interest tax deductions in response to Government’s concern over tax schemes that lead to base erosion, first raised in the section 45 proposals in 2011. As noted in a recent paper by the OECD (Base Erosion and Profit Shifting, available on http://www.oecd.org/tax/beps.htm), “base erosion constitutes a serious risk to tax revenues, tax sovereignty and tax fairness for many countries”. Base erosion includes profit shifting schemes, like excessive deductions and income-shifting to low-tax countries.

The outcome of this first round of consultation will be incorporated thereafter into the forthcoming 2013 TLAB, expected to be released for public comment (and parliamentary hearings) in June 2013.

II. Background

Over the past several years, tax schemes by some corporates have become an increasing concern locally as well as globally. The recent OECD paper notes that “[w]hile there are many ways in which domestic tax bases can be eroded, a significant source of base erosion is profit shifting”. One of the most significant types of base erosion in South Africa comes in the form of excessive deductions by some corporates with income effectively shifted to a no-tax or low-tax jurisdiction or converted to a different type of income in another jurisdiction. These deductions are typically channelled as interest, royalties, service fees and insurance premiums. Of greatest concern is excessive deductible interest. In terms of excessive deductible interest, Government has identified four recurring concerns:
1. **Hybrid Debt**: Hybrid debt instruments essentially involve instruments with the label of debt but with substantive features being more indicative of shares (equity). These instruments are typically labelled as debt in South Africa so that payments are deductible. However, these instruments are often labelled as equity in the other jurisdiction so as to benefit from cross-border arbitrage. Most of these instruments would otherwise be labelled as shares if tax were not a consideration.

2. **Connected person debt**: The relationship between creditor and debtor often becomes blurred once both parties form part of the same economic unit. This situation often arises when a parent company lends money to a wholly owned subsidiary. In this situation, the terms of the instrument are somewhat irrelevant because both parties can change the terms at will to serve the overall interests of the group. As a result, the debt label for instruments in these circumstances is often driven by tax and other regulatory factors; whereas, the payments often represent substantive capital contributions to be repaid only if the subsidiary at issue is profitable.

3. **Transfer pricing**: In a cross-border context, excessive interest can arise if the interest yield is driven by tax considerations as opposed to arm’s length commercial reasons, especially if the debtor and creditor are connected persons. Also of concern is “lending” that would not arise in a commercial context. In these cases, transfer pricing adjustments can be used to eliminate debt with excessive interest or excessive debt.

4. **Acquisition debt**: While the need to obtain debt financing for acquisitions is well-understood, excessive debt becomes problematic because excessive debt (or over-gearing) is often anchored on the expectation that the interest will be paid from future profits. If allowed to extremes, the interest on the debt often eliminates taxable profits for years to come. Acquisition debt of greatest concern is mezzanine and subordinated debt (i.e. debt containing an escalating number of equity features). Besides tax concerns, excessive debt gives rise to governance concerns with the excessive debt creating excessive risk (as a number of entities and economies have “painfully” discovered in recent years).

### III. Preliminary proposal

In order to curb excessive interest deductions as outlined above, a four-part proposal is being considered for inclusion in the forthcoming draft of the Taxation Laws Amendment Bill, 2013. These proposals are an outgrowth of the section 45 debate arising in 2011 and are partially outlined in the 2013 Budget Review.

#### A. Hybrid debt instruments

The Income Tax Act (“the Act”) presently contains certain anti-avoidance rules that seek to curb the use of hybrid debt instruments. These rules disallow an interest deduction in the hands of the payor and the instrument remains debt for purposes of the Act. This disallowance of a deduction occurs when the debt instrument has conversion features. However, for the rule to apply, the conversion feature must be exercisable within three years from the date when the debt instrument is issued.

Given the weaknesses in the current system, a broader set of hybrid rules were proposed (as contained in the draft Taxation Laws Amendment Bill, 2012). These hybrid rules fell into two parts. The first part recharacterises certain debt instruments entirely as equity, meaning that
the “debt principal” would be deemed to be the underlying shares and the ‘interest” yield would be deemed to be distributions (dividends and capital distributions). The second part merely treats certain “interest” yields as dividends. While the 2012 proposed rules targeted many of the objects intended, the triggers and application of those rules were overly broad, thereby adding unnecessary complexities and adversely impacting commercial non-tax driven instruments. These rules were accordingly removed from the final 2012 legislation for reconsideration.

Attached is a revised version of the proposed 2012 hybrid rules that have been adjusted based on the 2012 comments received (see Annexure A (section 8F draft legislation), B (section 8FA draft legislation) and C (corresponding explanatory memorandum)). These revised rules mainly target: (i) non-redeemable debt, (ii) debt that is convertible to shares at the instance of the company issuer, (iii) debt with yields not interest-related, and (iv) debt with repayment terms or yields conditional on the solvency of the company issuer. In terms of impact, the rules simply deem interest to be dividends for both the issuer and holder without creating other deemed changes. The timing triggers associated with hybrid debt have also been clarified. Lastly, under the revised exceptions, exemptions will exist for: (i) regulatory hybrid debt (e.g. Tier II debt) of banks, (ii) subordinated hybrid debt of long-term and short-term insurers, and (iii) private and unlimited liability debtor companies owing sums to resident natural persons.

B. Debt owed to untaxed entities within the same economic unit

As noted above, debts between entities of the same economic group are problematic because both the debtor and the creditor are part of the same economic unit. Because of this unity, the actual terms of the instruments are often not fully indicative when determining the substance of an instrument because both entities will act in unison to change the terms of the instrument as the need arises. Therefore, even if an instrument has no equity features, excessive debt between these entities remains a concern to the fiscus, especially if the creditor falls outside the tax net.

In order to curb this concern, the aggregate deductions for interest associated with debt between certain entities of the same group will be limited regardless of the terms associated with that debt. More specifically, if a company pays interest to another entity within the same IFRS group and the interest is untaxed (or taxed at a lower rate) when received or accrued by the other entity, the interest will be subject to an interest limitation. This interest limitation will similarly apply if the untaxed IFRS group entity guarantees or provides other security in respect of debt owed by the company debtor. In either of these circumstances, the deduction for interest paid or incurred in respect of the debt will be limited to:

- 40 per cent of the debtor’s taxable income (disregarding interest received, accrued, paid or incurred); plus
- Interest received or accrued; reduced by
- Interest paid or incurred in respect of debt falling outside the limitation.

To the extent interest paid or incurred on debt between IFRS group entities exceeds the limitation, the excess can be carried forward for up to five years (remaining subject to the limitation).
EXAMPLE 1(a): Group loan (year 1)

**FACTS**
- Foreign HoldCo lends R5 million at 10% interest to SA Subco.
- SA Subco’s taxable income before interest is R800 000

**RESULT**
- The interest limitation applies because the lender forms part of the same IFRS group and the creditor will not be liable to South African income tax on the interest income.
- Hence, SA Subco’s interest deduction in respect of the R5 million loan will be limited to R320 000 (i.e. 40% of the R800 000 taxable income).
- The balance of SA SubCo’s interest expenditure may be carried forward for up to five years.

EXAMPLE 1(b): Group loan (year 2)

**FACTS**
- In the subsequent year, the R5 million loan from Foreign HoldCo remains outstanding (see example 1(a) above).
- SA Subco’s taxable income in year 2 before interest is R1 million.

**RESULT**
- The interest limitation will still apply as the lender forms part of the same IFRS group because the creditor will not be liable to South African income tax on the interest income.
- Hence, SA SubCo’s interest deduction in respect of the carry-over of interest incurred in year 1 (of R180 000) and the interest incurred on the R5 million loan in year 2 will be limited to R400 000 (i.e. 40% of the R1 million taxable income).
- As the carry-over from the previous year is applied first and then followed by the current year’s interest expense, the balance of the interest incurred in year 2 in respect of the R5 million loan amounting to R280 000 (R500 000 + R180 000 – R400 000) may be carried forward for up to five years.
EXAMPLE 2: Group loan guarantee

**FACTS**
1 – Foreign HoldCo lends R5 million at 9.5% interest to Bank.
2 – Bank lends R5 million to SA SubCo at 10% interest. In addition, Foreign HoldCo guarantees the interest payments and provides security for repayment of principal owed by SA SubCo to Bank.

**RESULT**
- The interest limitation applies because the debt was indirectly funded or guaranteed by a lender that forms part of the same IFRS group as the borrower.
- Hence SA SubCo’s deductible interest in respect of the R5 million of debt from Bank will be limited to R320 000 (i.e. 40% of the R800 000 taxable income).
- The balance of SA Subco’s excessive interest expenditure may be carried forward for up to five years.

EXAMPLE 3: Group loan guarantee with interest income

**FACTS**
Company X (Unrelated to both SubCo and Foreign HoldCo)

**RESULT**
- The interest limitation applies because the debt was indirectly funded or guaranteed by a lender that forms part of the same IFRS group as the borrower.
- Hence SA SubCo’s deductible interest in respect of the R5 million of debt from Bank will be limited to R320 000 (i.e. 40% of the R800 000 taxable income).
- The balance of SA Subco’s excessive interest expenditure may be carried forward for up to five years.
C.  Transfer pricing interpretation note and potential safe harbour

As a general matter, cross-border interest between connected persons are subject to the facts and circumstances restrictions of transfer pricing as outlined in the proposed interpretation note (see Draft Interpretation Note on: ‘Determination of the taxable income of certain persons from international transactions: thin capitalisation’). However, given the general restrictions on debt as now proposed, the need for transfer pricing to address excessive debt and hybrid debt is reduced. Therefore, under consideration is a safe harbour that will be added to the transfer pricing rules (e.g. via a binding general ruling). In order to fall within this potential safe harbour, interest on connected person cross-border debt must satisfy the following two criteria:

- Firstly, interest on the connected person debt may not exceed 30 per cent of taxable income (with no adjustment for other interest received, accrued, interest paid or incurred); and

- Secondly, the interest rate depends on the currency denomination of the loan. The interest on the debt may not exceed the foreign equivalent of the South African prime rate if denominated in foreign currency. The interest rate on the debt may not exceed the South African prime rate if denominated in Rand.

Under current law, it should be noted that amounts viewed as excessive for transfer pricing purposes are permanently denied (not merely subject to an ongoing limitation on a carryover basis).

D.  Acquisition debt

Under current law, acquisition debt is subject to discretionary limitations as determined by SARS. These limitations are designed to target potential base erosion caused by excessive and hybrid debt (and to prevent the interest deduction from becoming a facilitator of unwarranted risk to the economy in the form of excessive debt). However, this discretionary system was never intended to be permanent. Taxpayers seeking debt-financing when
attempting to acquire control of companies cannot be expected to obtain pre-approval from SARS in the long-run; deal-making of this nature needs clear guidelines when seeking finance before core negotiations can be undertaken.

In view of these concerns, the discretionary system will be terminated in favour of a more concrete set of rules. Under the new system, debt used for the acquisition of the assets of target companies via an indirect section 45 acquisition or a direct section 24O acquisition will be subject to a fixed overall limitation roughly comparable to the untaxed group entity limitation. This limitation will ensure that acquisition debt does not eliminate excessive amounts of taxable income of the acquiring or target company for an indefinite period into the future.

More specifically, if an acquirer acquires the assets of a target company through the use of section 45, the deduction for interest paid or incurred in respect of the debt will be limited to:

- 40 per cent of the debtor’s taxable income (before taking into account interest received or accrued and interest paid or incurred); plus
- Interest received or accrued; less
- Interest paid or incurred in respect of debt falling outside the limitation.

To the extent the interest paid or incurred on the debt used for the acquisition exceeds the limitation, the excess can be carried forward for up to five years (remaining subject to the limitation).

The interest limitation in the case of a section 24O acquisition works in similar fashion with the deductible interest of the acquiring company being limited to 40 per cent of the taxable income of the target company (taking into account the interest adjustments). The 40 per cent taxable income limitation will be further adjusted in accordance with the percentage stake being acquired if the acquirer is not acquiring all the shares of Target Company. For instance if the acquirer acquires 80 per cent of the shares of Target Company, the limit will be 80 per cent of 40 per cent of the target company’s taxable income.

In addition, in the context of a section 24O acquisition, if the acquisition debt was funded or secured by another entity within the same IFRS group and the interest thereon is untaxed when received or accrued by that other entity, the limitation will be the lesser of (i) 40 per cent of the target company’s taxable income or, (ii) 40 per cent of the acquirer’s taxable income. The limitation method applicable must be further reduced to reflect so much of the period that the acquired stake was held in relation to the acquiring company’s year of assessment at issue. For instance where the acquiring company acquires shares of the target company half way through the acquiring company’s year of assessment, the applicable 40 per cent taxable income limit must be further reduced by 50 per cent.

Lastly, it is recognised that this overall limitation may be unduly restrictive if the target assets or the assets of the target company consist of sizeable amounts of immovable property generating rental income because commercial lenders are typically more willing to lend greater proportions for acquisitions of this nature. In light of this recognition, rental income from immovable property will be subject to a notional 50 per cent uplift for purposes of determining the impact of the limitation in respect of acquisition debt.
EXAMPLE 1: Basic section 45 acquisition

|||
|---|---|---|
|Parent Co| Target Co| New Co

(Taxable income before interest = R1 million)

Bridging finance used to acquire Target Co shares

RESULT:

40% taxable income rule:
Interest subject to limitation = R700 000
Interest allowable per limit = [40% of R1 million taxable Income)] = R400 000

- New Co’s interest deduction in respect of the acquisition debt will be limited to R400 000.
- As such, the balance of R300 000 may be carried forward for up to five years.
- Note: Ignore the interest incurred from the bridging finance as negligible.

EXAMPLE 2: Section 45 acquisition of assets generating rental income

|||
|---|---|---|
|Parent Co| Target Co| New Co

(Taxable income before interest = R1 million)

New Co

Taxable income includes gross rental income from immovable property of R600 000

Bridging finance used to acquire Target Co shares

R7 million permanent loan funding @ 10% interest used to acquire the assets of Target Co
FACTS:
The facts are the same as those in EXAMPLE 1, except that New Co has gross rental income of R600 000.

RESULT:

40% taxable income rule:
Interest subject to limitation = R700 000
Interest allowable per limit = [40% x (Taxable Income + 0.5(Gross Rental Income))]
= 40% x (1 million + 300 000)
= R520 000

- New Co’s interest deduction in respect of the acquisition debt will be limited to R520 000.
- As such, the balance of R180 000 may be carried forward for up to five years.
- Note: Ignore the interest incurred from the bridging finance as negligible.

EXAMPLE 3: Section 24O acquisition of partial interest

Target Hold Co  Parent Co

Op Co  Bank

Target
Taxable income before interest = R1 million

R8 million loan at 10% interest

R8 million used to acquire 80% of proportionate share

RESULT

Interest subject to limitation = R800 000
Interest allowable per limit = 40% of (R1 million taxable Income of target company x 80%)
= R320 000

- OpCo’s interest deduction in respect of the acquisition debt will be limited to R320 000 and the balance of R480 000 may be carried forward for up to five years
EXAMPLE 4: Section 24O acquisition with a related party guarantee

FACTS:
- Bank lends R 9 million to Opco at 10% interest. Foreign HoldCo provides guarantees and security to Bank in respect of the R9 million loan to OpCo. OpCo uses the loan proceeds to acquire all of the equity shares in Target Company.

**Acquisition Limitation**

- Interest subject to limitation = R900 000
- Interest allowable per limit = R600 000 (40% of R1.5 million)(target’s taxable income)

- OpCo’s interest deduction in respect of the acquisition debt will be limited to R600 000 due to the acquisition limitation.

**Untaxed Connected Person Limitation**

- Interest subject to limitation = R900 000
- Interest allowable per limit (connected persons) = R800 000 (40% of R2 million (acquirer’s taxable income))

- In terms of the unconnected person limitation, OpCo’s interest deduction will be limited to R800 000.

**Combined Limitation**

- The combined limitation will be R600 000. The remaining R300 000 can be carried over up to 5 years.
IV. Public Comments

As stated above, the Taxation Laws Amendment Bill to be published in June 2013 will include the proposed draft on the debt limitation rules as well as the hybrid debt instruments rules. In order to facilitate ongoing consultation with relevant stakeholders before the Taxation Laws Amendment Bill is published, the National Treasury and the South African Revenue Service (SARS) would like to formally invite members of the public to submit comments in the interim in respect of the above-mentioned proposals. Comments should be sent by 24 May 2013 to:

Ms Nomfanelo Mpotulo
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Ms Adele Collins
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or by fax to (012) 315 5516

A public workshop on this matter will also be arranged in the second half in May.

Attachments included:
Annexure A: Revised version of the proposed 2012 hybrid rules
Annexure B: Draft legislation
Annexure C: Corresponding explanatory memorandum

Issued by: National Treasury and the South African Revenue Service

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