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Global Tax Alert

South Africa proposes limiting excessive corporate interest deductions

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As part of South Africa's 2020 Budget Review, delivered by the country's Minister of Finance on 26 February 2020,[1] National Treasury tabled a proposal aimed at curtailing excessive corporate interest deductions.

Consultation on these proposals commenced with the release of a discussion document titled "Reviewing the Tax Treatment of Excessive Debt Financing, Interest Deductions and Other Financial Payments" (Discussion Document). Public comments on the Discussion Document are due by 17 April 2020.[2]

The stated policy rationale for the proposal is to protect South Africa's tax base in line with the Organisation for Economic Co-operation and Development's (OECD) 2015 Base Erosion and Profit Shifting (BEPS) report "Limiting Base Erosion Involving Interest Deductions and Other Financial Payments" (OECD Report), while balancing the need for legitimate investment and funding of businesses. It is further noted that as South Africa's corporate income tax rate is high relative to the global average, debt capital, while an important source of investment, can create opportunities for base erosion and profit shifting.

The Discussion Document therefore proposes that the existing interest limitation rule (contained in section 23M of the *Income Tax Act*[3]) be replaced with a new set of rules. Key proposed changes contained in the new interest limitation rules include:

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- The rules will apply to all entities operating in South Africa that form part of a foreign or South African multinational group.[4]
- Clarity that companies should first apply the transfer pricing rules contained in section 31 of the *Income Tax Act* (i.e., the interest limitation rules should be applied to the net interest expense that has already passed the arm's-length test).
- The tax deductibility of the net interest[5] expense[6] on *connected person and third-party* (external) debt will be limited to 30% of the entity's "tax EBITDA."[7]
- The disallowed (excessive) net interest expense may be carried forward, on a first-in-first-out basis, for a maximum period of five years. This is noted to be a fair period to allow for a smoothing of earnings.
- The introduction of transitional rules to address existing third-party loans will be considered.
- A *de minimis* rule is tentatively proposed which could see entities with a net interest expense below a certain threshold (suggested at between R2 million and R5 million) being excluded from the new rules.
- Section 23N,[8] which is a targeted interest limitation rule, will be retained.

It is proposed that the new interest limitation rules will apply with effect from years of assessment commencing on or after 1 January 2021.

Unlike other jurisdictions, South Africa will not provide alternative group ratio relief (i.e., where the net interest expense is deductible up to the group's third-party net interest expense to EBITDA[9] ratio).

Also addressed in the Discussion Document is South Africa's current thin capitalization rules and, in particular, the uncertainty being experienced by taxpayers as a result of the draft interpretation note issued by the South African Revenue Service back in 2013 titled "Determination of the Taxable Income of Certain Persons from International Transactions: Thin Capitalisation." In this regard, it is noted that with a view to enhance certainty, the Government is also considering a safe harbor debt-to-equity approach to determine whether taxpayer's need to apply the arm's-length principle to the quantum of debt. Taxpayers are invited to include their views on a safe harbor as part of their comments.

Given the significant impact that these new interest limitation proposals are likely to have on financing structures and on pricing and investment decisions, multinational enterprise (MNE) Groups are encouraged to engage National Treasury on the consultations.

Further, MNE Groups who believe they may be particularly impacted should undertake preliminary financial modelling assessments of the proposed rules on current funding arrangements and consider restructuring their funding and financing structures, especially as there will be limited, if any, grandfathering provisions for existing connected party loans.

Endnotes

1. See EY Global Tax Alert, *South Africa's Minister of Finance delivers 2020 Budget Review*, dated 28 February 2020.
2. All comments should be sent to hayley.reynolds@treasury.gov.za by 17 April 2020.
3. *Income Tax Act No. 58 of 1962*.
4. In this regard, the Discussion Document references the definition of an "MNE Group" for purposes of the South African regulations specifying the Country-by-Country Reporting Standard.
5. In line with the OECD Report, it is proposed that the rules apply to a wider concept of interest which could likely include payments under profit participating loans, imputed interest on instruments such as convertible bonds and zero-coupon bonds, amounts under Islamic finance arrangements, the finance cost element of finance lease payments, capitalized interest included in the balance sheet value of a related asset or the amortization of capitalized interest, amounts measured by reference to a funding return under transfer pricing rules, notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowing, certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance, guarantee fees with respect to financing arrangements, arrangement fees and similar costs related to the borrowing of funds.

6. Net interest expense refers to the difference between total interest expense and total interest income (including tax adjustments).
7. Meaning the sum of:
   (i) Taxable income;
   (ii) Net interest expense; and
   (iii) Deductions in respect of capital assets (depreciation and amortization).
8. Section 23N is an interest limitation rule aimed at interest incurred in respect of certain reorganization and acquisition transactions.
9. Earnings before interest, taxes, depreciation and amortization.

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