South African Institute of Tax Professionals

5 October 2020

To: The National Treasury
240 Madiba Street
PRETORIA
0001

Via email: National Treasury (2020AnnexCProp@treasury.gov.za)
Hayley.reynolds@treasury.gov.za

Dear National Treasury

RE: COMMENTS ON DISCUSSION DOCUMENT: LIMITING THE TAX TREATMENT ARISING FROM EXCESSIVE DEBT FINANCING

We attach hereto comments from SAIT on the Treasury Discussion Document entitled "Reviewing the Tax Treatment of Excessive Debt Financing, Interest Deductions and Other Financial Payments". We thank you for sharing National Treasury's thinking on this global tax matter.

Please do not hesitate to contact us should you need further information.

Yours sincerely,

Keith Engel

Keith Engel (CEO of SAIT)

All references to legislation are to the Income Tax Act, No. 58 of 1962, and proposals contained in the Draft Taxation Laws Amendment Bill, 2020.

I. Introduction

We recognize that the proposals contained within the National Treasury discussion document are being written within a pre-set framework inspired by Action 4 of the OECD action plan ("Limiting Base Erosion Involving Interest Deductions and Other Financial Payments"). As such, our suggestions will be limited solely to the general framework set by the OECD.

II. The fixed 30 per cent EBITDA limitation

A. General considerations

It is understood that National Treasury chose the upper range for the 30 per cent rule given South Africa's moderately high interest rate and inflation rate (as well as its currency volatility). This flat rate was chosen for simplicity.

First, the 30 per cent limit may need to be re-examined given recent events. The coronavirus has not only added considerable debt for government but also for the private sector. Even where debt levels for a company remain, earnings are being significantly impacted. The 2020 period and other periods of economic distress may mean that the 30 per cent limit compounds the difficulties of distressed companies. It may even mean that the OECD should re-examine the overall 30 per cent limit in this light.

It must be noted that the fixed ratio has an unduly large impact on businesses that operate in higher interest rate environments – much larger than the authors of the OECD papers probably realize. One example is the fact pattern provided below where there is a South African company that has financial statements provided in ZAR and a comparable UK company with financial statements provided in GBP. For ease of reference and comparison, the South African company has exactly the same values in its income statement and balance sheet as the UK company but the currency is ZAR as opposed to the currency of the UK company which is GBP.

Furthermore, assume the South African prime interest rate of 7% is applied in comparison to the UK prime interest rate of 1.1%. If both businesses are expected to achieve an operating profit margin (operating profit as a percentage of revenue) of 4%, then the net profit ratios would also be the same. The example uses a 1:1 debt / equity ratio under the traditional thin cap formulation (a ratio considered strongly within the reasonable range of most (if not all countries) under the old thin capitalisation rules).

Under this basic example, given the difference in the interest rates, the South African company would have excessive debt when applying the 30% EBITDA threshold while the UK company would not. Even if the 10% ratio were to be applied as may be the case in certain other developed countries, the UK company would still not have excessive debt.

This illustration indicates that the fixed ratio for interest deduction limitation severely prejudices companies that are operating in countries with higher interest rates because they have a higher portion of interest expenditure that is likely to be disallowed. Since debt can be an important enabler of growth, it means that South African subsidiaries of foreign companies (as well as other South African companies) seeking to grow may find that the hurdle to overcome is simply to high to be reasonably achievable given the high interest rate environment. We doubt very much the OECD would suggest a fixed 30 per cent rule if they actually felt the reality of meaningful interest rates.

t (012) 941 0400
f 086 626 0650
e info@thesait.org.za
w www.thesait.org.za

268 Voortrekker Road
Monument
Krugersdorp
Gauteng 1739

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0063
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	SA Co ZAR	UK Co GBP
Balance sheet		
Equity	2 000 000	2 000 000
Debt	2 000 000	2 000 000
Interest calculation		
Interest rate	7%	1.100%
Annual interest charge	-140 000	-22 000
Income statement		
Revenue	10 000 000	10 000 000
Cost of goods sold	-8 000 000	-8 000 000
Gross profit	2 000 000	2 000 000
Operating expenditure (e	-1 600 000	-1 600 000
EBITDA	400 000	400 000
Depreciation	-200 000	-200 000
Operating profit (EBIT)	200 000	200 000
Interest expense	-140 000	-22 000
Net profit before tax	60 000	178 000
30% of EBITDA	120 000	120 000
Interest expense	-140 000	-22 000
Excessive interest	-20 000	-

Other practical considerations of the interest deduction limitation are that companies in a start-up phase are prejudiced. In South Africa, there is a very big focus on encouraging the establishment and growth of new businesses. However, new businesses often have initial losses or have low levels of profitability. At an early stage, new businesses are often faced with very high costs while receiving very little income and to deny the start-up business the full deduction for the interest expense during the early years will place additional financial pressure on the business. This denial of deductions (especially across-the-board) could easily render projects still-born at the planning stage.

B. Distressed companies

The problem of distressed companies illustrates how the 30 per cent EBITDA proposal is not an arm's length solution but rather a mechanical solution to limit base erosion. As a commercial matter, independent third-party banks provide loans for a period of time despite annual fluctuations. Moreover, loans are not suspended are recalled due to a single bad year as can be seen during the crisis of Covid-19. The approach of the proposed 30 per cent limitation, on the other hand, implicitly assumes that each year should be judged on a stand-alone basis.

In short, we question the wisdom of restricting the use of their interest deductions during periods of distress to effectively force payment of income tax when cash is in short supply and overall annual company returns are negative. Many of these companies may have been operating within the 30% limit when the debt was incurred, only to find themselves in violation once gross revenues drop due to circumstances outside the company's control. In the least, we would suggest that the OECD discussions on this subject be re-examined (for example, see the discussion on averaging in Chapter 8 of the OECD document).

At a South African level, we would also suggest that the South African debt cancellation rules be re-examined (section 19 and paragraph 12A of the 8th Schedule) because excess losses from interest will at least be delayed or even lost. As you are aware, debt cancellation can trigger capital gain or revenue for the debtor. The technical relief rules often provide relief by eliminating this gain or revenue at the price of excess losses (or other tax attributes). In effect, the debt cancellation rules are premised on the notion that debt cancellation gain or revenue is more a problem of theory than reality because an indebted taxpayer should have significant losses to absorb debt cancellation gain or income. This equivalence will be lost once excess losses from interest are restricted (and will even be less equivalent should National Treasury separately proceed with the notion that all excess losses will only be partially useable against overall net revenue).

C. Industry relief

At a more fundamental level, we are concerned that the absolute fixed nature of the 30 per cent limit does not account for non-tax commercial realities in certain sectors. The OECD version allows for an overall group option (much like countries such as the UK have allowed). The group option means that a single company's interest cannot exceed the group average, thereby removing improper outliers. Stated differently, a local subsidiary with large payments of interest will be allowed to fully deduct its overall interest if the subsidiary's debt is in line with the group average. The net effect is that a local subsidiary can be heavily indebted if in line with the overall group, thereby accepting that debt can be commercial where in line with industry averages.

While we realize that National Treasury will be reluctant to adopt the complexities of a group average rule, the point to be made is that the fixed 30 per cent limit needs to be adjusted for certain sectors given their specific demands for debt capital (which can be illustrated with a higher group debt ratio). In the main, debt capital demands tend to be higher in sectors with fixed investment, such as real estate and mining. In these cases, high levels of debt are commercially driven with independent third parties so a different limit is probably more appropriate.

We note that an OECD has written a paper on this subject in terms of mining (but we admit their conclusions have been tepid). In terms of mining, one should also reconsider the five-year timing period given the long-life of mines and the associated ring-fencing. Banking (and insurance) is also an outlier, but the OECD focus on "net" interest (including related finance) may indirectly solve a large portion of the problem for these sectors. That said, it seems certain that Pillar I of the OECD proposals will have carve-outs for certain industries, and we suggest that industry carve-outs should similarly exist in this circumstance. If an industry carve-out can exist in one area of the tax law dealing with base erosion, no sound reason exists to say that similar carve-outs cannot exist in another.

III. *De minimis* Rule

The proposed *de minimis* threshold is way too low. The purpose of the OECD initiatives are to target tax avoidance of larger multinationals. The object of concern can clearly be seen in country-by-country reporting where only very large companies are targeted (i.e. R10 billion or 750 million Euro). While we realize that National Treasury won't push the numbers that high, the R2 million and R5 million thresholds will effectively bring smaller and mid-sized companies into the net. The OECD guidelines clearly indicate that administrative concerns should limit the anti-avoidance mechanism to larger companies.

This exclusion of smaller and mid-size companies is not just an issue of administrative convenience but also one of substance. Larger companies have more options for financing, especially in terms of debt. Besides the initial founder (friends and family), mid-size and smaller companies only obtain external funding in the form of debt (from banks and specialized lenders). The proposed *de minimis* number of R2 million and R5 million is essentially equivalent to a small and micro-business exclusion.

We would request that National Treasury revisit the comparisons with other countries. These numbers should be readjusted for proper currency conversions, country risk and inflation rates. Again, the goal is to limit the anti-avoidance concerns to companies at the larger-size of the scale. It is only the larger companies that pose a significant risk of cross-border base erosion.

IV. Net interest approach

We support National Treasury's approach to account for the new EBITDS rule on a "net interest" basis. We also support the notion that the term "interest" will include all finance-related charges.

The net interest approach is extremely important for banks and insurers. Banks and insurers are intermediary entities that lend based on borrowings. Some countries that have previously applied simple thin-cap ratios on a gross basis have previously adjusted their ratios as high as 12:1 for this sector. A net approach should presumably avoid the need for a separate ratio. We also note that banking and other financial intermediary regulations often require the lender to have capital reserves on hand that require borrowings from other parties, including government.

In terms of separate rules for banks and insurers, we also note that any proposed special rules for banks and insurers would be too narrow. Both institutions are, in effect, financial intermediaries. Financial intermediaries exist in other forms beyond these two heavily regulated industries. As seen in the debate over doubtful debts under section 11(j), there are many non-bank lenders, some of which may be wholesale independent entities. One type of largescale lenders are commodity trading firms, many of whom are dedicated to mining. These institutions effectively act like conduits between the banks and mining companies because bank lending to mining houses has significantly decreased since the 2008 financial crisis due to the risks associated with mining. These and other syndicated relationships need to be covered to the extent issues associated with formal banking are addressed.

The presumed intention of capturing all-related finance charges is based on anti-avoidance. Without such a rule, interest charges will be recharacterized. However, we note that the term "all related charges" should include related financing to avoid unfair mismatches. One set of important items are currency hedges. Cross-border debt often comes with currency hedges as a risk mitigation tool. The combined debt and related financing must be viewed together so that the EBITDA formula takes into account full commercial reality.

V. Focus on inbound

The real focus of concern in terms of base erosion is local subsidiaries of foreign multinationals. Excessively indebted local subsidiaries are at the heart of the problem. The use of cross-border interest being paid by a local entity to a foreign subsidiary is best addressed via the local controlled foreign company rules of section 9D. Indeed, section 9D may have fully addressed these concerns already. Interest income received by a foreign controlled company is tainted if paid by a South African group company even if associated with a business establishment but for some minor deviations (e.g. the de minimis exception). If section 9D is not strong enough, any remaining loopholes can easily be closed.

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Targeting of large South African companies merely due to the existence of a single foreign subsidiary seems excessive. Stated differently, should we really hamper all of the debt of a South African group merely because the group has begun the small process of investment abroad, especially if that cross-border investment is small and dedicated to one country?

We presume that National Treasury chose to target all groups with both foreign and domestic companies to prevent the argument of nondiscrimination. In this regard, we note that the United States has adopted its base erosion anti-abuse tax rules without this concern. The U.S. rules target payments to foreign entities without regard to payments to other comparably situated exempt domestic entities (section 59A of the U.S. Internal Revenue Code).

VI. Interaction between section 31 transfer pricing and the proposed EBITDA limitation

A. Section 31 should apply last

We realize that the current "technical position" is that section 31 should apply before all of the other anti-avoidance rules based on the current wording of the Income Tax Act. We also realize that the application of section 31 gives rise to a corollary dividend adjustment while the other anti-avoidance rules simply give rise to denied interest or deemed income.

Nonetheless, one should remember that pricing adjustments are a last resort in an efficient tax system – not a first resort. Transfer pricing is not only fact intensive; it requires a multi-disciplinary effort of accounting, law, economics and business. Skills for this discipline completely differ from the training of an ordinary tax professional. In South Africa, there are no more than 150 professionals who are dedicated solely to transfer pricing and no more than 40 of which are operating at a senior level. There may be another 50 or so in-house tax experts, most of whom only handle transfer pricing on a part-time basis to meet compliance requirements (master and local files, country-by-country reporting and the special IT14 requirements). Resources in government and the private sector are simply not sufficient to regularly and actively impose transfer pricing as the starting point for all cross-border transactions.

The historic international standard has been to impose objective anti-avoidance rules as a first option. The most notable rules in this regard are the controlled foreign company rules (section 9D). These rules create deemed income for offshore subsidiaries where the nature of the income can readily give rise to transfer pricing concerns (e.g. the diversionary rules). That said, one of the promises of the new OECD approaches is simplified administration. Pillar I and Pillar II are pushing for objective rules as the first line of defence with formulas included. While transfer pricing is to be retained, they are a fall-back position where the new rules are insufficient to protect the tax base. The new objective rules are being proposed partly on the promise that less reliance will take place on transfer pricing, which is not only complex and expensive but also gives rise to ongoing uncertainty (including the rise of double taxation).

B. Interaction of transfer pricing with the new interest limitation

Regardless of the ordering, care must be taken to ensure that both the new interest limitation and transfer pricing do not have a double impact on the same interest. If transfer pricing is applied to deny interest, this denied interest should be removed from the proposed EBITDA formula.

We also support the suggestion that the transfer pricing rule should contain a safe harbor (perhaps on a debt / equity basis or a minimum EBITDA basis). Clarity should also be provided as to where transfer pricing should indeed continue to apply to cover the gaps. It could be argued that transfer pricing is no longer necessary for companies within the ambit of the proposed limitation once the 30% per cent EBITDA rule is applied, except for the rate of interest itself (because the proposed EBITDA rule is really directed only at excessive capital as opposed to excessive interest). A safe harbor for the interest rate presumably could be made based on the current Exchange Control formulation.

C. Interaction with section 23N

As a side point, the interest limitation of section 23N rule needs to be considered – the twin analogue to section 23M for acquisitions. Companies subject to the newly proposed 30% limitation presumably should not be concerned with section 23N if the target will be subject to the newly proposed 30% limitation in any event under the newly proposed dispensation. Without this relief, the effect would be to possibly place the target company under two simultaneous sets of EBITDA rules. This dual set of measures seems excessive and problematic in terms of compliance.

End.

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w www.thesait.org.za

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