South African Institute of Tax Professionals

19 June 2014

Ms Y. Mputa
The National Treasury
240 Vermeulen Street
PRETORIA
0001

BY E-MAIL: YANGA.MPUTA@TREASURY.GOV.ZA

Dear Ms Mputa

RE: REQUEST FOR CONSIDERATION: SECTION 23M – LIMITATION OF INTEREST DEDUCTIONS IN RESPECT OF DEBTS OWED TO PERSONS NOT SUBJECT TO TAX

We would like to add our voice to the growing concerns expressed by industry with regard to section 23M. Before raising these concerns, however, we note that we recognise Government's anti-avoidance needs. In the main, Government is trying to prevent excessive interest deductions in line with recent pronouncements by the OECD relating to Base Erosion and Profit Shifting ("BEPS").

We understand this concern and express our support for the BEPS measures to prevent excessive deductions in respect of interest incurred that would not arise in a commercial setting. At issue for us is the extreme nature of section 23M and the lack of guidance in transfer pricing. We believe that these measures can proceed without adversely affecting legitimate commerce if section 23M is adjusted accordingly. The issues below are the main issues identified in relation to section 23M.

1 SPECIFIC MATTERS

1.1 The connected person test is too low

Problem statement

The initial definition of a 'controlling relationship' in sec 23M of the Draft Taxation Laws Amendment Bill, 2013, required "a more than 70 per cent" shareholding. The definition of 'controlling relationship' in section 23M(1) has since been amended to refer to '… a relationship between a company and any connected person in relation to a company'. According to par (v) of the 'connected person' definition in section 1, companies would be considered to be connected persons in relation to each other where '… at least 20 per cent of the equity shares or voting rights in the company are held by that other company, and no holder of shares holds the majority voting rights in the company'. Furthermore, all trust beneficiaries and partners are connected persons in relation to one another, no matter how small the interest is. It is therefore submitted that the connected

T: +27 86 177 7274
F: +27 86 626 0650
E: info@thesait.org.za
W: www.thesait.org.za
Riverwalk Office Park, Building A
C/O Garsfontein & Matroosberg Roads
Pretoria, South Africa
0081
PO Box 712
Menlyn Retail Park
0063

persons test is too low because the test is applicable to many consortium arrangements. We also note that debt is often used in the case of BEE arrangements to reduce the cost of BEE entry – many of these BEE players own a truly independent 26 per cent stake (all of whom cannot be controlled by the dominant shareholder and all of whom have different profit interests).

The purpose of the thin capitalisation/EBITDA rules is to have objective protection when the creditor and debtor are a single business unit. In these circumstances, the parties are free to choose debt or shares without any adverse business consequences. The connected person test moves beyond this threshold however. As a result, section 23M applies when the debt is real and would arise without consideration for tax.

Proposed solution/recommendation

The test should move back to the initial test of "control" (as in "the definition of group in section 1) as opposed to "connected person". However, the initial 70 per cent test is still too low. We suggest that the 70 per cent should be lifted to 80 per cent. Alternatively, special relief will be required in the case of BEE arrangements (or neutral criteria frequently arising in the case of BEE transactions).

1.2 Guarantees by connected persons

Problem statement

The need for the guarantee test is not entirely clear. A guarantee by an exempt connected/controlling person is not, by itself, evidence of avoidance, especially if no deductible interest is being paid to that exempt person. If a tax avoidance concern exists, it is an interest payment to a taxable party, followed by that party's payment of interest to an exempt party. The guarantee may be an indicator of such a scheme but not necessarily anything more. Furthermore, the mere existence of a guarantee is a poor indicator of avoidance because these guarantees frequently arise from exempt parties with no tax benefit occurring at all.

Proposed solution/recommendation

Instead of the guarantee test, section 23M should instead contain a rule similar to section 23M(6) that prevents back-to-back loans to taxable persons, followed by payments to controlling exempt persons.

1.3 Further inequitable results that may stem from the application of section 23M(2)(b)

Problem statement

Section 23M is primarily targeted at interest on loans owing by a resident to connected persons who are not subject to tax under Chapter 2 of the Income Tax Act (refer section 23M(2)(a)). In addition, section 23M(2)(b) contains anti-avoidance provisions intended to target arrangements where a third party is interposed between the debtor and the connected person either through the connected person lending the funds through a third party who is not subject to tax (subsection (b)(i)) or where the connected person guarantees the loan from the third party who is not subject to tax (subsection (b)(ii)). Subsection (b) makes sense in the context of anti-avoidance arrangements i.e. where the provisions of section 23M would have applied had the loan been granted directly from the connected person. The section, however, seems overly broad and can lead to inequitable results, as explained in examples A and B below.

Example A

A resident company sources interest bearing debt from a consortium of local banks who are subject to tax. It is clear that section 23M would not be applicable to the interest. The loan is guaranteed by various resident group entities all of whom are subject to tax. It is clear that section 23M is still not applicable to the interest. The lenders enter into an inter-funder agreement allowing them to syndicate the debt further (our resident debtor is not party to the inter-fund agreement) and one of the lenders subsequently syndicates a portion of its debt to a pension fund (potentially without the knowledge or consent of the debtor). Technically the requirements of section 23M(2)(b)(ii) are met (as a result of the guarantee provided by the group entities) and the interest deduction on that portion of the debt would be limited under section 23M. **However, the provisions of section 23M would never have been applicable had any of those connected persons been in a position to advance the loan themselves.** Furthermore, the application of section 23M in these circumstances is inequitable as neither the debtor nor any of its connected persons were party to the arrangement in terms of which the debt was syndicated.

Proposed solution/ recommendation

The application of section 23M(2)(b) should be limited to instances where the party in the controlling relationship is not subject to tax under Chapter 2 of the Income Tax Act. This can be achieved either through an amendment to the definition of “controlling relationship” in subsection (1) or through the inclusion of a proviso to subsection (2).

Example B

A resident company issues bonds which are listed on the JSE or a foreign stock exchange. Due to the listed nature of the bonds, some of the bond holders could conceivably be foreigners or pension funds. Repayment by the resident company of the bonds is guaranteed by a person that is in a controlling relationship with the debtor. The person in the controlling relationship could either be a South African tax resident or a foreign parent company. The application of section 23M in these circumstances is inequitable for two reasons:

- Due to the listed nature of the bond the debtor has no control over the identity of the creditor at any given time; and
- The guarantee is in respect of **repayment** of the bonds for purposes of achieving a better rating, and it is not a guarantee of **the amount advanced**. The latter type of guarantee is contemplated in section 23M.

Proposed solution/ recommendation

Section 23M(2)(b) should not apply to debt listed on a recognised exchange as defined in paragraph 1 of the Eighth Schedule to the Income Tax Act, similar to the exclusion in respect of interest withholding tax. Alternatively, section 23M(6) should be amended to read as follows:

"*This section does not apply to so much of the interest incurred by a debtor in respect of a debt owed by a creditor as contemplated in subsection (2) where-*

(i) *That creditor funded that debt amount advanced to that debtor* ***from own funds or*** *with funding granted by a lending institution that is not in a controlling relationship with that debtor*"

1.4 Relationship between sec 23M and thin capitalisation

Problem statement

Many within the industry are concerned about the lack of linkage between section 23M and the thin capitalisation rules of section 31. A common question is which applies first? If interest is wholly disallowed under the thin capitalisation rules, the interest should not count against section 23M as section 23M(3) refers to "interest incurred" and not "deductible interest".

Others have raised the question whether section 23M is needed at all as shouldn't the transfer pricing rules be sufficient? Industry is also concerned about the fact that the interpretation note for thin capitalisation has never been finalised.

Proposed solution/recommendation

Both the test for interest under transfer pricing and section 23M need to form part of a package to be understandable. If section 23M is indeed required, it seems that Treasury and SARS may be seeking to achieve the following landscape: (i) a "*per se* bad zone" – which is the ambit of section 23M; and (ii) a possible "*per se* good zone" if the safe harbour from transfer pricing is adopted as widely requested by industry. The facts and circumstances of transfer pricing then provide a discretionary middle-ground so that commercial financing can be separated fairly from avoidance.

This will narrow down the application of section 23M rather than make it very broad as it currently stands.

1.5 Recognition of foreign tax

Problem statement

The legislation contains no relief for amounts subject to a comparable level of foreign tax. The net result is effective cross-border double taxation. It is understood that foreign tax is not recognised due to fears of back-to-back debt (the debt owing initially to a person subject to high foreign taxes, followed by a back-to-back loan to a low tax country). However, we submit it is unfair to tarnish all transactions for a small minority of avoidance.

Proposed solution/recommendation

Foreign taxes should be recognised unless part of a back-to-back arrangement.

2. CLOSING

When section 23M was finalised with a 2015 effective date, we had hoped that the one-year delay would have been used for further discussion. Unfortunately, industry has had little opportunity to fully engage on the matter. Given the importance of this issue and the many other technical concerns associated with this provision, we would suggest that section 23M be delayed for another year. It is hoped that a further round of adjustments could result in a fair compromise that protects SARS from avoidance while ensuring that section 23M does not undermine commercial non-tax motivated transactions.

Yours sincerely,

Prof Sharon Smulders

Head: Tax Technical Policy & Research

The South African Institute of Tax Professionals

Cc: ismail.momoniat@treasury.gov.za;
rmoodley3@sars.gov.za;
zrento@parliament.gov.za

T: +27 86 177 7274
F: +27 86 626 0650
E: info@thesait.org.za
W: www.thesait.org.za

Riverwalk Office Park, Building A
C/O Garsfontein & Matroosberg Roads
Pretoria, South Africa
0081

PO Box 712
Menlyn Retail Park
0063