Natural Resource Charter Case Study

Natural Resource Governance Institute

Preventing Base Erosion: South Africa's Interest Limitation Rules

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SUMMARY

Challenge	Designing interest limitation rules to prevent companies from abusing interest deductions to erode their tax base. (Precept 4 of the Natural Resource Charter)
Country and period of focus	South Africa, 2015–2016
Objective in country	Preventing tax base erosion caused by related party borrowing, in a context heavily dependent on foreign investment
Core decisions	Setting a reasonable limit on interest deductions that would preserve the corporate tax base without deterring foreign direct investment.
Implications of decisions	The new rule is a response to the difficulties in applying the arm's length principle to related party debt, due to a lack of comparable data and expertise.
Policy decisions, implementation and governance	Section 23M was introduced in 2013, and became effective in 2015. The new rule caps the deduction of connected interest payments at a percentage of earnings before interest, tax, depreciation, and amortization (EBITDA), from an initial cap of 40 percent to a flexible formula linked to the South Africa Reserve Bank interest rate.
Did it work?	The South African Revenue Service (SARS) is yet to receive tax returns for 2015 and it is too early to determine whether the rule has successfully curbed excessive interest deductions. However, SARS has already identified a few design challenges: high interest rates have put pressure on the fixed percentage, and there are potential conflicts with transfer pricing rules.
Quantified losses	A 2016 United Nations WIDER working paper reveals a significant impact of variations between South Africa's corporate income tax rate and other jurisdictions' tax rates on debt levels of subsidiary companies in South Africa, showing that multinationals systematically respond to profit shifting incentives.
Lessons learned	Countries should employ a fixed ratio to cap interest deductions as a percentage of EBITDA, to prevent base erosion caused by the cost of borrowing related party debt. A fixed ratio rule can involve a fixed cap, or a flexible formula that adjusts for inflation. The former is comparatively easier to administer, and therefore preferable for resource-constrained tax authorities. Interest limitation rules should be used as a hard cut-off to limit interest deductions, and transfer pricing rules should only be invoked when the loan appears not at arm's length, necessitating a transfer pricing adjustment. A limit on interest deductibility should also cover foreign exchange losses connected to debt finance, otherwise the cost of borrowing may continue to erode the tax base. Interest limitation rules should explicitly state that zero-rated tax arrangements on interest income do not exempt the borrowing subsidiary from complying with the cap on interest deductions.

ABOUT THE SERIES

This is one of a series of case studies that illustrates the principles of the Natural Resource Charter. The charter is a tool used by governments and societies seeking to better harness the opportunities created by extractive resources.

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THE CHALLENGE

Companies can finance an investment in the mining sector through various instruments that fall into two broad categories: debt or equity. Debt is treated differently to equity for tax purposes: interest payment on the debt can be deducted from taxable income, reducing a company's overall tax bill. Consequently, companies have an incentive to increase their leverage (i.e., increase the proportion of debt in their sources of financing), in particular for subsidiaries in high-tax countries. Shareholders practice "thin capitalization" when they finance an investment with little equity compared to debt for the sole purpose of minimizing their taxes. Thin capitalization is not a practice unique to mining, but it is a more significant risk for projects that require high levels of capital investment not directly obtainable from third parties, which is often the case for mining investments.

Applying the "arm's length principle," the typical way for tax administrations to address transfer prices in transactions between related parties, was, and still is, extremely difficult for SARS. (For more information see NRGI's transfer pricing primer.) Transfer pricing rules are complex, particularly for developing countries dealing with large multinationals. SARS has a shortage of transfer pricing specialists, many of whom leave for the private sector after training on the job, which hinders its capacity to analyze complex related party transactions, such as valuing the cost of debt. According to a former South African National Treasury official, "SARS has five to eight people, then they all leave." Capacity constraints and limited access to comparable data led SARS to prefer clear, objective rules rather than complex transfer pricing procedures as a way to limit thin capitalization.

The most common legislative response to thin capitalization is to limit the maximum level of debt on which interest payments are deductible, by way of a debt-to-equity ratio. In 1995, the treasury introduced a debt-to-equity ratio of 3:1 (i.e., a company's capital comprised a maximum of 75 percent of debt), which meant that any interest payment due on debt above that threshold would not be deductible against income. However, there are ways for companies to go around this rule by converting debt to equity.[1]

An interest limitation rule is another way to limit thin capitalization. It entails capping interest deductions with reference to some measure of operational margins, for example, taxable earnings before interest, taxes, depreciation, and amortization (EBITDA). Interest limitation rules do not require tax authorities to distinguish between debt and equity or to control the total amount of related party debt, and are therefore easier to administer, and less open to manipulation.

THE RESPONSE

Concerns about excessive interest deductions arose in South Africa in response to "debt push-down" arrangements by private equity firms. Foreign firms used debt to buy shares in target companies in South Africa. Once the transaction was final, and the entities had become part of the same group, the interest on the debt used to purchase the target company became tax deductible in South Africa. These are referred to as "leveraged private equity buy-outs." According to SARS, revenue losses from debt push-down arrangements in 2011 alone amounted to approximately USD 357 million.

1 See for example Arthur Beesley,"Engie tax arrangements broke European tax law – EU Commission," *Financial Times*, 5 January 2017, accessed 8 March 2017, https://www.ft.com/content/38779574-35a8-3b00-86ef-f6498186a3fa.

In 2011, the South African treasury introduced a rule to deal with debt push-downs. Section 23N of the Income Tax Act limits the deduction of interest payable on debt used to finance, or refinance, reorganization or acquisition transactions. The second rule, Section 23M, was introduced in 2013 to address interest deductions in the context of cross-border related parties where the lender is not subject to tax in South Africa. Section 23M limited interest deductions to 40 percent of EBITDA per legal entity. Interest disallowed could be carried forward to the following year.

IMPLEMENTATION OF SECTION 23M

A number of design challenges may be instructive to other countries looking to introduce interest limitation rules:

Fixed versus flexible ratio

In 2013, when Section 23M was drafted, the cost of borrowing in South Africa was 5 percent. By 2016 it had risen to 7 percent. In response to rising interest payments, SARS has amended Section 23M from a fixed cap of 40 percent, to a flexible formula linked to the South African Reserve Bank interest rate.

The flexible formula is: $A = (B \times C)/D$.

- "A" represents the percentage limit on interest deductions to be determined by the formula
- "B" represents the number 40, the original fixed percentage limit
- "C" represents the average central bank rate plus 400 basis points (100 bps equals 1 percent)
- "D" represents the number 10

The purpose of the formula is to adjust the ratio according to changes in the rate of the reserve bank. The additional 400 basis points is a risk premium to account for volatility in the South African rand. For example, assuming the reserve bank rate is 6 percent, the limit will be 40 percent: (40 x (6 percent + 4 percent))/10; if the rate falls to 3 percent, the limit would be 28 percent: (40 x (3 percent + 4 percent))/10. The limit on interest cannot exceed 60 percent of EBITDA.

SARS's shift to a flexible formula must be viewed in context. Weak economic growth, high inflation and low commodity prices were putting pressure on the government to provide incentives to attract foreign investments. However, this amendment makes administration of Section 23M potentially more complex. SARS needs additional information such as the precise timing of related party debt to determine the corresponding reserve bank rate to use in the formula. While the reserve bank rate in South Africa has been relatively steady, this may change, in which case it would be more difficult for SARS to update the formula in agreement with taxpayers. For tax authorities with less capacity than SARS, a fixed cap such as that recommended in Action 4 of the OECD action plan against base erosion and profit shifting (BEPS) may be preferable.

Coordination with transfer pricing rules

The interaction of Section 23M with transfer pricing rules may be problematic. While Section 23M has a transfer pricing element, it is first and foremost an anti-avoidance rule. Officials at the South African treasury and SARS expected Section

23M to present a hard cut-off to interest deductions and provide a solution to the complexities of transfer pricing. If they decide that Section 23M takes priority, transfer pricing rules will be invoked only in cases where the loan is not arm's length.

Definition of controlled relationship between lender and borrower

The definition of a "controlled relationship" in Section 23M differs from that used in South Africa's transfer pricing rules. In Section 23M, "control" is established whenever the lender/borrower owns, directly or indirectly, either a 50 percent equity share or 50 percent of voting rights of the borrower/lender. This is a significant increase in threshold from transfer pricing rules, which treat all connected persons as being in a controlling relationship with the company. On the one hand, setting a hard cut-off exposes the system to potential gaming by taxpayers. For example, a lender with 49 percent equity can presumably still exercise substantial control over the borrower. On the other hand, such a clear, objective criterion for implementation of Section 23M should make it easier for SARS to administer.

THE OUTCOME

Section 23M only became effective on 1 January 2015 and it is too early to determine whether or not it is working. However, there are two issues that have the potential to significantly undermine its application.

The first relates to the tax treatment of foreign exchange (FOREX) losses connected to raising finance. A South African company operating in rand and borrowing in another currency, for example US dollars, must buy dollars to pay back the loan. If the rand loses value against the dollar, the company must use more rand to repay the loan, increasing the total loan amount to be repaid. To protect against this scenario, the company may purchase from a broker the right to buy dollars at a specified rate in the future, called a FOREX hedge. To purchase this right, the company has to pay a premium, which for tax purposes is treated as a FOREX loss. Like interest payments, a FOREX loss is part of the cost of borrowing, and is tax deductible. However, in South Africa, unlike interest payments, there is no limit on deduction of FOREX losses, so the cost of borrowing may continue to erode the tax base, undermining the objective of Section 23M. It is for this reason that BEPS Action 4 suggests that interest limitation rules should cover interest on all forms of debt, payments economically equivalent to interest, and expenses incurred in connection with the raising of finance.

The second issue relates to the interpretation of "subject to tax." Section 23M only applies to situations where the lender is not subject to tax in South Africa on interest income earned in the year of assessment. A problem arises when the lender is located in a jurisdiction that has a double taxation agreement with South Africa, allowing companies to be legally "subject to tax" without actually paying taxes. For example, under the United Kingdom-South Africa double taxation agreement of 2003, UK entities lending to related parties in South Africa are legally subject to withholding tax on interest, exempting them from Section 23M. In addition, this particular agreement reduces withholding taxes on interest income to 0 percent and therefore removes all incentives that would prevent abusive use of thin capitalization. This issue is particularly relevant given the dominance of UK-owned mining companies in South Africa.

LESSONS LEARNED

- **Countries should introduce a cap on interest deductions on related party debt.** This approach, in combination with a debt-to-equity ratio and implementation of the arm's length principle, protects the tax base against excessive interest deductions caused by high interest rates, and also offers certainty, clarity, and simplicity of administration for both tax authorities and taxpayers.

- **Economic and political circumstances may require that a fixed ratio be adjusted for inflation, but the fixed percentage recommended by BEPS Action 4 is easier for tax authorities to administer.** South Africa's move to a flexible ratio may have been required in this specific context, but its implementation will be more complicated than a fixed percentage.

- **Interest limitation rules should have legal priority over transfer pricing rules.** A major purpose of interest limitation rules is to reduce reliance on the arm's length principle as a means of controlling the interest rate for related party debt. Transfer pricing rules should only be employed as a complement in the most obvious cases.

- **FOREX losses connected with the raising of finance should be subject to interest limitation rules.** FOREX losses increase the cost of borrowing, reducing taxable income. To comprehensively protect against tax base erosion via related party debt, interest limitation rules should apply to FOREX losses connected to debt finance, all forms of debt, payments equivalent to interest, and finance related expenses.

- **Interest limitation rules should apply to multinationals not practically "subject to tax" on interest income earned in the source country.** A multinational may be legally subject to withholding tax on interest income, but, if the tax rate is zero, it is not actually paying any tax to the source country. In designing interest limitation rules, finance ministries should explicitly state that zero rated withholding tax arrangements with foreign companies do not exempt their domestic affiliates from the limit on interest deductibility.