



## Tax and Legal News



# National Treasury discussion paper on limitation of interest deductions on cross-border debt

### Opening paragraph

National Treasury (NT) issued a discussion paper (the paper) on 26 February 2020 titled 'Reviewing the Tax Treatment of Excessive Debt Financing, Interest Deductions and Other Financial Payments' for public comment. (Click [here](#) to access the document). The public comments were initially due for submission to NT on 17 April 2020, however, due to the impact of COVID-19, NT communicated<sup>[1]</sup> an extension until 30 September 2020 (Click [here](#) for the extension document).

### What the document relates to

In essence, the paper is NT's attempt to limit base erosion and profit shifting (BEPS) in South Africa (SA). BEPS has been a key area of interest for NT and SARS in recent years given the flattish collection of tax revenues and the overall growth rate of the SA economy. Much of the paper is based on an OECD<sup>[2]</sup> report relating to the limitation of base erosion involving interest deductions. It is however evident that NT also considered studies from The Davis Tax Committee (DTC) and The African Tax Administration Forum (ATAF), amongst others.

NT notes that SA has a high corporate income tax rate in relation to the global average (and some of its trading partners) and as such, may be susceptible to a global trend in which taxpayers engage in schemes or arrangements that minimise their tax liabilities by placing the majority of their debt funding in high-tax countries. This is because interest (as a cost of debt) is tax deductible whereas dividends (as a cost of equity) is not.

The OECD performed extensive empirical studies on this subject and ultimately recommended a limitation on the deduction of the net interest expense in terms of a fixed ratio of between 10% and 30% of earnings before interest, tax, depreciation and amortisation (ie tax EBITDA). We understand net interest expense to mean the balance of interest expense after having combined and set off any interest income against the gross interest expense (local and cross-border, however, this has not been clarified). Furthermore, the OECD recommended, as a minimum, applying the aforesaid rule to all entities of a multinational group.

### What has SA proposed implementing?

We note that although SA has interest limitation and tax avoidance provisions (such as those relating to hybrid debt instruments, section 23M of the Income Tax Act, transfer pricing rules and withholding taxes), these are often onerous and very specific.

The paper therefore indicates that government proposes to restrict net interest expense deductions to 30 per cent of tax EBITDA and to apply the proposed legislation to all entities operating in SA that form part of a foreign, or SA multinational group. Furthermore, the paper proposes to repeal section 23M of the Income Tax Act.<sup>[3]</sup> While the paper notes the OECD recommendation to focus on MNE<sup>[4]</sup> groups<sup>[5]</sup> as being rational in terms of which taxpayers the proposed rule should apply, it nevertheless provides that

'Net interest expense in respect of debt from both external and connected persons is included so that any attempts to circumvent the rules with back-to-back loans, for example, are ruled out and there is no need for complex anti-avoidance rules'. This, in our view, is counterintuitive and contrary to the rest of the paper.

A five year carry-forward period in relation to excess non-deductible net interest expense is also proposed, albeit on a FIFO<sup>[6]</sup> basis. Furthermore, government tentatively proposes that a *de minimis* rule be included (of between R2 million and R5 million) in relation to the net interest expense, subject to the proposed legislation. While the *de minimus* rule is welcome, KPMG will be submitting comments to NT in relation to aspects of the paper that may result in unintended consequences.

### Do you have any questions?

We are able to assist you with determining the appropriate tax consequences and preferred approach based on your specific circumstances.

#### Contact us



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Regards  
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#### FOOTNOTES

- [1] On 9 April 2020 and 19 May 2020
- <sup>2</sup> Organisation for Economic Co-operation and Development
- <sup>3</sup> Section 23M limits applies to cross-border interest remitted from SA in relation to connected persons whom have a controlling relationship. In order for section 23M to apply, the interest must've not been subject to in SA.
- <sup>4</sup> The term "MNE Group" means any Group that includes two or more enterprises the tax residence for which is in different jurisdictions, or includes an enterprise that is resident for tax purposes in one jurisdiction and is subject to tax with respect to the business carried out through a permanent establishment in another jurisdiction.
- <sup>5</sup> The term "Group" means a collection of enterprises related through ownership or control such that it is either required to prepare Consolidated Financial Statements for financial reporting purposes under applicable
- <sup>6</sup> First in first out



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