BASE EROSION AND PROFIT SHIFTING: THE EFFECTIVENESS OF IMPOSING FIXED RATIO LIMITATION RULES AS A MEANS OF COMBATTING EXCESSIVE INTEREST DEDUCTIONS

by

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2 ABSTRACT

The erosion of the tax *fiscus* as a result of excessive interest deductions and the shifting of the related profits (interest income) outside of the jurisdiction where such profits are derived, is a worldwide phenomenon impacting both developed and developing nations. Such is the gravity of this practice, that the Organisation for Economic Co-operation and Development (OECD) performed a study on this matter and published recommended best practice methodology and/or rules to combat this practice and consequently assist in protecting the integrity of taxing systems.

In light of the above, the OECD recommended a best practice approach in the form of a fixed ratio rule that must be applied to limit deductions in the form of interest amounts (and other financial payments). This rule may be adopted together with a group ratio limitation rule, and other special supplementary rules consisting of a *de minimis* threshold, the carry forward of disallowed/unused interest, as well as special rules in respect of assessed loss companies, financing instruments with tainted interest components and interest bearing funding utilised for public benefit projects.

The purpose of this study is to ascertain the effectiveness of the imposition of such rules, with a primary focus upon the fixed ratio limitation rule. Moreover, the secondary focus of the study is to ascertain whether the imposition of such a rule positively assists in the limitation of excessive deductions of interest amounts (as supported by the supplementary rules recommended by the OECD). We have excluded from the scope of this study “other financial payments”, and as such have only focused upon interest expenditure amounts.

The study herein also focuses upon the South African tax landscape, and the interplay of the recommended best practice approach with the South African legislative provisions, as currently contained in the tax laws.

3 LIST OF ABBREVIATIONS AND ACRONYMS

Below is a list of abbreviations and acronyms which are cited in this document.

ATAF	African Tax Administration Forum
BEPS	Base Erosion and Profit Shifting
CFC	Controlled Foreign Company
CIT	Corporate Income Tax
DTA	Double Taxation Agreement
DWT	Dividend Withholding Tax
EBITDA	Earnings before Interest, Tax, Depreciation and Amortisation
G20	An international forum for the governments and central bank governors from 19 countries and the European Union (EU), which includes South Africa.
IWT	Interest Withholding Tax
MNEs	Multinational Enterprises
National Treasury	The National Treasury of the Republic of South Africa
OECD	Organisation for Economic Co-operation and Development
SARS	South African Revenue Services
UN	United Nations

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INTRODUCTION AND BACKGROUND

1 INTRODUCTION AND BACKGROUND

1.1. OVERVIEW

In an attempt to respond to challenges associated with base erosion and profit shifting (BEPS), the OECD in 2013 launched the so-called “BEPS Action Plan” project (OECD, 2013). The BEPS Action Plan arose as a result of a call by the G20 finance ministers on the OECD “… to develop an action plan to address BEPS issues in a co-ordinated and comprehensive manner. This Action Plan [was to] specifically provide countries with domestic and international instruments that would better align rights to tax with economic activity…” (OECD, 2013:11).

The purpose of the BEPS Action Plan was to address the concerns associated with a global tax system which permits taxpayers (in particular, multinational enterprises (MNES)) to extract profits from countries where the economic activities are derived and employed, whilst escaping the ambit of the tax net of those countries. This purpose is succinctly described in the OECD’s initial press statement where it is noted that the BEPS Action Plan was set to address concerns with respect to matters which “…erode the tax base of many countries and threaten the stability of the international tax system…” (OECD, 2013).

The Minister of Finance of the Republic of South Africa in his 2013 National Budget Speech noted that “…The Budget Review outlines various measures proposed to protect the tax base and limit the scope for tax leakage and avoidance….” (Ministry of Finance, 2013:21). In 2013, the National Treasury of the South African Government (hereinafter referred to as National Treasury), issued a media statement, in which it noted excessive interest deductions as one of the more significant forms of base erosion in South Africa, and also outlined the proposed introduction of measures to limit the scope of tax leakage arising from such base erosion (National Treasury, 2013:3-4).

It therefore came as no surprise that the OECD in its final reports relating to the BEPS Action Plan project, listed excessive interest payment deductions as an area which needs further consideration (OECD, 2015:15). In this regard in 2015, the OECD published an action report, the Final BEPS Action Plan 4 Report, which sets out best practice recommendations for the mitigation of BEPS as a result of excessive interest deductions (also colloquially referred to as “BEPS Action Plan 4”). The OECD recommends that countries apply a fixed ratio that will limit the interest expense claimable as a deduction in terms of a ratio based upon earnings before interest, tax, depreciation and amortisation (EBITDA) within a fixed benchmark corridor of approximately 10% to 30%. This fixed ratio limitation rule may be supported by recommended supplementary rules such as the group ratio limitation rule, the *de minimis* rule and other specific exclusions (OECD, 2015:15).

In order to adequately address the concerns related to excessive interest payment deductions and the application of recommendations in the Final BEPS Action 4 Report, one must have an appreciation and understanding of the concept of “interest”. In addition, one must further having an understanding of the tax consequences attendant upon such amounts and consequently the adverse impact of any excessive interest deductions upon taxing systems.

From a South African tax perspective, the term “interest” is defined in section 24J(1) of the Income Tax Act No (58/1962) (hereinafter referred to as the Income Tax Act) to, *inter alia*, include the “…gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement...”. This definition does not deviate substantially from the commercial definition of interest, which can be construed to mean “… compensation for the use of money…”, although commercially it may take different forms (Brincker, 2011: V-3).

In terms of South Africa’s income tax law, interest expenditure incurred in respect of a productive purpose will qualify for a deduction in the computation of a taxpayer’s taxable income. That is, the amount of interest expenditure allowable as a deduction may be applied as a reduction to the income against which a tax liability may be determined (section 24J(2) of the Income Tax Act).

This is because the provisions of section 24J(2) of the Income Tax Act dictate that in order for an amount of interest to qualify for deduction, such amount must have been incurred in the production of income, for a productive purpose. In the case of *CIR v Standard Bank SA Ltd,* 1985 (4) SA 485 (A) (47 SATC 179), the courts held in determining the deductibility of interest on borrowed money, the enquiry relates primarily to the purpose for which the money was borrowed. Where a taxpayer's purpose in borrowing money at interest was to obtain the means of earning taxable income, the interest paid upon the money so borrowed is *prima facie* expenditure incurred in the production of that taxable income. If, on the other hand, the purpose of the borrowing was for some other purpose than obtaining the means of earning taxable income (for example to acquire shares), the interest is not deductible.

The enquiry in terms of the study conducted herein is that if interest deductions are related to a productive purpose in relation to which income is earned, is there a valid economic concern regarding the excessiveness of the quantum claimable as a deduction? Excessive interest deductions give rise to a fiscal tax revenue/collection gap in circumstances where funds obtained in the form of debt and/or financial arrangements with an attendant interest cost are utilised for the derivation of gains/interest income which is not taxable in the same state (OECD, 2015:15). Put differently, the gains/interest income are subject to tax at a lower rate, giving rise to a mismatch in the tax relief provided (in the form of the amount available for deduction in the tax computation) versus the tax which would have been collected had the gains (interest income) been subject to tax in the jurisdiction in which the economic activities arose. Excessive interest deductions give rise to a "fiscal tax gap" arising as a result of the mismatch in the taxation of the interest income component versus the relief (deduction) in respect of the interest expense component; resulting in an erosion of the tax *fiscus* / reduction of the tax bill (Møen, Schindler, Schjelderup and Tropina, 2011:3,17).

The OECD lists the most widely known scenario(s) giving rise to excessive interest deductions in respect of funding arrangements as those which involve MNEs within the same group, where the interest income flow is payable to a party in a low tax paying jurisdiction; whilst the corresponding interest deduction arises in the hands of the party which is resident in a high tax paying jurisdiction (OECD, 2015:19).

In addition, excessive interest deductions may also arise by virtue of tax planning mechanisms which circumvent or abuse anti-avoidance measures relating to:

(i) arm's length pricing of debt, which typically relates to funding arrangements, where the rate of interest or the terms thereof are not concluded on an arm's length basis, merely for purposes of inflating interest deductions in order to obtain a tax 'benefit' (pricing of debt concluded outside of the terms one would expect between an independent willing creditor and debtor) (OECD, 2015:19),
(ii) measures dealing with hybrid debt instruments, thus debt/financing arrangements with equity like features (OECD, 2015:19), and
(iii) the imposition of withholding taxes in respect of beneficial taxpayers that are tax resident in zero or low rate jurisdictions (OECD, 2015:19).

The abuse of efficient tax planning measures generally comes about because commercially, funding arrangements structured as debt with deductible interest payments are more economically viable from a tax perspective than equity funding, which gives rise to non-deductible dividend payments (Schjelderup, 2016:109). The consequence of this is that (undue) tax benefits in the form of excessive interest deductions may be obtained, leading to an erosion of the tax *fiscus*.

The Final BEPS Action Plan 4 Report reviewed the effectiveness of various of anti-abuse measures utilised to curtail excessive interest deductions, which *inter alia* included but is not limited to pertaining to (i) arm's length pricing of debt, (ii) hybrid debt instruments and interest arrangements and (iii) the imposition of withholding taxes in curtailing excessive interest deductions; and further the review extended to the analysis of the effectiveness of a fixed ratio limitation rule, group ratio limitation rule, specific anti-avoidance rules in respect of specific transactions (for example, assessed loss companies and/or public benefit companies) and specifically a *de minimis* threshold rule (OECD, 2015:19-21). In summary, the Final BEPS Action Plan 4 Report dictates that the fixed ratio limitation rule constitutes the best practice approach.

It is important to note that the analysis of the Final BEPS Action 4 Report pertaining to issues of excessive interest deductions was conducted with reference to transaction groups/types listed as high risk areas in the derivation and abuse of excessive interest deductions. These transaction groups/types include, *inter alia*, the following:

- high levels of third party debt being procured and utilised in entities within the group which are situated in high tax paying countries (OECD, 2015:11),
- the implementation of intra-group loan funding arrangements which allow for the generation of interest payment deductions in excess of the group's overall third party interest expenditure (OECD, 2015:11), and
- the procurement of funding for the production of non-taxable (tax exempt) income (OECD, 2015:11).

In South Africa, various anti-avoidance provisions have been adopted in combatting excessive interest deductions. These include:

- the transfer pricing and thin capitalisation rules in section 31 of the Income Tax Act,
- rules which are aimed at curtailing funding arrangements whose economic substance and related yield result in a mismatch between the economic benefit derived versus the tax cost which should have been realised as a result of such transaction, being the so-called ”hybrid instrument” and ”hybrid interest” rules (section 8F and section 8FA of the Income Tax Act),
- a withholding tax upon interest regime to not only expand the tax collection base to non-resident benefactors of income derived in the Republic, but also to bring within the tax net the revenue yield generated in the Republic (section 50A to section 50H of Part IVB of the Income Tax Act),
- limitation rules in respect of debts owed to persons not subject to tax (section 23M of the Income Tax Act), and
- limitation rules in respect of certain re-organisation and acquisition transactions (section 23N of the Income Tax Act).

Overall the purpose of the above specific anti-avoidance legislation was to strengthen tax policy and consequentially protect the integrity of the South African tax system, in respect of specific investment and funding structures or arrangements. However, the effectiveness of the introduction of these rules still remains a question for consideration. This question remains partly due to the fact that the scope of these rules serves as targeted anti-avoidance measures in respect of only specific transactions, as contemplated in each legislated section. As a result, the rules would only cover specific aspects and not all transactions which may lead to excessive interest deductions.

Albeit that South Africa is not a member country of the OECD, the OECD Council at ministerial level through its adoption of "…[the Council resolution on enlargement and enhanced engagement] led to South Africa's becoming one of five Key Partners to the OECD…" (OECD, 2007). The adoption of a such a resolution evidences that South Africa, in the development and review of its tax policies, recognises the importance of considering the measures recommended by the OECD in addressing BEPS, as it relates to excessive interest deductions (Davis Tax Committee, 2016: Annexure 4,1). The OECD has recommended the adoption of a fixed ratio limitation rule, in the determination of interest expenditure amounts eligible for deduction. The recommended fixed ratio limitation rule, which constitutes the primary best practice recommendation, will be measured as a fixed percentage of EBITDA (OECD, 2015:25). As part of the OECD's Final BEPS Action Plan 4 Report, the introduction of a fixed ratio limitation rule is to be adopted together and/or in combination with a group ratio limitation (EBITDA percentage) rule which will cater for scenarios where, if an entity exceeds the allowable fixed ratio, then a percentage of any excess interest may qualify for deduction. This is based upon the group's (same economic group) third party net interest expense or a percentage of the group's EBITDA; subject further to other supplementary rules such as the *de minimis* threshold rule and specific exclusion rules.

1.2. PROBLEM STATEMENT

Considering that South Africa already has various anti-avoidance provisions to deal with excessive interest deductions, the question is whether the adoption of the OECD's recommendation will be more effective in combatting excessive interest deductions in a developing state such as South Africa.

It therefore follows that the introduction of a fixed ratio limitation rule (together and/or in combination with a group ratio limitation rule), must be considered in the context of South

Africa's tax landscape and the objectives of its tax policy. It is important to bear in mind that the consideration of such a rule in the context of the South African landscape is that tax policy must not be considered outside of the potential commercial and economic impact the introduction of such rules may have. For instance, the Davis Tax Committee's Final Report on BEPS in South Africa notes the following as a cause for consideration, originally extracted from the OECD's (initial) BEPS Action Plan 4 Report of 2013 at 16:

"… From a policy perspective, failure to tackle excessive interest payments to associated enterprises gives multinational enterprises an advantage over purely domestic businesses that are unable to gain such tax advantage..." (Davis Tax Committee, 2016: Annexure 4,9).

Therefore the need to address BEPS in respect of excessive interest deductions is not just a matter relating to the protection of the integrity of the tax base. It is important in determining and identifying the feasibility of the approach adopted in the assessment of whether it adequately addresses additional underlying issues which include the economic participation of domestic businesses (versus the participation of MNEs with access to "preferential" tax planning mechanisms in respect of debt instruments). Typically, debt within the same economic group ("internal debt") has been construed to carry preferential costs and benefits, as opposed to external debt. In certain instances, "internal debt" is akin to "equity" and as such will represent a cheaper form of funding (Schjelderup, 2016:112).

National Treasury has released explanatory memoranda setting out the ambit, intention and purpose of the transfer pricing and thin capitalisation provisions, interest withholding tax regime, limitation on deductibility of interest legislation and legislation related to hybrid instruments and hybrid interest rules, which are the current and existing legislative anti-avoidance measures (National Treasury, 2010 & National Treasury, 2013). National Treasury is yet to provide feedback upon the effectiveness of the legislative measures as a means of achieving the intended purpose.

The significance of the above is that the introduction of the fixed ratio limitation rule (as appropriately supported by the group ratio limitation rule and other supplementary rules) cannot be considered in isolation. This is because the concerns in relation to the OECD recommenced rules are in themselves exacerbated by the concerns noted in respect of already existing anti-avoidance measures, as relevant to the country in question.

Thus one needs to ask the question: will the proposed recommendation of a fixed ratio limitation rule (as appropriately supported by the group ratio limitation rule and other supplementary rules) assist with the combatting of BEPS, or will the introduction of this proposed measure create additional unintended complexities and increase the taxpayers' burden in respect of tax positions taken; and as a result, undermine the tax policy framework objectives. Alternatively, will the introduction of the recommended fixed ratio limitation rule strengthen current tax policy whilst also streamlining current legislation, for example the streamlining of the current interest limitation rules (removal of unintended duplications), and combination of the rules resulting in a targeted focus of the specific anti-avoidance measures adopted.

1.3. RESEARCH QUESTION

Given the concern regarding the potential undermining of the integrity of the global tax system (as well as the tax system of South Africa) as a result of BEPS; the elements contributing to the erosion of the *fiscus* need to be appropriately and effectively addressed (OECD, 2015:20).

To this end, the research question that is addressed herein can be summarised as follows:

- Can it be reasonably construed that the imposition of a fixed ratio limitation rule, measured with reference to an entity (taxpayer's) EBITDA, constitutes an effective instrument in managing the impact of the deductibility of excessive interest upon the tax *fiscus*? If not, would the adoption of the OECD supplementary action points such as the *de minimis* threshold, or specific rules relating to for example the carry forward of disallowed interest or specific exclusion rules, aid the achievement of the desired effectiveness?

1.4. PURPOSE OF THE STUDY

In order to appropriately respond to the research question, it is important that the intended purpose of the study is clearly understood. Of particular importance is that the results of the study should provide a body of literature which positively contributes to the reform of tax policy as it relates to excessive interest deductions.

As already articulated in the discussion above, BEPS has an adverse impact not only upon revenue collections, but it also undermines tax policy. Lower revenue collections lead to poor economic growth and development as a result of a lack of government funds. In my view, where tax policy is undermined, the acceleration and sustainable development of fiscal policies is generally inadequately supported, making it more susceptible to BEPS risks.

In the instance where the excessive interest deduction concerns remain unresolved, then the erosion of the South African tax *fiscus* will continue to remain a concern. The Minister of Finance of the Republic of South Africa in his 2019 National Budget Speech stated the following "… There are no quick fixes. But our nation is ready for renewal. We are ready to plant the seeds of our future ..." (Ministry of Finance, 2019). In my view, strong tax policy will strengthen South Africa's tax system, and consequentially positively impact economic and fiscal developments. It is therefore only fitting that tax policies in relation to funding arrangements be strengthened as part of our road to renewal.

In this regard, this study embarks on the following:

- the identification of the current interest limitation rules from a domestic corporate income tax perspective,
- broad assessment of the advantages and disadvantages of the abovementioned rules, as well as
- an analysis of recommendations of the Davis Tax Committee to determine the effectiveness of South Africa's interest limitation rules in the context of the OECD's recommendations under the BEPS Final Action 4 Report; supported by a brief overview

of the African Tax Administration Forum's outlook on interest deductibility legislation following on from the OECD's recommendations.

In light of the above, the purpose of this study is to discuss the effectiveness of the imposition of the fixed ratio limitation rule as a primary means of combatting excessive interest deduction (together and/or combined with a group ratio limitation rule, supplemented by a *de minimis* threshold rule and other specific rules or exclusions); and to determine whether is it an effective tool in shielding the tax system from being undermined due to and as a consequence of BEPS.

1.5. STRUCTURE OF THE STUDY

Section 1 of this dissertation provides an introduction to the topic, the research problem, the research question and the purpose of the study, namely the consideration as to whether the BEPS recommendations would be effective in combatting excessive interest deductions. In summary, this section provides an overview of the research objectives and methodology adopted for purposes of the study.

Section 2 addresses the legislation in respect of limitations to interest deductions and/or the impact of the tax treatment of interest (in particular excessive interest deductions). Section 3 deals with the analysis of the recommendations detailed in the Final BEPS Action Plan 4 Report, in respect of excessive interest deductions and the recommendations specifically set out therein, underpinned by a discussion on the viability thereof from an African (as well as a South African) perspective.

Section 4 is a summary of findings and a conclusion, with regard to the reasonableness of adopting a fixed ratio limitation rule (together and/or in combination with a group ratio rule, supported by a *de minimis* threshold and specific supplementary exclusion rules) as an effective means of combatting excessive interest deductions in South Africa.

1.6. SCOPE OF STUDY

The scope of the study primarily focuses upon the research topic (the effectiveness of the fixed ratio limitation rule upon interest deductions, supported by various supplementary rules), and extends to the tax and underlying economic principles (where appropriate) relating to the research question.

Considerations in respect of indirect taxes, accounting considerations, regulatory requirements, and financial and investment features are excluded from the scope of the study.

Finally, it is important to state that a detailed exposition of the legislation affecting excessive interest deductions such as transfer pricing and thin capitalisation rules in respect of hybrid interest or hybrid instruments, and specific interest limitation rules, are not the main focus of the study. The discussion of these provisions will only be for the sole purpose of highlighting the effectiveness of these provisions in curtailing excessive interest deductions.

1.7. METHODOLOGY

The research methodology undertaken in the study is a qualitative literature review of applicable tax legislation, OECD reports on the matters discussed, as well as relevant journal articles in both hardcopy and online form.

Onwuegbuzie, Leech and Collins (2012:2) define a literature review as follows: "…A literature review is a written document that presents a logically argued case founded upon a comprehensive understanding of the current state of knowledge about a topic of study. This case establishes a convincing thesis to answer the study's question…".

Practically, the literature review for purposes of this study was undertaken through the identification of a research topic and the problem statement (area of enquiry). Upon the identification of the research topic, information was gathered from various primary and secondary sources (guided by specific terms when searching for relevant data). Rabianski (2003) contends that secondary data includes "…information from secondary sources i.e.

not directly compiled by the analyst, which may include published and unpublished work based upon research that relies upon primary sources of any material other than primary ones, used to prepare a written book…".The information gathered helped to formulate the subject of the review and the analysis in the dissertation.

In order to ensure that only documents of relevance were obtained and retained for purposes of the research, each primary and secondary source was perused to ensure that it contained literature which was relevant to the research topic and addressed the tax and economic principles relating to the research question. For the sake of completeness, we note that excluded from the scope of the academic literature sample selected was secondary information data sources/documents, which related to the financial aspects or specific granular economic aspects of the subject matter, as such as for example, literature focusing upon financing structure mechanisms which lead to interest deductions, unless such document was required for purposes of understanding any underlying terms related to the sample selected.

All the documentation perused and/or reviewed as part of the research is listed in the reference list at the end of the study.

CURRENT SOUTH AFRICA ANTI-AVOIDANCE LEGISLATIVE RULES IN RESPECT OF INTEREST DEDUCTIONS

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2 CURRENT SOUTH AFRICAN ANTI-AVOIDANCE LEGISLATIVE RULES

2.1. INTRODUCTION

Oguttu (2016:131) in Part Two of a paper discussing Africa's response to challenges imposed by BEPS, indicates that base erosion arising as a result of excessive interest deductions is one of the priority challenges facing African developing states from a tax perspective.

The United Nations ("UN") in its 2019 World Economic Situation and Prospectus Report lists the Republic of South Africa as a developing country (United Nations, 2019:). As such, and following on from the concessions noted by Oguttu as set out immediately above, base erosion as a consequence of excessive interest deductions in respect of financing transactions, is by implication an area of challenge for South Africa. This challenge is also conceded by the ATAF in its 2016 outlook publication, where it notes the following with regard to the measures undertaken by South Africa in relation to corporate income tax systems undermined by BEPS:

"… South Africa has taken several measures to check BEPS and ensure high tax productivity of [Corporate Income Tax ("CIT")]. The policy principles are based upon the taxation of the source company and **allow the ring-fencing of deductions in certain circumstances**. It **focuses the taxation of corporate profit** upon worldwide income and **transfer pricing**, especially in services, to ensure higher effective tax rates…" our emphasis (ATAF, 2016:92).

Excessive interest deductions therefore pose a real threat to the South African taxing system.

The discussion below sets out an overview of the tax treatment of interest from a South African tax perspective and specific anti-avoidance measures prescribed as part of the income tax rules/laws of the Republic. This discussion extends to comments upon the challenges arising in respect of each specific targeted or anti-avoidance measure, as well as the relevance thereof to the current research question.

2.2. TAXATION OF INTEREST IN SOUTH AFRICA

Interest (and similar finance charges) are deductible in terms of section 24J of the Income Tax Act. In determining the deductibility of interest upon borrowed money, the enquiry relates primarily to the purpose for which the money was borrowed (*CIR v Standard Bank SA Ltd,* supra). Legislatively, interest incurred in the production of income will be deductible in the computation of a taxpayer's taxable income (section 24J(2) of the Income Tax Act).

Section 24J(2) of the Income Tax Act provides that:

"… where any person is the issuer [borrower] in relation to an instrument [such as an interest bearing loan] during any year of assessment, such person shall for the purposes of [the Income Tax Act] be deemed to have incurred an amount of interest during such year of assessment, which is equal to … [and] which **must be deducted from the income** of that person derived from carrying on any trade, if that amount is incurred in the production of the income…" (own emphasis).

An instrument is defined in section 24J(1) of the Income Tax Act to include any interest bearing arrangement or debt, any acquisition or disposal of any right to receive interest or the obligation to pay any interest in terms of any interest bearing arrangement, specific repurchase agreement or resale agreement (excluding certain lease agreements). The provisions of section 24J therefore extend to amounts of interest in respect of a spectrum of widely defined funding arrangements.

The effect of the provisions of section 24J of the Income Tax Act, in my view, is that of a taxing section. Historically, the provisions of section 24J of the Income Tax Act had regard, in the case of interest deductibility, to the general deduction provisions in sections 11(a), read together with section 23(g) of the Income Tax Act. What is important to note with regard to the requirements of the taxing provisions of section 24J of the Income Tax Act, is the use of the word "must" by the legislator, which signifies the affirmation of a deduction if "… the amount is incurred in the production of income…" (section 24J(2) of the Income Tax Act).

The "in the production of income" requirement is an important requirement, in that it assists in the determination or otherwise of the deductibility of an amount of interest. This requirement has been the subject of many judicial decisions. The general principle laid down by our courts is that expenditure that is so closely connected with the taxpayer's business that it can be regarded as part of the cost of performing it, is usually regarded to be incurred in the production of income (*Port Elizabeth Electric Tramway Co Ltd v CIR,* 1936 CPD 241 (8 SATC 13)).

It is important to point out that, whilst a general rule has been established, there is no single rule governing whether expenditure is incurred in the production of income. The courts establish the facts of a case based upon the strength of the evidence presented. In doing so, courts take a number of factors into account, including commercial expediency and the taxpayer's particular trade, in establishing a link, based upon the facts between expenditure and the income it is intended to produce (*Port Elizabeth Electric Tramway Co Ltd v CIR,* supra).

In the case of *CIR v Allied Building Society* 1963 AD (4) SA 1 (A) (25 SATC 343), the court rejected the view that the true criterion of deductibility was not the purpose for which the society borrowed the funds in issue, but the actual use to which it put the borrowed moneys. Expanding upon the above principal laid down by the court, it is submitted that a court can and should look through the actual use of funds, and acknowledge the ultimate purpose of the funds. It is therefore imperative that a taxpayer can discharge the onus of proof regarding the ultimate purpose of the funding (section 102(1)(b) of the Tax Administration Act No. 28 of 2011, hereinafter referred to as the Tax Administration Act). It is this principle, which in my view raises concerns regarding the general applicability of section 24J and its impact upon “tax planning structures”, giving rise to BEPS.

Put differently, the provisions of section 24J dictate to a taxpayer the manner in which it should treat interest expenditure incurred and arising from a financing instrument in the computation of taxable income. Section 24J also dictates the manner in which the deductible interest expenditure should be quantified, in the circumstances where the criteria in section 24J are met. However, the ambit of the provisions of section 24J do not look further to determine whether the allowable interest deductions are within the scope and measure of the tax *fiscus*. That is, the provisions of section 24J do not provide a further test in determining whether the use of funds, albeit in a productive manner, generate an income stream which falls outside the ambit of the South African tax *fiscus* (productive use of funds which escapes the South African tax net).

It is to this end that South Africa enacted various anti-avoidance measures pertaining to excessive interest deductions. The effectiveness of these measures needs to be scrutinised against their intended policy objectives and measured against global recommendations (the Final BEPS Action Plan 4 Report recommendations published by the OECD).

2.3. CRITICAL ANALYSIS OF THE SPECIFIC SOUTH AFRICAN ANTI-AVOIDANCE RULES IN THE CONTEXT OF THE BEPS RECOMMENDATIONS

2.3.1. ARM’S LENGTH PRICING OF DEBT

The arm’s length pricing of debt from a South African tax perspective is subject to transfer pricing rules which currently extend to a thin capitalisation test. In the context of excessive interest, transfer pricing refers to the arm’s length pricing of debt, namely the pricing of the interest rate applicable to a debt/finance instrument based upon an independent borrower and an independent lender (section 31 of the Income Tax Act). Conversely, thin capitalisation relates to the evaluation of the level of debt within an entity, as compared to its equity as a means of regularising the level of deductible interest, also subject to the arm’s length principle in terms of South African tax law (section 31 of the Income Tax Act).

The purpose of the transfer pricing and thin capitalisation rules is to ensure that related parties transact on an arm's length basis with regard to cross-border transactions, particularly so as to not inflate profits in low tax jurisdictions. This is because it is common that high levels of debt, priced incorrectly and not aligned to exchange control requirements, may lead to an erosion of the *fiscus*.

The South African transfer pricing legislation was introduced in 1995 by section 31 of the Income Tax Act. In August 1999, the South African Revenue Services ("SARS") issued Practice Note Number 7 entitled "Determination of the taxable income of certain persons from international transactions: Transfer Pricing" dated 6 August 1999 (hereinafter referred to as "Practice Note 7"). The guidance in Practice Note 7 is primarily based upon the OECD Transfer Pricing Guidelines of 1995 (paragraph 3.2.1 of Practice Note 7).

In its current form, the existing transfer pricing legislation is such that the burden of proof in ensuring that cross-border related transactions (transactions between a resident tax person and non-resident tax person) are concluded based upon arm's length terms, and rests with the taxpayer (section 31 of the Income Tax Act read with section 102 of the Tax Administration Act). In circumstances where it can be evidenced that such cross-border transactions were concluded outside of the arm's length terms, certain adjustments will apply (as explained further ahead).

In a time where the exchange of information is on the rise and countries are required to provide key financial information per jurisdiction, it is imperative to note that SARS does not necessarily accept that a transfer pricing review undertaken in a foreign jurisdiction, for example in the United States of America or in Europe, implies that the transfer pricing automatically complies with South African transfer pricing rules. The reality is that those jurisdictions would not insist on pricing adjustments made in favour of their taxpayers. Therefore, the specific facts and circumstances applicable to the local entity need to be reviewed in light of South African tax legislation.

Similar to the transfer pricing regime, the primary guidance to the thin capitalisation requirements of South African companies prior to 1 April 2012 was section 31(3) of the Income Tax Act, read with SARS Practice Note No. 2, entitled "Determination of taxable income where financial assistance has been granted by a non-resident of the Republic to a resident of the Republic", dated 14 May 1996 (hereinafter referred to as "Practice Note 2"). In essence, Practice Note 2 provided a safe harbour debt to equity ratio of 3:1, which applied to limit the deductibility of interest upon excessive debt (paragraph 4 of Practice Note 2).

The provisions of section 31 were substantially amended with effect from 1 April 2012, with the effect that the safe harbour rule is no longer applicable. The amended provisions evaluate the thin capitalisation levels of an entity, based upon an arm's length test, encompassed as part of the transfer pricing regulations (section 31(5) to 31(7) of the Income Tax Act). In this regard, the guidelines in Practice Note 2 would no longer be relevant in the evaluation of the thin capitalisation position of an entity. In this regard, on 05 August 2019, SARS withdrew Practice Note 2 with effect from years of assessment commencing on 1 April 2012 (being the effective date of the amended legislative provisions of section 31of the Income Tax Act).

In an attempt to provide guidance upon the amended legislative provisions of section 31, SARS released a Draft Interpretation Note (SARS Draft Interpretation Note: Determination of Taxable Income of Certain Persons from International Transactions – Thin Capitalisation initially uploaded on SARS website on 03 April 2013), to replace Practice Note 2. The Draft Interpretation Note specifies high level guidance upon the methodology that SARS will follow when assessing and/or evaluating the thin capitalisation position of taxpayers (paragraph 7 of the Draft Interpretation Note at page 11). The methodology provided in the draft interpretation note focuses upon two main areas:

- the arm's length nature of the terms and conditions of the loans from connected persons, including the interest rates charged (paragraph 7.1 of the Draft Interpretation Note at page 11); and
- the debt capacity of the taxpayer, that is the level of finance which the borrower could have secured under the same terms and conditions had the borrower (the local company) and the lender (the foreign company) been independent parties dealing at arm's length, and whether as a result of the transaction a tax benefit is derived by the

parties to the transaction (paragraph 7.1 read with paragraph 7.2 of the Draft Interpretation Note at page 11 - 12).

In the instance where a taxpayer has excess connected party debt, which would not have been otherwise obtained from third party lenders at that rate; then the inherent excess interest (excess interest, including other finance expenses and other considerations payable for or in relation to or on that portion of the related non-arm's length debt) payable in respect of that debt, will not be allowed as a deduction for tax purposes (section 31(2) of the Income Tax Act). As a result, the taxable income of the affected taxpayer must be re-calculated to reflect its arm's length debt capacity (section 31(2) of the Income Tax Act). This is also referred to in the Draft Interpretation Note as the "primary adjustment" (paragraph 6.1 of the Draft Interpretation Note).

In addition to this primary adjustment, the excess interest incurred by a taxpayer would, in the case of a company, be considered to be a "…dividend consisting of a distribution of an asset *in specie* declared and paid by that resident to that other person, … on the last day of the period of six months following the end of the year of assessment in respect of which that adjustment is made …" (section 31(3)(i) of the Income Tax Act). This is what is most commonly referred to as the secondary adjustment. The significance of a dividend *in specie*, is that the resident company would suffer the dividend withholding tax ("DWT") charge in respect of such amount (section 64EA(b) of the Income Tax Act); thereby giving rise to an additional layer of tax cost for the resident company. The aforementioned secondary adjustment only extends to corporate entities, as in the instance of natural person (individual taxpayers) the secondary adjustment takes the form of a donation for which the donor would be liable for donations tax (section 31(3)(ii) of the Income Tax Act).

The effect of the transfer pricing and thin capitalisation provisions as contained in section 31 of the Income Tax Act, is that the evaluation of the level of debt and the pricing of the debt are tested separately. The Davis Tax Committee concedes that albeit these tests should continue to apply separately in respect of the pricing of debt, these tests are not effective and should not be utilised as a tool for evaluating excessive interest deductions that undermine the integrity of the tax *fiscus* (Davis Tax Committee, 2016: Annexure 4,2). This point is expanded upon by Oguttu (2016), who confirms that the transfer pricing and thin capitalisation provisions are effective in recognising that different levels of interest may apply based upon a company's circumstances. However, these need to be applied together with the fixed ratio and group ratio (limitation) rules recommended by the OECD (Oguttu, 2016:137). This point is expanded upon later in this document.

From the above, it is clear that the application of the thin capitalisation and transfer pricing provisions are intended to constitute a fiscal measure that regulates the tax position of investor funding. However, it can be ineffective because it fails to recognise different debt structures or funding mechanisms, particularly in the instance of group debt, where the terms applicable to debt instruments issued in a group context may re-characterise the instruments to an equity like features to justify excessive interest costs (Davis Tax Committee, 2016: Annexure 4,11). Moreover, the arm's length principle associated with the evaluation of transfer pricing and thin capitalisation provisions does not prevent taxpayers from claiming interest expenditure relating to funds utilised to fund underlying tax exempt investments (Davis Tax Committee, 2016: Annexure 4,12).

In this regard, tax authorities and policy makers (extending to both SARS in its capacity as the national tax authority and National Treasury in its capacity as policy maker) need to consider different ways in which to curb BEPS as a result of excessive interest deductions.

2.3.2. HYBRID INTEREST AND INSTRUMENT RULES

The 2013 Taxation Laws Amendment Act introduced provisions targeting interest bearing arrangements which contain features normally associated with equity instruments (section 8F and section 8FA of the Income Tax Act).

These sections have the effect of re-characterising interest to a non-deductible dividend in the hands of both the debtor and the creditor. The effect of the re-characterisation rules is that from a tax perspective, the treatment of the instrument is aligned to the substance of the transaction (equity), as opposed to its form (debt) (section 8F and section 8FA of the Income Tax Act).

In making these rules, it is understood that the features distinguishing debt from equity are varied and are often contextual. National Treasury in the Explanatory Memorandum to the 2013 Taxation Laws Amendment Act states that the intention of the provisions was aimed at companies that "… issue debt instruments so as to artificially generate interest deductions if clear cut equity features exist when viewed in isolation…" (National Treasury, 2013).

Interest bearing arrangements will fall within the ambit of section 8F if any one of the following broad circumstances are applicable ("tainted instruments"):

- the debtor is entitled to or obliged to settle the debt through the issue of or delivery of shares, unless the market value of the shares is equal to the amount owed in terms of the debt, on the date that the shares are issued or exchanged in settlement of the debt (paragraph (a) of the definition of instrument in section 8F(1) of the Income Tax Act),
- the interest bearing arrangement contains terms which provide that the obligation to pay any amount under that arrangement is conditional upon the market value of the assets of the debtor not being less than the market value of the liabilities of that debtor, that is the payment of interest amounts is dependent upon the solvency and liquidity (paragraph (b) of the definition of instrument in section 8F(1) of the Income Tax Act), **or**
- the interest bearing arrangement has a term of 30 years or longer and the parties are connected persons, excluding instruments payable upon demand (paragraph (c) of the definition of instrument in section 8F(1) of the Income Tax Act).

In the instance where any of the above requirements is met, the effect of section 8F is that any interest incurred in relation to a hybrid debt instrument will be re-characterised to a dividend in the hands of both debtor and creditor, and will be deemed to be a dividend *in specie* that accrues to the creditor on the last day of the debtor's year of assessment and will not be deductible (section 8F(2) of the Income Tax Act).

Contemporaneously with the introduction of section 8F, the 2013 Taxation Laws Amendment Act also introduced section 8FA, which regulates the tax treatment of "hybrid interest". Like section 8F, section 8FA re-characterises interest incurred to a dividend *in* *specie* in the hands of both debtor and creditor (applicable in respect of interest amounts incurred on or after 1 April 2014). Section 8FA will be triggered if:

- the interest on an instrument is not determined with reference to a specified interest rate or with reference to the time value of money (paragraph (a) of the definition of hybrid interest in section 8FA(1) of the Income Tax Act); or
- the interest rate increases as a result of an increase in the profits of the debtor (paragraph (b) of the definition of hybrid interest in section 8FA(1) of the Income Tax Act).

In the first instance, the entire return upon the instrument will be treated as a dividend. However, where the only tainting factor is the existence of a term of the instrument providing an equity like position or equity like features (instrument as contemplated in section 8F), it is only the additional interest charged as a result of the increased profits which will be re-characterised.

Upon interpretation of the provisions, the effect of section 8F and section 8FA is that any "interest" arising from arrangements with equity features is effectively removed from the normal income tax ("non-qualifying interest" or "tainted interest"). In this regard, the hybrid debt instrument (section 8F of the Income Tax Act) and hybrid interest (section 8FA of the Income Tax Act) rules exclude from the ambit of the tax net non-qualifying or tainted interest. In my view, these measures serve as an aiding tool in ensuring that excessive deductions are only determined with reference to arrangements where the interest payments would qualify for deduction for tax purposes.

Oguttu (2016:137) indirectly notes that BEPS must be considered in the context of "… intra-group debt with equity like features justifying interest payments…". Although the focus of the requirements of section 8F and 8FA is not in respect of intra-group debt, the provisions do focus upon instruments where the terms of payment (return) are linked to equity like features. This may give rise to certain concerns, that the hybrid equity and hybrid interest rules could be construed as "… [complicating] the rules relating to cross-border debt and could discourage foreign investment, especially for investors who are not involved in such sophisticated schemes…" (Oguttu, 2016:141); as a result of the focus extending to beyond intra-group transactions.

Furthermore, it has been raised that these sections are effective in the prevention of excessive interest deductions as they relate to inbound transactions (and not outbound transactions), thus skewing the scope of effectiveness in respect of only the inbound leg of transactions. Consequently, the provisions do not take into account the impact of double taxation treaty conventions, which may give rise to BEPS leakage (Davis Tax Committee, 2016: Annexure 4,4). It is therefore important that the tax authorities and policy makers consider different ways in which to curb the underlying BEPS leakage.

2.3.3. INTEREST LIMITATION RULES

2.3.3.1. Overview

In terms of current tax laws, specific anti-avoidance provisions have been introduced to limit the quantum of interest expenditure allowable as a deduction in respect of debt procured for purposes of facilitating specific transactions. These are debt used to finance any tax neutral intra-group transfer of assets or a liquidation distribution to a shareholder (section 23N of the Income Tax Act); transactions pertaining to the acquisition of shares in an operating company (section 23N of the Income Tax Act); or transactions with parties in a controlling relationship not subject to tax (section 23M of the Income Tax Act).

In terms of paragraph 2.6 read with paragraph 2.7 of the Explanatory Memorandum to the 2013 Taxation Laws Amendment Bill, the limitation rules were specifically introduced to curb the misuse and abuse of the utilisation of debt financing procured to facilitate leveraged buyout transactions, where the transactions where structured in such a manner that gave rise to income exempt returns or did not trigger any taxes (National Treasury, 2013).

The rules contained in section 23M and similarly section 23N are such that where an instrument procured in respect of a transaction falling within the ambit of the interest limitation rules gives rise to interest costs, the taxpayer will be required to apply a formula to determine the extent to which the interest upon the qualifying debts may be deducted.

Essentially, the interest allowed as a deduction in respect of ”qualifying” debts owed may not exceed the sum of the interest accruing to the debtor (on all debts) and 60% of ”adjusted taxable income” for the year of assessment less any interest incurred, that being an interest limitation calculation determined with reference to a tax EBITDA (section 23M(3) read with section 23M(4), **or** section 23N(3) read with section 23N(4) of the Income Tax Act; as the case may be).

At present, inconsistency arises with regard to the carry forward of disallowed interest and furthermore the limitation is only in respect of specifically identified transactions, giving rise to additional risks related to tax planning abuses.

We proceed to discuss each section in further detail below.

2.3.3.2. Section 23M Limitation Rules

Section 23M stipulates that interest payable by a resident (in its capacity as debtor) upon debts owed to persons within a controlling relationship with that resident debtor, will be subject to certain limitations if the interest is not subject to tax in the hands of the creditor or is not included in the net income of a controlled foreign company (“CFC”) in terms of section 9D of the Income Tax Act (section 23M(2) of the Income Tax Act). The provisions of section 23M contain specific carve-outs for debt arrangements where the creditor obtains funding from a financial institution to fund the debt to the debtor (section 23M(6)(a) of the Income Tax Act), debt arrangement where the creditor is a long term insurer (section 23M(6)(b) of the Income Tax Act), as well as special rules if the loan is granted by a third party but is secured by a connected person.

The term “subject to tax” is somewhat problematic and has not been defined for purposes of section 23M. However, based upon the contents of the Explanatory Memorandum to the 2013 Taxation Laws Amendment Act (which would constitute a generally prevailing practice in terms of the rules set out in the Tax Administration Act), it would appear that a creditor would be regarded as not being subject to tax where a creditor completely escapes both the income tax as well as the interest withholding tax nets, whether by virtue of an exemption in the Income Tax Act or through the operation of a double taxation agreement (“DTA”).

Where the requirements of section 23M are met in respect of any instrument, the taxpayer will be required to apply a formula set out in section 23M to determine the extent to which the interest on section 23M debts may be deducted, subject to certain adjustments and inclusions (section 23M(3) read with the definition of "adjusted taxable income" under section 23M(1) of the Income Tax Act). The interest allowed as a deduction in respect of all section 23M debts owed may not exceed the sum of the interest accruing to the debtor (on all debts) and 60% of adjusted taxable income for the year of assessment less any interest incurred upon non-section 23M debts (section 23M(3) read with section 23M(5) of the Income Tax Act). Any interest in excess of this amount can be carried forward and will be deemed to be an amount of interest incurred in the subsequent year of assessment (section 23M(4) of the Income Tax Act).

It has been noted that the section does not necessarily achieve the base erosion effect targeted (Van der Zwan, Schutte & Krugell, 2018:4). Compare for instance the position of an operating company which pays interest to a parent company who is not subject to tax. Applying the formula set out in section 23M would result in a limitation of the interest deduction upon the loan to the parent company. If, however, a resident investment holding company is interposed between the parent company and the operating company and the loan is advanced to the operating company via the investment holding company, the provisions of section 23M may technically apply to the loan between the investment holding company and the parent company, but the formula set out in section 23M will still allow a deduction of interest to the extent of the interest received from the operating company (Van der Zwan *et. al*, 2018:5-6).

2.3.3.3. Section 23N Limitation Rules

Section 23N seeks to limit a deduction in respect of interest incurred upon debt used to finance any section 45 (intra-group) transaction or section 47 (liquidation) transaction – collectively referred to as "reorganisation transactions" - or any section 24O "acquisition transaction" (section 24O provides for the deduction of interest upon debt used to acquire at least 80% of the equity shares in an operating company). In addition, section 23N will apply to interest on any debt used to refinance such reorganisation transactions (primarily applicable in the instance of a South African group of companies scenario, unless otherwise dictated by the requirements of that specific section), **or** acquisition transactions as the case may be.

2.3.3.4. Concerns relating to Section 23M and Section 23M

Following a review of the OECD's Final BEPS Action Plan 4 Report, the Davis Committee in its "Final Report on BEPS in South Africa" was of the view that although the provisions of section 23N and section 23M in substance represent fixed ratio limitation and constitute targeted measures in the context of the South African landscape, these failed to consider the circumstances of different entities (Davis Tax Committee, 2016: Annexure 4,40). Concerns with sections 23N and 23M, *inter alia*, include that:

- the rules do not have regard to status of the beneficial recipient/status of the person to whom the payment is made (Davis Tax Committee, 2016: Annexure 4,39);
- the rules do not extend beyond the tax ambit of the South African tax net and particularly section 23M "…does not take account of whether or not the foreign creditor is subject to tax in their home jurisdiction on the interest they receive…" (Davis Tax Committee, 2016: Annexure 4,39); furthermore,
- the application of the interest limitation formula under the rules is more favourable towards taxpayers who generally pay more tax, as opposed to those with generally lower levels of income tax (Davis Tax Committee, 2016: Annexure 4,39).

In addition, there is inconsistency regarding the carry forward of productive disallowed interest expenditure. Section 23M(4) of the Income Tax Act allows for the carry forward of disallowed interest expenditure in respect of funding obtained from persons in a controlling relationship not subject to tax in South Africa; whilst section 23N of the Income Tax Act does not contain a similar provision to cater for the carry forward of assessed losses in respect of interest bearing financing arrangements relating to specific re-organisation and acquisition transactions.

2.3.4. WITHHOLDING TAX ON INTEREST

Payments in the form of interest by any South African resident person to any foreign person will fall within the ambit of the interest withholding tax ("IWT") regime, and will be subject to tax at a rate of 15% (section 50B of the Income Tax Act). Payment to certain specified persons may be exempt or a reduced rate may apply under a DTA (section 50D read with section 50E of the Income Tax Act).

The IWT provisions came into operation with effect from 1 January 2015 in terms of the Taxation Laws Amendment Act No. 43 of 2014, and are applicable in respect of interest that is paid or that becomes due and payable upon or after that date. At the time of its introduction, the regime not only applied to interest bearing arrangements entered into with foreign persons on or after 1 January 2015, but also impacted interest bearing arrangements where the term of such arrangement extended beyond the effective date of the IWT regime.

The IWT provisions are contained in sections 50A to sections 50H of the Income Tax Act. The 15% tax levied under the IWT provisions will apply to an amount of interest paid "…. by any person to or for the benefit of any foreign person to the extent that the amount is regarded as having been received or accrued from a source within the Republic in terms of section 9(2)(b)…" (section 50B(1) of the Income Tax Act).

We note here that section 9 of the Income Tax Act prescribes when, for tax purposes, an amount will be derived or deemed to have been derived from a source within South Africa by a non-resident person. In particular, section 9(2)(b) prescribes when an amount of interest will be derived or deemed to have been derived from the Republic. In this regard, IWT will be payable by a foreign person to the extent that an amount of interest:

- is paid by a resident (the debtor is a South African resident); or
- the funds in relation to such interest are applied or utilised in the Republic.

Simply put, interest paid to any foreign person must have arisen from a South African resident person or permanent establishment; or must be attributable directly or indirectly to funds utilised or applied in the Republic. Where the aforementioned exists, then the IWT provisions will apply.

In terms of section 50C(1) of the Income Tax Act, IWT is imposed at the recipient level. This means that the liability for tax lies with the foreign person who is the recipient of an amount of interest sourced from within the Republic. The Income Tax Act does however provide for relief in certain instances. In this regard, recipients of interest may be subject to a reduction in the IWT rate in accordance with the provisions of an applicable DTA (section 50E of the Income Tax Act). In the event that a DTA does apply, we note that the person making the interest payment will not withhold any interest tax or will withhold tax at a reduced rate from the interest so paid, again subject to certain administrative requirements which dictate that interest tax will be withheld at a reduced rate to the extent that a declaration form has been submitted by the recipient evidencing that a reduced rate in terms of a DTA applies (section 50E(3) of the Income Tax Act).

The withholding tax rate on interest is levied at 15%, whilst the income tax is levied at a rate of 28% upon corporate entities. Therefore there is a disparity between the tax leakage benefit, because a corporate entity will have the benefit of an interest deduction at 28%, whilst the corresponding income is only brought into the ambit of the tax net at a rate 15% or often reduced to a lower percentage under Article 11 of a DTA (Oguttu, 2016:139).

However, notwithstanding the OECD’s rejection of withholding tax imposition as a means of curbing BEPS, from a South African point of view a withholding tax regime is an important factor for bringing within the ambit of the tax net South African sourced income (Davis Tax Committee, 2016: Annexure 4,42).

2.4. OVERVIEW

It is clear from the above that whilst targeted anti-avoidance provisions have been formulated against the backdrop of the South African tax landscape, the concerns and inconsistencies noted in relation to the current interest limitation rules have a negative impact upon the effectiveness and alignment of these provisions in the context of international financing arrangements. The rules may also have the effect of giving rise to double layers of taxation due to different tax jurisdictions applying differing tax rates (Davis Tax Committee, 2016: Annexure 4,12), groups and entities being leveraged at different levels of debt (Davis Tax Committee, 2016: Annexure 4,19), as well as different rules applying between different countries (Davis Tax Committee, 2016: Annexure 4,32). This is counter intuitive to the BEPS concerns it wishes to address.

RECOMMENDATION IN THE FINAL BEPS ACTION PLAN 4 REPORT

3 FINAL BEPS ACTION PLAN 4 REPORT

3.1. INTRODUCTION

As noted above, one of the areas of concern related to the BEPS challenges includes excessive interest deductions. The OECD in its Final BEPS Action Plan 4 Report "…identify[s] coherent and consistent solutions to address base erosion and profit shifting using interest and payments economically equivalent to interest…" (OECD, 2015:25).

In this regard, the OECD notes that the purpose of the recommendations and in effect the solutions set out in the Final BEPS Action Plan 4 Report, are meant to address the risk faced by countries as a result of excessive interest deduction; balanced with the need that any proposed solutions should also give rise to ease of application and administration for both taxpayers and revenue authorities (OECD, 2015:25).

The OECD further recognises in the Final BEPS Action Plan 4 Report that although different risks may be best addressed by different kinds of solutions, the recommendations set out in the final report best address the mitigation of the BEPS risk arising from excessive interest deductions within a group, with related parties outside a group and/or through the use of structured arrangements with third parties (OECD, 2015:33). This would, *inter alia*, include: (a) MNEs within an international group, where the BEPS risk arising by virtue of excessive interest deductions relates to both inbound and outbound investment and financing transactions; (b) entities which are part of a domestic group, provided that it is recognised that domestic group entities pose a lower risk than those in a multinational group; and/or (c) standalone entities not part of the group, which often pose a different risk compared to entities housed within a group scenario (OECD, 2015:33-35).

In the context of the recommendations set out in the Final BEPS Action Plan 4 Report, it is important to bear in mind that certain entities may pose a sufficiently low risk, and as such should fall outside those scenarios which would give rise to a BEPS risk. Such entities therefore would fall within a specific *de minimis* threshold (OECD, 2015:35). This is an important aspect to bear in mind. The reason for this is that revenue authorities do not want to impose measures which will negatively impact legitimate transactions and/or transactions which do not pose a legitimate risk to the *fiscus*.

3.2. OECD RECOMMENDATIONS

The recommended approach as set out in the Final BEPS Action Plan 4 Report is based upon a fixed ratio rule, which limits the net interest deductions of an entity by applying a fixed percentage to the earnings/profits of that company, after taking into account interest, taxes, depreciation and amortisation; thus essentially a recommended fixed ratio limitation rule based upon the EBITDA methodology (OECD, 2015:25). The EBITDA methodology proposed, which must be applied within the recommended 10% - 30% benchmark corridor, essentially allows countries to provide relief to taxpayers in the form of interest deductions within a range that still allows revenue authorities to tax the corresponding gains or income produced within a reasonable extent of the economic activity derived (OECD, 2015:45). The OECD note the following with regard to the recommended best practice fixed ratio limitation rule, as it pertains to the 10% - 30% benchmark corridor:

"…On balance and taking into account the above factors, it appears that for a fixed ratio rule, earnings is the most appropriate measure of economic activity, for groups operating in the majority of sectors and in different countries …" (OECD, 2015:44). This approach was adopted upon the premise that an entity's economic activity is evaluated upon the value of the assets which derive creation of value, and which value is measured as the earnings made (OECD, 2015:44).

The fixed ratio is however not to be adopted in isolation. Additional supplementary rules exist to support the fixed ratio rule. Accordingly, the OECD dictates in the Final BEPS Action Plan 4 Report that the fixed ratio rule be supplemented by additional rules, to take into account the varying jurisdictional constraints which may apply (OECD, 2015:38). The first supplementary rule is the group ratio rule, which allows net interest deductions based upon a fixed percentage to be applied to a group's net EBITDA (OECD, 2015:25). This is to assist in instances where different levels of leveraging/financing may be required across different groups in different sectors (OECD, 2015:26). In addition, it is proposed that a *de minimis* rule be applied in order to exclude low risk entities from the scope of the limitation provisions (OECD, 2015:25). The recommended approach also includes scope for the carry forward of disallowed interest deductions to reduce the effect of entities whom will earn interest in later periods, effectively bringing into the tax net interest deductions previously disallowed (OECD, 2015:26-27).

Practically and given the broader policy aims which each specific country desires to achieve, the OECD recognises that implementation of the recommendations may take many different forms. A country may adopt the rules in a manner which either limits the level of interest expenditure and/or limits the level of debt in the entity (OECD, 2015:37). These rules may take the following forms:

- a rule which specifically limits the quantum (level) of deduction allowable in the hands of an entity,
- a rule which identifies the maximum interest (rate or quantum) allowable as a deduction upon specific debt levels or over a period,
- a rule which specifically scopes the "interest" payments which should be subject to the limitation rules, or
- rules which take into account commercial considerations and/or the economic standing of an entity.

Other practical mechanisms suggested for the implementation of applying the recommendations under the Final BEPS Action Plan 4 Report include rules which apply the limitation to an entity's gross and/or net interest expense; or more specifically the introduction of exclusions, extending to exclusions of public sector bodies or entities (OECD, 2015:38-39).

These rules however cannot be viewed in isolation. This is because each country has its own specific set of circumstances and constraints, which would require it to uniquely address its own challenges. Moreover, the suggested implementation of the fixed rules would need to fall within the administrative parameters of each jurisdiction.

3.3. INTERACTION OF THE FIXED RATIO RULE AND OTHER SUPPLEMENTARY RULES

The recommended best approach, as provided by the OECD, extends to the implementation of a fixed ratio rule, supported by various supplementary rules. In terms of the practical approach to be adopted, the rules would need to be considered in the context of the legal nature of the taxpayer(s) in question; for example, whether the taxpayer constitutes (a) an MNE within a group, (b) a domestic group entity, or (c) a standalone entity, which is distinguishable further based upon the size (OECD, 2015:33-35).

For instance, the adoption of a fixed ratio limitation rule together with the group ratio limitation rule in the context of a corporate entity within a multinational group, may define the level at which an entity is included for group purposes (level of consolidation for financial reporting purposes), and thus consequently the level at which the ratio limitation rules would be applied, subject to the overall position of that jurisdictional entity within the group (OECD, 2015:33).

On the other hand, a different approach may be applied in the context of a corporate entity within a domestic group where the risk of BEPS is perceived to be much lower than in the context of a multinational group entity (OECD, 2015:33). In this instance, the adoption of a fixed ratio rule and/or group ratio rule may need to be supplemented by more specific targeted rules to mitigate BEPS risks, which often arise as a result of structured investment of financing transaction involving interest payments to related parties or third parties (OECD, 2015:34).

The risks related to stand alone entities are different compared to those of entities within a group, and thus one must have regard to the structures within which standalone entities exist, for example holding structures involving individuals (low BEPS association risk), or holding structures involving trusts or partnerships (higher BEPS association risk) (OECD, 2015:34). In this instance, a fixed ratio limitation rule supplemented by specific targeted rules to take into account the differing levels of risk may be appropriate to adopt (OECD, 2015:35).

To isolate low risk entities, it is recommended that countries also introduce a *de minimis* threshold; thereby ensuring effectiveness of the policy framework parameters related to the limitation rules by excluding immaterial entities and consequently lowering the administration costs, as well as ensuring that tax authority resources are focused upon transactions which pose a real BEPS risk (OECD, 2015:35).

3.4. PARAMETERS RELATED TO THE IMPLEMENTATION OF THE LIMITATION RULES

It follows from the discussions immediately above that a fixed ratio limitation rule may not necessarily target and encompass all transactions giving rise to BEPS. In this regard, the OECD asserts in its Final BEPS Action Plan 4 Report that to ensure effective implementation of the fixed ratio and group ratio rules, countries may want to adopt, as a support, specific targeted rules in respect of interest payments under specific arrangements or transactions (OECD, 2015:71).

Specific targeted rules would not only isolate those transactions which would not fall within the fixed ratio limitation rule, but would ensure to test transactions which seek to exploit the deductibility of interest costs, coupled with targeted rules to prevent the abuse of the limitation rules (OECD, 2015:71). In this regard, one would seek to introduce rules under the following two categories (1) "…targeted rules to prevent avoidance of the general rules…" and (2) "… targeted rules to address other base erosion and profit shifting risks…" (OECD, 2015:72)

The benefit of introducing specific targeted rules under the two different categories is that the first category serves to dictate anti-abusive measures in respect of the overall limitation rules (fixed ratio limitation rule, together and/or combined with group ratio limitation rule);

whilst the second category will constitute a targeted focus against specific transactions or arrangements (OECD, 2015:71).

In respect of target rules relating to specific transactions, the Final BEPS Action Plan 4 Report dictates that specific rules regarding the disallowance of purported interest in respect of equity funding transactions disguised as debt should be implemented and applied prior to the application of a fixed ratio limitation rule, removing from the parameters of the limitation rules any “tainted interest” (interest in respect of instruments with non-debt features) (OECD, 2015:81). Alternatively, limitation rules may be applicable to certain arrangements that fall outside of the fixed ratio limitation rule, for example transactions targeting reorganisation transactions or offshore transactions where the recipient of the gain escapes the tax net (OECD, 2015:82). Furthermore, the specific targeted rules may extend to target artificial financing transactions not concluded on arm’s length terms, financing arrangements where interest costs are incurred for the generation of tax exempt income, or financing arrangements where interest costs are not in the production of income, additionally with rules relating to transactions where interest cost associated with interest income attributable to low tax or no tax jurisdictions is subject to tax via a withholding mechanism (OECD, 2015:73).

Importantly, given that the fixed ratio limitation rule as contemplated in the Final BEPS Action Plan 4 Report is based upon an earnings (EBITDA) methodology; the application of the methodology in determining the quantum of disallowable interest may have the effect of utilising the assessed loss of loss making entities, and thus taxing them as a result of the disallowance (OECD, 2015:44). In this regard, a country adopting specific rules to supplement the fixed ratio rule would need to take this into account, so as not to prejudice entities with legitimate accumulated trading losses. Furthermore, specific rules would need to be considered in the context of tax exempt entities.

In South Africa, National Treasury has introduced various specific rules targeting hybrid debt and hybrid interest with tainted interest elements (section 8F and section 8FA of the Income Tax Act), rules regarding the transfer pricing and capitalisation of debt within the ambit of arm’s length principles (section 31 of the Income Tax Act), limitation rules in respect of specific reorganisation and offshore transactions (section 23M and section 23N of the

Income Tax Act), an interest withholding tax regime (section 50A to section 50H of the Income Tax Act), all of which are underpinned by an underlying rule which provides for the deduction of interest where the financing in respect thereof was applied for a productive purpose (section 24J of the Income Tax). The scope of these rules is exceptionally targeted in respect of only specific transactions, and can be construed to constitute reactive legislation addressing only specific risk areas concerned with BEPS and thus dealing with such risks only as it emerges (OECD, 2015:71). The current South African tax laws do not implement an overall fixed limitation and/or group ratio rule as recommended by the OECD.

In the Final BEPS Action Plan 4 Report, the OECD affirms that in order to effectively apply the fixed ratio rules as a means of curbing excessive interest "…a fixed ratio rule [supported by the group ratio rule and other specific exclusion or *de minimis* threshold rules, where applicable] should therefore be supported by targeted rules to counteract planning undertaken by [entities or groups] to reduce the impact of [limitation] rules…" (OECD, 2015:72).

One can deduce from the analysis herein that the imposition of a fixed ratio rule as a means of effectively combatting excessive interest deductions is a complex area, which requires consideration of various aspects dependent upon each country's specific objectives and needs. Accordingly, the imposition of fixed ratio rules cannot be implemented in isolation, but must holistically take into account the constraints and capacity of the tax policies of the jurisdiction within which it must be adopted from a BEPS perspective.

For the sake of completeness, we note that the manner in which the fixed ratio limitation rule (together and/or combined with the group ratio rule, and supplemented by additional specific targeted provisions) will apply differently in the banking and insurance sector, given that the role that interest plays in the operations of entities within such a sector and also the regulatory environment governing this industry is different (OECD, 2015:71). In this regard, the considerations in respect of this sector would need to be isolated and are thus not considered as part of the study herein.

REMARKS ON WHETHER SOUTH AFRICA SHOULD ADOPT RECOMMENDATIONS IN BEPS ACTION 4

4 REMARKS ON WHETHER SOUTH AFRICA SHOULD ADOPT THE OECD RECOMMENDATIONS

4.1. REFLECTION ON PURPOSE OF THE STUDY

At the commencement of this document, the intended purpose of the study was noted as (a) the identification of the current interest limitation rules from a domestic corporate income tax perspective, (b) broad assessment of the advantages and disadvantages of the abovementioned rules, as well as (c) an analysis of recommendations of the Davis Tax Committee to determine the effectiveness of South Africa's interest limitation rules in the context of the OECD's best practice recommendations under the Final BEPS Action Plan 4 Report.

Fundamentally, the study as set out in this document was meant to discuss in detail the challenges arising out of BEPS as a result of excessive interest deductions and the best practice recommendations outlined by the OECD. It therefore follows that the final conclusions (as set out in section 4), pertain to whether the imposition of the rules is an effective measure in combatting BEPS in respect of excessive interest deductions.

It is reiterated that the discussion and results herein are intended to contribute to the body of literature that could be utilised in a manner that could positively contribute towards the reform of tax policy, as it relates to excessive interest deductions.

Set out below is the response in respect of the findings present in Sections 2 and 3 above, which findings are in response to the research question set out in Section 1 of this study.

4.2. SUMMARY OF OECD RECOMMENDATIONS

The OECD recommends as a best practice approach a fixed ratio limitation rule, calculated essentially with reference to the EBITDA of an entity within a specific benchmark corridor. The limitation is to be imposed within a benchmark corridor of about up to 10% – 30% of the calculated (tax) EBITDA of an entity. The fixed ratio rule is to be implemented together and/or in combination with a group ratio limitation rule, determined upon the basis of a ratio which is computed specifically with reference to that group's worldwide financial position. Further to this, the fixed ratio limitation and group ratio limitation rules are to be supported by specific targeted rules in relation to specific transactions (subject further to a *de minimis* threshold and carry forward rules in respect of disallowed/unused interest).

The purpose of a defined calculation methodology such as that prescribed in the Final BEPS Action Plan 4 Report is to provide an international best practice, particularly given that BEPS arises in the context of international trade and taxing systems. The benchmark corridor provides a basis for global alignment upon matters relating to BEPS, whilst still providing flexibility to adapt the rules to the specific needs of a country. The scope of the rules however is such that the fixed ratio limitation rule provides an overall interest limitation framework.

As the fixed ratio limitation rule together and/or in combination with the group ratio provides an overall overarching interest limitation framework, it is for this reason that the implementation of these is not recommended in isolation, but that such rules must be extended to include supportive and supplementary rules (in particular to carve out transactions with a low BEPS association risk).

The importance of a *de minimis* rule is in this respect a welcome approach in that it provides a level of protection for transactions falling outside the high BEPS risk net. On the other hand, a group ratio rule is slightly problematic in that it assumes, all things being equal, that entities within the group are leveraged in the same manner. This can be mitigated by the group ratio limitation rule being determined based upon the group's financial position, and taking into account industry constraints or regulatory requirements which may apply. From a South African tax perspective, the tax position and status of entities are reviewed upon an individual basis. Thus, where a supplementary group ratio implementation is adopted, this would need to be adjusted to take into account the taxpayer's debt position as it relates to the group.

4.3. SUMMARY OF CURRENT LEGISLATIVE PROVISONS IN SOUTH AFRICA

South African has various anti-avoidance and specific target measures such as the (i) general interest deduction rules, (ii) transfer pricing and thin capitalisation provisions, (iii) hybrid debt and hybrid interest rules, (iv) interest limitation rules in respect of specific transactions and (v) the IWT regime.

The South African tax law does not contain an overall provision that can, in all respects, be compared to the best practice approach as recommended by the OECD. However, the provisions of section 23M and section 23N of the Income Tax Act, which limit interest deductions where a payment is made to persons not subject to tax in South Africa, or limit interest deductions in respect of specific funding/acquisition transaction, contain certain elements which are similar to those of the recommended fixed ratio limitation and group ratio limitation rules. The limitation rules encompassed under section 23M and section 23N of the Income Tax Act are calculated based upon a tax EBITDA calculation methodology which is similar to the methodology recommended by the OECD in respect of the fixed ratio limitation and group ratio rules, as these rules are also determined with reference to the EBITDA of an entity or of the group (as the case maybe). The provisions of section 23M are subject to the carry forward of disallowed/unused interest, whereas similarly the OECD recommendations make provision for the fixed ratio limitation and group ratio limitation rules (or a combination of both) to factor into such rules the carry forward of disallowed/unused interest.

Fittingly, certain aspects of the fixed ratio and group ratio limitation rules are already encompassed as part of the South African tax laws; the application of which is restricted to specific defined transactions. The OECD recommendation, as set out in the Final BEPS Action Plan 4 Report, prescribes the adoption of an overarching rule, and not the adoption of certain elements or characteristics of the recommended rule.

Comparisons can also be drawn between the South African legislative anti-avoidance and the specific targeted rules, as set out in the OECD's Final BEPS Action Plan 4 Report. The targeted rules which are noted by the OECD are supplementary in nature, and as such are not the primary overarching rules relating to BEPS, as a result of excessive interest deductions. Comparison can be drawn between principles of the OECD supplementary rules relating to artificial debt against the transfer pricing and thin capitalisation rules, particularly with regard to the arm's length pricing and level of debt. Recommended supplementary rules relating to investments or funding structures with tainted interest elements can be compared to the hybrid interest and hybrid instrument rules, and the South African interest withholding regime could potentially be compared to supplementary rules intended to bring within the tax net interest income gains generated by tax deductible interest but taxed in no tax or low tax jurisdictions.

It requires no elaboration to state that although certain aspects and characteristics of the South African tax law are comparable to components of the OECD's recommended approach; these are different in substance. The recommended supplementary rules do not constitute stand-alone targeted or anti-avoidance rules, applicable on a case by case basis, but are meant to constitute supporting rules to strengthen the primary rules to be embodied as part of the fixed ratio limitation and group ratio limitation rules.

Simply put, even where it is arguable that South Africa tax law already contains rules which in part align with the recommended approach to be adopted globally, further refinements to these rules may be required to bring the substance of the policy framework within which these rules were enacted in line with the OECD recommendations and framework highlighted in the Final BEPS Action Plan 4 Report guidance.

4.4. AFRICAN OUTLOOK

The implementation of a best practice approach as recommended by the OECD is not a fiction. The recommendations have already been adopted by countries such as Finland, which applies a 25 percentage ratio to taxable income or earnings, Germany which applies limitation rules based upon taxable EBITDA of 30 percent, as well as Portugal and Spain who also apply a 30 percent tax EBITDA measure subject to certain adjustments (ATAF, 2017:7).

The question therefore, from an African perspective (which houses other developing nations, similar to South Africa) is whether the OECD's recommended approach works for developing African nations?

The ATAF in its publication entitled "The suggested approach to drafting interest deductibility legislation", accepts that BEPS as a result of excessive interest deductions "…poses a significant risk to African tax bases…" (ATAF, 2017:1). The ATAF further remarks that cross border debt funding arrangements may potentially result in tax bias where interest deductions are obtained in the hands of the payer, with no corresponding tax inclusion for the payee (ATAF, 2017:1). This tax bias may be compounded further by complex tax planning structures and techniques (ATAF, 2017:1). The aforementioned are precisely some of the scenarios which are noted in the Final BEPS Action Plan 4 Report as giving rise to excessive interest deductions, resulting in BEPS.

A significant observation made by ATAF is that "…African countries are capital importers and will be net borrowers rather than net lenders. Taxpayers in African countries are usually the subsidiaries referred to and will usually be net payers of interest rather than net payers …" (ATAF, 2017:2). In this manner, the BEPS risk appears to be much higher in African countries.

The tax laws of most countries do not contain specific legislative measures or provisions relating to interest deductions, with most only containing rules similar to the South African section 24J dispensation which limits the deduction of interest to interest expenditure which has been incurred in the production of income (ATAF, 2017:2). It is upon this basis that the ATAF considers the recommendations set out in the Final BEPS Action Plan 4 Report as an appropriate tool and response in combatting excessive interest deductions in Africa (ATAF, 2017:3). Generally African countries have addressed the limitation of excessive interest deductions through transfer pricing and thin capitalisation rules through the application of a debt to equity ratio test, which can be easily circumvented (ATAF, 2017:3)

Support in favour of the implementation of a fixed ratio rule and group ratio rule by the ATAF is that the rules are determined with reference to an EBITDA calculation linking the interest deduction directly to the economic activities of the financing advanced or utilised; and also directly linking it to the interest income gains produced (ATAF, 2017:2). In this way, any mischief or adverse tax planning in respect of such rules is mitigated.

It is therefore along these lines that the ATAF published a base interest deductibility legislation framework which incorporates the OECD's best practice recommendations as contained in the Final BEPS Action Plan 4 Report (ATAF, 2017:2). The framework excludes the banking and insurance sector, given the specialised nature of these sectors and that these sectors trade in debt instruments (ATAF, 2017:6). Appropriately so, the ATAF takes a similar view to the OECD that specialised fixed ratio and limitation rules are required in respect of the banking and insurance sector; given the very specific operations of these sectors.

The suggested legislative framework provided by the ATAF is based upon the 10% - 30% corridor benchmark range, at the discretion of each country; depending upon the risk to the tax base of that country (ATAF, 2017:6). The benchmark corridor may be implemented based upon (i) an option which disallows the amount of interest in excess of the ratio (not the total interest), (ii) an option which disallows the amount of interest paid or accrued that exceeds the ratio (as opposed to the amount of net interest expense), or (iii) optionally, disallows the amount of gross interest expenditure that exceeds the ratio (ATAF, 2017:6-8). The framework in the suggested ATAF approach also sets out supplementary rules which may be adopted in support of the fixed ratio limitation and group ratio limitation rule, which were also drafted with reference to the Final BEPS Action Plan 4 Report recommendations as "additional optional provisions" (ATAF, 2017:5).

The recommendations of the OECD should therefore be seriously considered by the African countries, including South Africa. In fact, the ATAF has also considered the practicality and implementation of the measures to be imposed, with the observation that the rules would be easy and straightforward "…for [taxpayers] to apply and authorities to audit…" (ATAF, 2017:9). What remains is for a country to choose which ratio to apply, be it the fixed ratio limitation or the group ratio limitation (ATAF, 2017:10).

In terms of concerns with regard to the implementation of a group ratio limitation rule alongside a fixed ratio limitation rule, particularly with access to information which would be required to determine the group ratio in respect of offshore group entities, tax authorities may evoke the international exchange of information rules, or promulgate a rule dictating that the application of a group ratio rule is subject to the requisite being provided to the tax authorities upon request (ATAF, 2017:10).

The proposals by ATAF demonstrate the viability of the adoption of the fixed ratio limitation and group ratio limitation rule, and the feasibility thereof in the African context when these are supported by supplementary rules which have been considered in line with the jurisdictional needs of that country.

4.5. REMARKS ON WHETHER OR HOW SOUTH AFRICA SHOULD ADOPT OECD RECOMMENDATIONS

Following on from the reasoning provided for in the ATAF “Suggested approach to drafting interest deductibility legislation” and having cognizance of the recommendations set out by the OECD in the Final BEPS Action Plan 4 Report, it is proposed herein that South Africa adopt the recommendations as part of its tax policy framework.

In this regard, South Africa should adopt a fixed ratio limitation rule and group ratio limitation rule as an overall legislative provision in combatting excessive interest deductions. Currently, as South African tax law already contains a number of target and anti-avoidance provisions as a means of combatting excessive interest deduction (transfer pricing and thin capitalisation rules, hybrid debt and hybrid interest rules, limitation rules in respect of debt obtained from persons not subject to tax or in respect of specific reorganisation acquisition transaction, IWT regime), these rules can remain to serve as supplementary rules in support of the fixed ratio limitation and group ratio limitation rule to be adopted. Albeit that the OECD allows for countries to continue using other methods, these methods will best be employed as supplementary rules.

To avoid duplication, it is suggested that provisions which possess the fundamental principles of the fixed ratio limitation rules, in particular the provisions of section 23M and section 23N of the Income Tax Act be phased out and repealed.

A transitional period is however required to align the phasing in of any new rules, against the phasing out of any rules which may give rise to duplications. So as not to undermine the integrity of any new rules to be adopted, a *de minimis* threshold should be applied to ensure that the rules target only those transactions with a high BEPS risk association.

4.6. CONCLUSION

Whilst the OECD puts forward a well presented and viable approach in relation to how best to uniformly address matters of BEPS arising out of excessive interest deduction, such recommendations came after the introduction of targeted rules in South Africa. The South African anti-avoidance legislative provisions are however open to further refinement, to align with international best practice, by ensuring that any aspects of the OECD best practice recommendations in relation to the supplementary rules, should be embedded as part of the current existing legislative provisions. The fixed ratio limitation and group ratio limitation rules should be introduced as an overarching provision, with transitional rules to phase out duplications.

Commercially and from a policy perspective, the adoption of the rules in the manner suggested above will cater for investor friendly rules/regulations, whilst taking into account the specific needs and capacity of taxpayers and the revenue authorities or law makers within the Republic.

4.7. SUGGESTIONS FOR FURTHER RESEARCH / IMPLEMENTATION

Generally, the introduction or proposed amendment to tax laws is the subject of public consultation issued under draft legislation. It follows that any legislative amendments would therefore take into account public comment, as well as specific industry and taxpayers' comments. In this regard, we note that although public consultation upon the phasing in or transitioning of new and existing legislative rules is helpful in ensuring the effective implementation of the rules, with regard to both the policy makers' intention and commercial concerns of the business and general community at large; it would be important in this instance that any proposed amendments be supported by workshops regarding the studies conducted by the OECD to contextualise any proposals. For this reason, as a first step in broadening the discussion around the combatting of excessive interest deductions utilising the OECD best practice recommendations, a discussion paper focusing upon fiscal economic impact of interest limitation rules from a South African perspective is recommended.

The road to narrowing the fiscal gap arising out of excessive interest deductions still requires further work, but it is surely not out of sight.

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