A RATIONAL APPROACH TO THE DEBT – EQUITY DICHOTOMY

by

CORDELIA DEIDRE MAISTRY

A mini-dissertation submitted in part fulfilment of the requirements for the degree

LLM TAX LAW

in the

FACULTY OF LAW

at the

UNIVERSITY OF PRETORIA

Supervisor: Adv C Louw

NOVEMBER 2011
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CHAPTER 1. INTRODUCTION

1.1. **Background**

The grim opening words to the World Economic and Financial Survey sets the tone for investment and growth over the next few years, “The global economy is in a dangerous new phase”.\(^1\) Dangerous because there is uncertainty as to the swelling sovereign debt crisis prevalent in European economies, the increasing risks of conducting business, and the stability of the banking system. “One of the main problems today is the amount of debt in the global financial system; among sovereigns, banks and households and especially among advanced economies”.\(^2\) The sentiments expressed by the head of the International Monetary Fund provide a sobering reality for companies and governments, which ultimately will impact the way in which these entities interact.

“The final question is whether the enterprise tax system (business taxes) encourages firms (participants in an economy) to finance their investments excessively through debt. If so, it is feared that firms (participants) would be vulnerable to bankruptcy (liquidations) in times of economic downturn and that increased numbers of bankruptcies would exacerbate the destabilisation of the national economy during such a period”.\(^3\)

These sentiments have also been raised by our Minister of Finance which provide a basis for the debt debate in South Africa:

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"[t]he confluence of large fiscal and financial imbalances, high debt levels and slowing growth in advanced economies underpin the current sovereign debt crises, particularly in the [European Union], and weigh heavily on policy makers and business leaders across the world".4

Furthermore, the,

"[p]olicy uncertainty appears pervasive, and policy space has been narrowed by the fiscal and stimulus measures of the past. The escalating debt crisis in the [European Union], and growing concerns over the ill-health of the [United States] economy where the housing market is experiencing a double-dip and unemployment remains stubbornly high have started to impact on already fragile real activity in these regions. Confidence measures have fallen, together triggering rising global financial market volatility and bouts of risk aversion".5

Debt financing affects every role player in the world economy from governments to households, as identified above, and such significant debt levels have contributed significantly to the present financial turmoil. The recovery of the global economy depends on many factors, including the reduction of debt financing.

However, it must not be forgotten that debt financing has made large scale investments in infrastructure, telecommunications and industry a reality in most economies.

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5 Ibid, p2.
1.2. **Purpose**

The purpose of this work seeks to identify and explain issues in that arise in the debt-equity dichotomy. Firstly, how the tax system contains a bias in favour of debt financing over equity financing. Secondly there are two competing interests in financing transactions; the revenue authority struggling to protect and grow its tax base, and companies trying to foster growth and generate profits during a tough economic climate.

Thirdly, other jurisdictions have encountered similar issues regarding the bias within their tax systems and have adopted measures to restrict excessive interest deductions being claimed. The research therefore attempts to strike a balance between these competing interests by proposing reforms that address issues pertinent to each party. Most emerging economies, including South Africa, have a particular problem in trying to secure lucrative investment as it comes at a cost to revenue collections. In marketing itself as an investment destination for holding companies, companies are trying to use their existing platforms to launch themselves into unchartered markets, in particular Africa, and the cost of financing becomes a key concern. Therefore a rational approach must be adopted as a careful balance must be struck for all stakeholders between these competing interests.

1.3. **Relevance**

Should South Africa fail to address and implement measures that restrict the financing bias within the tax system, it will continue to threaten revenue collections for government. Apart from the immediate impact at the corporate level of liquidations and unemployment for companies that excessively leveraged, there is also a broader national interest at stake. The government will be unable to service its sovereign debt obligations and it will place South Africa in similar position to that of Greece, Italy and Spain, i.e. on the brink of financial collapse.

In order to create a sustainable business environment, provisions in the tax legislation that create distortions should be revised accordingly.
1.4. *Financing for a company*

The main objective for any company is to generate profits. In order for the company to achieve its objective, the company requires finance to conduct its business operations. The company will obtain finance largely from two sources: capital from its shareholders in the form of equity, or loans from its shareholders and third party lending institutions such as banks or finance houses in the form of debt. When a company receives debt funding and is unable to service the debt, the continued existence of that company is threatened, which places employment and other stakeholder interests at risk.

There is an argument that debt is cheaper to finance than equity investment as the interest expenditure incurred is tax deductible. The liability for tax is one of the main determinants that influences the development of corporate financial policies for companies and multinational enterprises, as a reduced tax liability increases the entity’s profitability to shareholders. Most tax jurisdictions today contain an inherent ‘debt bias’ that offers a tax advantage to companies to finance their investments through the use of debt financing. It has been noted that there is no justification for these generous tax breaks and one cannot compellingly argue for allowing the tax preferences for debt based on legal, administrative or economic considerations.\(^6\) The common reasoning that arises is that debt triggers an interest expense and is therefore deductible.

The levels of debt financing utilised by corporate entities have grown at alarming rates over the recent years, especially prior to the financial crisis, and as a result most revenue authorities and governments have become increasingly wary of such financing. The negative impact on the revenue collections has resulted in interest deductions being curtailed in some jurisdictions and has encouraged the implementation of measures that restrict the preference of debt over equity financing.

1.5. **Basic paradigm**

The distinction between debt and equity can be described as follows;

"[a]n equity investment involves the contribution of capital in return for shares. As a result the investor has no assurance of any return. Debt involves the lending of money to the company, which is often evidenced by the issuing of debentures to the creditor, in exchange for [an] interest or some other form of fixed return".  

The main difference between debt versus equity is that the returns on a loan are guaranteed whereas on an equity investment no return is guaranteed. “A major reason for using debt (financing) is that the interest is tax deductible, which lowers the effective cost of debt”, thereby raising the argument that the tax system creates a subsidy in favour of lending transactions. As companies engage in more aggressive investments backed by high levels of leverage, it makes them vulnerable to economic downturns, as witnessed during the present economic crisis.

The common term ‘debt-equity ratio’ refers to a measure of a company’s financial leverage calculated by dividing its total liabilities to shareholders equity. It indicates what proportion of equity and debt the company is using to finance its assets. A high debt-equity ratio generally means that a company has been aggressive in financing its growth with debt. However, it is important to note that capital intensive industries, for example the auto manufacturing sector and the parastatals like Eskom, tend to have a higher debt to equity ratio compared with less capital intensive sectors.

South African tax law does not provide guidance as to how to distinguish between debt and equity instruments.

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The case authority and company law have not been helpful in this regard either. Hence the characterisation of a financial instrument is often a difficult matter for the revenue authority. The lack of rules to differentiate debt from equity has led to sophisticated financial instruments being used to take advantage of this loophole. The impact of the debt bias is the fact that it encourages excessive leverage within the economy and the effects thereof, fiscal revenue drain, and investor confidence.

In order to legislate specific rules as to what constitutes 'debt or equity', characterisation criteria must be formulated, which is possibly the subject of a broader enquiry. Companies use debt to take advantage of the tax bias in favour of equity investment. Therefore an interim approach would be to have mechanisms that minimise the tax bias. As this has also been the approach of other jurisdictions, the reforms that have been adopted are considered later in this work as a starting point for future discussions.

1.6. Conclusion

"The globalisation of finance has expanded the opportunity for arbitrage by facilitating the exploitation of differences in tax treatments across jurisdictions. Transactions may be structured to place at least one end in a low or no tax jurisdiction. Cursory evidence, such as the growth of business channelled through offshore tax havens, suggests that arbitrage activity and revenue loss can be significant and may be growing.

There is as yet little empirical evidence to quantify the extent of revenue loss resulting from the imperfections of the tax systems and aggressive avoidance (behaviour) by taxpayers, although recent work done at the OECD on aggressive tax planning and offshore non-compliance suggests it is large and growing." \(^9\)

The company is a legal entity whose primary focus is to generate profits for its shareholders and it will actively seek opportunities to reduce its tax liability. Therefore companies have seized advantages that exist at the global level, as by trading in various countries companies they are able to play tax systems against each other.

It is interesting to note that,

"[a]lthough taxation was not at the root of the ongoing financial and economic crisis, tax arbitrage may have exacerbated global imbalances in some regions by creating distortions in the composition of banks' portfolios, and/or by shaping the debt structure of multinational financial institutions, by affecting subsidiary/parent firm location decisions, or by making foreign lending more attractive than domestic."\(^{10}\)

It is against this background that revenue authorities must ensure that their tax legislation is resilient enough to withstand tax avoidance structures.

CHAPTER 2. THE PROBLEM STATEMENT

2.1. Introduction

The European Court of Justice ("ECJ") has defined the term 'abuse of rights' as an action that,

“...occurs only if the purpose of the law is defeated despite formal compliance with conditions set out in the law and if there is an intention to obtain an advantage by artificially creating the conditions for obtaining such an advantage.”\(^{11}\)

The use of excessive debt financing by companies may be viewed as an abuse of rights whereby companies exploit their capital structure to secure a tax advantage. The interest expenses incurred are deductible because there is formal compliance with the requirements set out in the law. The sought after interest deduction that arises in the excessive borrowing transactions acts as a tax shield, as the deduction claimed is offset against the taxable income which is intended to reduce the company’s overall tax liability.

Therefore the tax shield created by legislation enhances the attractiveness of debt financing as opposed to equity financing. Interest expenses are generally deductible as an expense if they are incurred in the ordinary course of a business enterprise. However, due to the interest deduction being unrestricted, it has become the subject of abusive transactions which defeats the purpose of the law, despite compliance with the requirements, and therefore qualifies as an abuse of rights.

2.2. General theory

It is a generally accepted principle in most jurisdictions that interest expenses incurred are of a revenue nature and therefore tax deductible, whereas equity distributions in the form of dividends are non-deductible.

In addition, equity distributions are paid from the ‘after tax profits’ of a company, whereas interest deductions are claimed when calculating the company’s tax liability. There appears to be a resultant tax distortion that arises in favour of debt financing arrangements. Therefore companies have an incentive to be saddled with high debt ratios in South Africa as well as in foreign jurisdictions. The requirements in claiming an interest deduction in terms of the Income Tax Act\textsuperscript{12} are easily satisfied as debt funding for a company has the masquerade of fulfilling a legitimate business purpose.

Companies are entitled to claim a deduction on the interest expense incurred, which is offset against their taxable income. This results in the company’s liability for corporate tax being substantially reduced or eliminated for the present as well as future years of assessment. As a result of the deduction, companies prefer their capital structure to be denominated by debt financing as opposed to equity investment. It is perceived that it is economically efficient for a company to have a high level of debt rather than equity investment, as the immediate benefit is the reduction in the tax liability. The key issue that arises is if the interest were not deductible; there would be no immediate preference in law in favour of debt over equity financing.

It has been researched that with the imposition of a high corporate income tax rate, the ability to claim deductions is imperative for companies.\textsuperscript{13} Therefore the deductibility of interest expenses without restrictions is a significant incentive to utilise debt financing.

\textsuperscript{12} Income Tax Act 58 of 1962.

South Africa imposes a corporate tax rate of 28% which is comparable with other jurisdictions; however companies prefer to reduce their taxable income to increase profits that are reflected on their financial statements. The combined effect of a relatively high corporate tax rate and the deductibility of interest expenditure will increase the attractiveness for companies to become highly leveraged.

Table 1 Illustration of the optimal tax result for the fiscus

<table>
<thead>
<tr>
<th>Interest expense</th>
<th>Interest income</th>
<th>Tax result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deduction</td>
<td>+ Inclusion</td>
<td>Tax Neutrality (perfect market result)</td>
</tr>
<tr>
<td>Deduction</td>
<td>0 Zero</td>
<td>Tax Distortion (revenue mismatch)</td>
</tr>
</tbody>
</table>

In accordance with the principle of tax neutrality, a deduction in a taxpayer’s records must be matched with a corresponding inclusion in another taxpayer’s records. Therefore it caters for a system whereby a minus is balanced against a plus for the revenue system. However, taxpayers often manipulate the tax system by creating a revenue mismatch.

Example 1: Basic illustration of interest expense matched by interest income

Company A takes a loan of R100 000 from a domestic bank to finance the acquisition of operating assets from a third party. Interest of R10 000 is charged by the bank. Therefore Company A claims a deduction of R10 000 in respect of interest expenditure incurred and the bank accounts for interest income as part of its gross income. The result for the fiscus is tax neutral and is a perfect commercial result.

However, taxpayers have manipulated the system by claiming a tax deduction with no corresponding inclusion for another taxpayer, which creates only in a minus in the system. The resultant effect is that a tax distortion has been created.

The South African tax laws do not contain tracing rules, therefore a mismatch in the system
often goes undetected unless an audit investigation is raised against a taxpayer. The issue is further compounded when a transaction is structured in a manner in which the interest income is payable to an exempt institution.

Section 10(1)(d) of the Income Tax Act specifies entities that are exempt from normal tax, for instance pension funds, pension preservation funds, provident funds, provident preservation funds and retirement annuity funds.\textsuperscript{14} Foreign banks and registered public benefit organisations also included in the exempt institutions category.\textsuperscript{15} These tax exempt investors prefer to be the debt financers to transactions as there is a clear arbitrage gain in lending to a tax paying company and receiving untaxed interest income.

2.3. \textit{Types of funding}

Debt funding can be sourced from the domestic financial sector or foreign investors and banks. South Africa currently does not impose a withholding tax on interest that is paid to foreign investors, which is an entrenched article in most of the Double Tax Agreements with other countries. However, a withholding tax on interest is proposed to be implemented from 1 January 2013, and is discussed in a subsequent chapter.

The current section 10(1)(h) of the Income Tax Act grants an exemption from tax on interest income that accrues to non-residents. Therefore companies financed with foreign sourced debt are entitled to a deduction on their taxable income without the corresponding income being taxable in the South African net.

However, if the cross border debt financing is arranged between related parties, the transaction will be subject to the thin capitalisation rules. The resultant effect of the reduction in tax liability for companies has contributed to high levels of debt financing as the preferred funding mechanism.

\textsuperscript{14} Section 10(1)(d)(i) and (ii) of the Income Tax Act No. 58 of 1962, hereinafter referred to as “ITA”.

\textsuperscript{15} Section 10(1)(j) and section 10(1)(cN) of the ITA.
A further complexity exists in the South African tax dispensation as interest expenses incurred on loans to fund the acquisition of shares is a non-deductible expense, whereas the acquisition of assets is an allowable deduction. The anomaly regarding the different treatments applicable to the purchase of shares and assets has led to a number of structures utilising the corporate reorganisation provisions to get around the above non-deductibility aspect.

2.4. Abusive structures: Usually in the form of Intra-group and BEE transactions

The National Treasury has recently indicated that policy changes are forthcoming as there is an increasing focus to reconsider the tax treatment of debt and equity, as evidenced in the Draft Taxation Laws Amendment Bill of 2011. It was stated that,

"Government is determined to take action against excessive debt stemming from (the) section 45 (intra-group) transactions as well as schemes involving hybrid shares."\(^{16}\)

The government has recognised that the debt – equity paradigm is a pertinent issue for macroeconomic policy, as well as encouraging foreign investment into South Africa. Companies have entered into a number of transactions that derive tax-free benefits from the distortion in the treatment between debt and equity funding by manipulating other provisions in the legislation. The structures usually contain an interest deduction in a highly geared entity with interest income either being channelled to exempt entities or offshore investors. Section 45 of the Income Tax Act allows for intra-group reorganisations between group companies without triggering tax implications.

The provision caters for the transfer of assets from one company to another within the same group of companies, regardless of the justification for such group re-structuring.

Section 45 of the Income Tax Act provides rollover relief to facilitate the intra-group transactions, thereby triggering no immediate tax implications for either party to the reorganisation.

An ‘intra-group’ transaction is defined in the legislation as,

“... a transaction in terms of which an asset is disposed of by one company to another company that is a resident and both companies form part of the same group of companies at the end of the transaction date”.17

The rollover relief provides a tax shield on capital gains or profits that would have been triggered had the disposal of a business enterprise or assets occurred between unrelated parties. The tax favourable treatment in section 45 has been manipulated in transactions that were not envisaged by the Legislature at the time of enactment to take advantage of the rollover relief. The structuring of these transactions can be labelled as ‘an abuse of rights’ in terms of the ECJ description above.

Example 2: Leveraged buyouts utilising a foreign loan

The Acquiring and the Target companies are both domestic companies and the owners of the Target company want to dispose of their shares. However the Acquiring company seeks to acquire the assets of the Target only, due to the deductibility of interest expenses and further alleviates the Acquiring company from assuming the contingent liabilities, if any.

• Step 1: The Acquiring Company obtains a domestic bridge loan and uses the funds to acquire the shares in the Target Company.

• Step 2: The Acquiring Company sets up a special purpose vehicle (SPV). "The purpose of the SPV is to insulate the shareholders from the insolvency of the venture and to insulate the bank lenders from the insolvency of the shareholders." 19

• Step 3: The SPV obtains long-term funding from a foreign bank with a local branch that acts as the facilitator. The SPV uses the funding to purchase the operating assets from the Target Company as part of a section 45 transfer.

• Step 4: The Target Company then declares a dividend to the Acquiring Company, which satisfies the bridging loan and may have disposable income.

Figure 1 Leveraged buyouts utilising a foreign loan

The section 45 transfer operates as a tax-free mechanism to link the operating assets of the Target Company to the foreign loan as collateral.

The SPV houses the income earning part of the business and is thus excessively leveraged. The interest expense effectively reduces the operating income of the Target Company; however the interest income is not taxable in South Africa because the interest is paid to a foreign bank (investor). The foreign funding typically comes in three tranches from various sources besides a foreign bank, including foreign shareholders (supplying senior, mezzanine and junior debt). The debt is typically substantial in relation to the total equity of the SPV and the debt may contain equity-like features in most situations, in the form of preference shares.

In structuring the transaction in this manner, both the Acquiring Company and the SPV have utilised the legislation to secure tax benefits that would not generally have been available. Further, the transaction ensures that debt financing is the lucrative form of funding for the parties.

Black Economic Empowerment ("BEE") transactions play a significant role in the South Africa corporate ownership environment. The Government has mandated economic transformation which seeks to empower the previously disadvantaged groups in our society. Therefore it encourages the meaningful participation in the corporate arena by persons that would not have otherwise had the opportunity to participate, as they lack the financing to purchase equity shares in companies.

_The private equity industry plays a significant role in the development of BEE structures._ "Private equity transactions enable(s) higher gearing, whereby a combination of private equity investment and bank loans allow the implementation of an appropriately geared financial structure, allowing management of the investee company to acquire a significant stake in the company. This leveraged model also creates opportunities for the involvement of black management and other BEE parties in the ownership and management of the investee company."^{19}

Even though private equity facilitates the loan financing and also acts in a _de facto_ position of

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managing the company, the entire structure is laced with debt, which transcends into large interest deductions being claimed against the fiscus. Furthermore, private equity investors are generally institutional investors that comprise pension funds, retirement funds, banks and foreign investors. These institutions also fall into the category of tax exempt entities.

**Example 3: Facilitation of a BEE structure**

A Parent Company requires BEE participation within its company structure. However the BEE holders do not have the cash to acquire the shares in the Subsidiary company as the Subsidiary is a profitable entity and the share price is very high. Therefore the Parent company starts up a New company (“New Co”) and creates a BEE SPV. The New Co receives funding from the private equity fund (which may consist of foreign investors) that results in the interest expenses being deductible. New Co acquires the operating assets from the Subsidiary utilising a section 45 intra-group reorganisation.

Due to the excessive leveraging in New Co, the share value is minimal. The SPV BEE then acquires a stake in New Co for a nominal amount, and such stake could be in the form of restricted equity instruments. Lastly, the Subsidiary on-declares a dividend to the Parent Company.

![Diagram of BEE structure](image_url)

**Figure 2 Facilitation of a BEE structure**

In the above transaction, section 45 was a key provision for the tax-free transfer of assets from
the Subsidiary to the New Co, and such transfer enabled the New Co to secure funding using the operating assets as collateral. However the entire transaction was structured to enable BEE participation in the company that was facilitated by using debt financing. Therefore the group benefits because the BEE rating will increase the possibility of securing work and the taxable income that will be generated in New Co will be reduced due to the interest deduction. The interest income is not taxable as the recipient consists of exempt institutions.

During 2010 the source of third party funds raised from foreign investors amounted to R6 989 million.\(^{20}\) It is not advocated that all the funds raised were used to facilitate debt investment, however a significant portion of that amount would be used to fund debt financing to ensure that the interest income flows untaxed out of South Africa to the foreign investors. Further, a creditor has a secured claim against the company in the case of insolvency, as opposed to equity investment, thus debt funding reduces the risk of the investment for the investor and the cost of debt finance is cheaper.

### 2.5. Hybrid financial instruments

Another aspect that has further complicated the tax bias is the increased usage of hybrid financial instruments. These instruments contain a blend of characteristics that define debt and equity individually.

"Hybrid instrument can be described as a financial instrument whose economic features diverge from its formal characterisation, commonly one that has mainly features of equity but is treated for tax purposes as debt or is treated for tax purposes differently in other jurisdictions."\(^{21}\)

Hybrid instruments have blurred the broad distinction between debt financing and equity

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financing, therefore contributing to the existing dichotomy. The holders of the instruments may at some stage convert their debt into a participation in the equity of the company, and the ownership interest which they could receive may be dependent on the profits generated by the company. In these circumstances it is not always possible to differentiate the financing as purely debt finance or purely equity finance. "What is essentially equity capital may possibly be disguised as debt."\(^{22}\)

Preference shares are an example of a hybrid instrument, as they pay a fixed rate of return, however they do not entitle the holder to a return if the company has insufficient profits. Other convertible debt instruments include junk bonds, subordinated debt, warrants and indexed securities that can also be used to blur the traditional distinction between debt and equity. Hybrid financial instruments have resulted in tax laws becoming increasingly complex because rules are required to determine whether payments are deductible expenses or not to establish taxable income. Hybrid instruments provide investors with an option as to whether they wish to be taxed at the corporate tax rate by investing in equity or the personal tax rate by investing in debt.

Legislators, in seeking to clamp down on the manipulation of the terms, have decided to create their own definitions of what debt is, which further opens the door for tax avoidance.\(^{23}\) Companies and financial investors have used the terms ‘debt’ and ‘equity’ interchangeably in transactions to secure a desired tax result. It is against this background that the tax treatment of debt and equity should be reconsidered.

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2.6. Conclusion

"Tax leakage from excessive debt is a global phenomenon and various countries (have introduced) measures to control interest deductions from excessive debt." \(^{24}\)

It has been conservatively estimated that South Africa is losing between R3 to R5 billion in tax revenue due to the deductions being granted in the form of interest expenditure. The loss to the fiscus is relatively substantial at a time of declining tax revenues worldwide and financial instability in global markets. Further, as South Africa continues to expand and establish itself as a dynamic emerging market, and importantly as a ‘gateway into Africa’ to attract foreign investment, should the deduction of interest remain easily accessible, it will be open to widespread abuse.

Therefore the National Treasury has undertaken to reconsider the policy on the taxation of debt and equity funding and the factors that influence the funding choices. Importantly, transactions are structured to secure tax benefits as opposed to being structured and dictated by a proper commercial rationale. Taxation should not be the determining factor in financing decisions and this principle has been widely recognised as the ‘business purpose doctrine’. \(^{25}\)

If perfect market conditions prevailed, the tax preference in favour of debt would not exist and companies would base their decision to source funding from debt or equity facilities based on the operational requirements or the objects of business.


"The tax system should remain in the background, and business, investment and consumption decisions should be made for non-tax reasons."\textsuperscript{26}

However, due to the inherent tax preference in favour of debt, companies are swayed into utilising debt funding to secure the deduction to reduce their taxable income. Companies also use hybrid financial instruments to disguise equity as debt in order to secure the interest deduction. Therefore companies are excessively leveraged without a proper commercial rationale, which transcends into other problems that threaten macroeconomic stability for South Africa and the global economy.

CHAPTER 3. DEDUCTIBILITY OF INTEREST

3.1. Introduction

The historical issue with regard to the concept of ‘interest’ is the characterisation of such expenditure, whether it is of a revenue nature or capital nature. If the expense is regarded as a revenue expense, it is deductible against taxable income and ultimately reduces the tax liability of a company. However if such expense is regarded as capital in nature, it will not be deductible.

3.2. Definition of ‘interest’

Interest is generally perceived to be compensation paid or received for the use of money. The term ‘interest’ is commonly associated as being expended as a direct consequence of obtaining finance. The dictionary defines interest as “money paid for the use of money lent or for the forbearance of a debt”.

The Appellate Division in CIR v Genn & Co (Pty) Ltd accepted that interest is paid for the use of money. In CIR v Cactus Investments (Proprietary) Limited, a wider definition was attached to the meaning of interest within the context of a loan for consumption. It was said that interest is not necessarily compensation for the use of money, but it is the stipulated return which a lender would require if he lends money to a borrower and that such return does not necessarily have to be linked to compensation or similar criteria.

In Halsbury’s Laws of England, interest is described as the “return or compensation for the use

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29 20 SATC 113.
30 61 SATC 43.
or retention by one person of a sum of money belonging to or owed to another".  

Section 24J(1) of the Income Tax Act defines interest to include a wider meaning and reads as follows:

"(a) gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of … a financial arrangement,

(b) amount (or portion thereof) payable by a borrower to the lender in terms of any lending arrangement as represents compensation for any amount to which the lender would … have been entitled".

Therefore for the present discussion it is accepted that ‘interest’ is a finance charge, an expense, incurred as compensation for the use of money by the borrower payable to the lender.

The concept of ‘interest’ is best understood when compared with a dividend, as these concepts are comparative. A return on a debt instrument is interest, whereas the return on a share is a dividend. The main difference between debt and equity is that a creditor is entitled to a fixed return on investment, whereas the shareholder’s right to receive a dividend is contingent upon the company declaring a dividend. Interest and dividends are similar in the fact that both constitute returns on investment; however, these concepts are distinct and are treated differently for tax purposes.

### 3.3. Section 24J of the Income Tax Act

Section 24J was introduced into the tax legislation to regulate the timing of the accrual and incurral of interest in relation to interest bearing instruments. The section had no impact on the characterisation of amounts as either capital or revenue in nature within the tax system. The section effectively,

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“spread the interest over the period or term of the financial arrangement by compounding the interest over fixed accrual periods using a predetermined rate referred to as the ‘yield to maturity’”.  

However, due to extensive avoidance structures in the form of structured finance schemes and revenue stream swaps, section 24J underwent important amendments in 2004. The Explanatory Memorandum elaborates on the policy rationale for the amendments as providing certainty as to the tax treatment of interest and to introduce the principle that interest should always be treated on revenue account. The nature of interest has been the subject of contention in many tax disputes. It was therefore proposed that section 24J be restructured to specifically provide for the inclusion in gross income of interest deemed to have been accrued or the deduction of interest be deemed to have been incurred in terms of that section. It has become an entrenched principle of tax law that the nature of interest incurred is a revenue expense and will therefore be deductible against taxable income. The legislative amendment closes the much debated nature of interest as some share view that interest may be of a capital nature.

As a consequence of the amendments, section 24J(2) specifically provides the issuer of an instrument with a deduction for interest and subsection, and (3) caters for a corresponding inclusion of the amount in the gross income of the holder of an income instrument.

34 *CIR v Genn & Co (Pty) Ltd 1955 (3) SA 293 (A)*, the court remarked obiter on the possible capital nature of interest expenditure, which has been relied upon in subsequent cases that dealt with the issue of the capital or revenue nature of such expense.
Section 24J(2) deems "an amount of interest (to have been incurred) during a year of assessment which is equal to the sum of all accrual amounts in relation to all accrual periods". The deduction is permitted provided that two requirements are satisfied; namely, the deemed interest should be derived from the carrying on of a trade, and the amount should be incurred in the production of income. These requirements replicate the section 11(a) requirements.

Therefore section 24J effectively became "the main section under which interest will be either deductible or included in income (and no longer section 11(a) of the Income Tax Act)". However, it is important to note that should interest be paid or received over a period shorter than 12 months, the provisions of section 11(a) will apply. Therefore section 24J only applies to long-term financial arrangements that extend in excess of a 12 month period. The application of section 24J deems an amount of interest to accrue or to be incurred during a year of assessment, regardless of the actual amounts received or paid during that year.

Even though there is certainty as to the deductibility of interest expenses, the deduction remains open to abuse in lending transactions. The requirement that the expenses must have been incurred in the production of income can be easily satisfied, as in most instances the finance is obtained to satisfy a legitimate business purposes. The issue is interest expenses incurred purely to reduce taxable income.

3.4. Section 11(a) of the Income Tax Act

Interest expenses incurred on lending transactions for a period shorter than 12 months will be deductible in accordance with the requirements as contained in the general deduction formula. Section 11(a) of the Income Tax Act is referred to as the ‘general deduction formula’ and the section reads as follows:

“For the purpose of determining the taxable income derived by any person from carrying

on any trade, there shall be allowed as deductions from the income of such person so derived –

(a) Expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature."

Therefore in determining the deductibility of interest on borrowed money in terms of the above deduction, the enquiry relates primarily to the purpose for which the money was borrowed, as well as the other requirements being satisfied. If the taxpayer’s purpose in borrowing money on which interest expenses were incurred was to produce taxable income, then such interest expense will accordingly be deductible.

It should be noted that if a taxpayer engages in a course of conduct and acknowledges that in doing so its main purpose was to obtain a tax benefit, that fact alone would not result in the expense concerned to be not deductible. In Burgess v CIR\(^{37}\) the court said,

“I do not think that this argument is sound in law, even if the facts supported it. If a taxpayer pursues a course of conduct which, standing on its own, constitutes the carrying on of a trade, he would not, in my view, cease to be carrying on a trade merely because one of his purposes, or even his main purpose, in doing what he does is to obtain some tax advantage. If he carries on a trade, his motive for doing so is irrelevant”.

In CIR v DG Smith\(^{38}\) it was emphasised that it is up to a taxpayer to choose the source from where it derives capital to fund its income earning operations. Even to the extent that a taxpayer may have surplus cash available, there is nothing which compels the taxpayer to use the surplus cash as opposed to borrowing money from a bank in order to fund such expenditure.

Therefore, even if a taxpayer prefers to obtain debt financing as opposed to sourcing equity

\(^{37}\) 55 SATC 185.

\(^{38}\) 60 SATC 397.
investment due to the tax benefit of securing a deduction, such interest expense will not be
disallowed from being deducted against taxable income. Further, the fact that the taxpayer has
surplus cash is irrelevant. This is in accordance with the principle that taxpayers are entitled to
structure their tax affairs in such a manner as to reduce their tax liability.\(^\text{39}\) However, interest is
not deductible where the purpose of the borrowing is to derive dividends as ‘dividends’ are
exempt from tax under section 10(1)(k)(i) of the Income Tax Act.

3.5. Assumption

The interest expenses in relation to the debt financing structures for purposes of this work are
incurred for \textit{bona fide} income earning purposes, and not with regard to avoidance transactions.

3.6. Double taxation issue

Currently a company is a taxpayer in its own capacity, and from 1 April 2012 when the
Dividends Tax regime comes into effect, the beneficial owner will become taxable in its own
capacity. The company is subject to corporate tax and secondary tax on companies when it
declares a dividend. Therefore the income of a company is effectively taxed twice; firstly as
taxable income in the company, and secondly as dividends upon distribution to shareholders.

This situation remains unaltered under the Dividends Tax regime, as the beneficial owner
remains liable for Dividends Tax. The interest expenses incurred in lending transactions at the
company level are deductible and results in a single layer of tax in the hands of the debt holder.
Therefore the argument has been raised that the income tax system has a presumed bias in
favour of debt financing as opposed to equity financing.

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\(^{39}\) \textit{IRC v Duke of Westminster} (1936) 19 TC 490 at 520.
3.7. Complexities

It is a generally accepted principle that interest expenses incurred on a loan to acquire shares will not be deductible. The purpose of the expenditure incurred is to obtain dividends, which is classified as exempt income in terms of section 10(1)(k)(i) of the Income Tax Act.\textsuperscript{40} Therefore,

\begin{quote}
"if interest paid on money borrowed by a company to acquire shares in another company is linked with the actual or prospective receipt … of dividends, it cannot be allowed as a deduction, since all dividends constitute exempt income."\textsuperscript{41}
\end{quote}

The Dividends Tax regime imposes a separate withholding tax on the beneficial owner of the dividend. The Dividends Tax is regarded as a tax levied at the shareholder level and will be imposed at a rate of 10\%. Therefore there is an argument that interest incurred on borrowed money to acquire shares should be deductible, as dividends will no longer be regarded as exempt income, thereby creating an incentive to invest in the equity of a company.

Further, section 11C of the Income Tax Act makes provision for a deduction in respect of any interest that is incurred by a taxpayer in the production of income in the form of foreign dividends. Subsection (2) provides for a limitation to the foreign dividends included in income during the year of assessment. However, it must be noted that section 11C has been subsequently deleted in terms of the current Taxation Laws Amendment Bill.\textsuperscript{42} The deletion will become effective from 1 April 2012 with the coming into effect of the new Dividends Tax. However, it is interesting to note that such deduction was permitted in the first place, and if such interest was deductible at the foreign level, comparable treatment should be afforded to domestic dividends.

3.8. Withholding tax on interest


\textsuperscript{41} ITC 1820 (2007) 69 SATC 163.

\textsuperscript{42} Taxation Laws Amendment Bill of 2011, clause 31.
Section 10(1)(h) of the Income Tax Act currently provides for a blanket exemption in respect of interest income that is payable to any person who is a non-resident. A non-resident is classified as any person that does not satisfy the requirements of the definition of ‘resident’ as contained in section 1 of the Income Tax Act. The definition of ‘resident’ refers to two categories of persons; namely, natural persons and persons other than natural persons. A natural person is a tax resident in South Africa if such person is ordinarily resident in the Republic or passes the physical presence test. A person other than a natural person will qualify as a resident if “incorporated, established or formed in the Republic or which has its place of effective management in the Republic”.

The blanket interest exemption is part of an overall effort to attract foreign debt capital to South African shores. The exemption is subject to two exceptions that apply to non-residents who are active participants in the domestic economy. Firstly, the exemption is not available to non-resident persons that conduct business in South Africa through a permanent establishment, and secondly, to non-resident individuals that are physically present within the Republic for more than 183 days during the relevant year of assessment.

The Explanatory Memorandum to the Taxation Laws Amendment Bill of 2010 provided that the above policy rationale for the interest exemption can no longer be sustained as the “exemption does not achieve a fair balance between the attraction of foreign debt capital and the need to protect the (domestic) tax base against erosion”. Further, the authorities have recognised that the exemption provides foreign investors with an incentive to fund businesses with a disproportionate amount of debt as opposed to equity investment.

Therefore the Taxation Laws Amendment Act of 2010 enacted new sections, 37I to 37M, that introduced a withholding tax on interest. The withholding tax will be imposed at rate of 10%, set.

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43 Section 1 of the Income Tax Act, definition of ‘resident’.
45 Ibid.
to become effective from 1 January 2013.⁴⁶

The proposed amendment will impose a final withholding tax obligation on any person who pays any amount of interest to a non-resident that is not a controlled foreign company. However the “interest from domestic debt paid to foreign portfolio investors will remain wholly untaxed”⁴⁷. The provisions contain a broad list of exemptions that apply to interest income that is paid to the following non-resident persons; bonds issued by any sphere of Government, listed debt instruments on the JSE or a foreign exchange, any debt owed by a domestic bank or the South African Reserve Bank, domestic dealer, brokerage accounts and domestic collective investment schemes and controlled foreign companies. There are three additional exemptions that apply: trade finance, certain foreign payors and foreign payees, and back-to-back debt owed by a headquarter company.

The effect of imposing a 10% withholding tax rate in conjunction with the list of exemptions and the unrestricted interest deduction of all interest expenses is bound to have a negative impact on the fiscus. It nullifies any impact that the proposed withholding tax would have had on interest income paid to non-residents. The effective date of the proposed amendments has been delayed until 1 January 2013 in order to renegotiate certain tax treaties that have zero interest ceilings.⁴⁸ There is no certainty that other jurisdictions are going to agree to the rate of 10% and might negotiate for a lower rate, if at all.

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⁴⁶ Taxation Laws Amendment Act No. 7 of 2010, clause 58.
⁴⁷ SARS, EM 2010 p70.
3.9. Conclusion

Interest expenditure incurred is deductible provided that it was incurred in the course of carrying on a trade and in the production of income. The above requirements restrict the deductibility of interest to a trade element, and most loans obtained are for the purpose of producing income, either acquiring equipment or for the general operational needs of the business.

The issue is not the legitimacy of the expenses being used to further the business, but the heart of the matter relates to the amount of such expenses being deducted within a year of assessment. Excessive interest deductions being claimed have the effect of eroding the corporate tax base, not only for the current year of assessment but for future years of assessment, which contributes to exposing companies to financial instability.
CHAPTER 4. DEBT VERSUS EQUITY ISSUES

4.1. Introduction

"The distinction between debt and equity (essentially) draws on the historic legal division between creditor interests … and ownership interests (shareholders). The extent to which these debt/equity distinctions matter from an economic standpoint in company decisions is the subject of a longstanding controversy."\(^{49}\)

The debt-equity characterisation is particularly relevant for accounting purposes, as the distinction plays a major role when the financial statements of an enterprise are published to the general public, shareholders and importantly investors.\(^{50}\) Debt is often viewed as being a risk on the company’s balance sheet; however such risk has not hindered its continued use by the business industry. The distinction between debt and equity is also important as the corporate income tax system plays a role in influencing the choice of funding for a company.\(^{51}\) And the difficulty in choosing funding is further exacerbated when the companies are either domestic or multinational enterprises.

"For domestic companies, only the domestic tax system is relevant and they optimise their capital structure accordingly. The multinationals, however, face another dimension in that they are exposed to the different national tax systems of the distinct countries in which their affiliates are active."\(^{52}\)


\(^{52}\) Ibid.
This provides multinationals with an opportunity to engage in tax planning activities that seek to minimise their overall group tax liability.

4.2. Capital structures

The term ‘capital structure’ originates as a business finance term that broadly describes the proportion of a company’s capital that is obtained through debt and equity funding.

“Four decades of research on capital structures has not conclusively answered the basic question of whether there is an optimal mix of debt and equity” for enterprises.\textsuperscript{53} Capital structure has been defined as “the structure that would maximise (the firm’s) stock price … however it is difficult to establish this with confidence.”\textsuperscript{54}

Another definition of ‘capital structure’ notes it as a mix of a company’s long-term debt, short-term debt, ordinary shares and preference shares, and specifically refers to the manner in which a firm finances its overall business operations and growth prospects by using multiple sources of funds.\textsuperscript{55}

Therefore it is clear that the capital structure of a firm is a composite of debt and equity, and the proportions in which that debt and equity is utilised is the matter for concern for the tax system. However, it has been established that the “corporate tax is central to the theory of capital structure”.\textsuperscript{56}


“Theoretically and empirically, taxes (are said to) play an important role in determining the capital structure of companies.” Empirical literature already provides evidence that companies situated in high tax jurisdictions have higher debt ratios, as the tax deduction of interest expenses acts as a tax shield. The different tax treatments and rates of corporate tax allow companies to manipulate jurisdictions so as to secure the best tax advantage in cross border financing contracts. The “return on equity is regularly taxed in the country where the business is carried on while return on debt is taxed in the country where the holder of the debt instrument is resident.” Therefore the debt-equity divide seems to be decisive for the allocation of taxing rights at the international level.

According to the theory of Modigliani and Miller (1958), in the case of complete markets and perfect information, a company’s choice between debt and equity would be socially efficient. There is no unique optimal debt-equity choice of firms, and the value of the firm would not depend on its financial structure.

The general influence of taxes on the financing decision has already been investigated in many studies. A starting point is Modigliani and Miller (1963) who point out that the tax deductibility of interest has contributed to the preference of debt in corporate financing. It was an established result that taxes play an important role in determining the capital structure of companies.

A company may source financing using an array of financial instruments. However each source of finance will either fall into one of the two broad categories for classification; debt or equity instruments.

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60 Ibid.
A company usually relies on two mechanisms for financing: "[o]ne is by the issue of shares in the equity of the company and the other is [through] borrowing." These funding concepts are not substitutes for each other; rather they differ in nature and are complementary. The optimal result will be to strike the correct balance between debt and equity funding within the business structure using both forms in a commercially acceptable ratio. This ratio is known as the ‘debt to equity’ ratio. It is difficult to establish an ideal debt to equity ratio as the ratios vary greatly depending on the industry and company structure. Both debt and equity financing are imperative methods for businesses to obtain capital in order to fund their operations. In order to propose an optimal capital structure for a company it is important to understand the nature of the broader concepts of debt and equity.

Companies require funding to conduct their business operations, the acquisition of assets, project funding, and to fulfil general expansion requirements. It is important to understand that the debt that raises concerns for the revenue service is not the debt raised by small or medium sized companies. The focus is on large companies and multinational enterprises investing through institutional investors, not individuals.

### 4.3. Debt financing

The debt market is a sophisticated industry that offers a range of specialised instruments for different transactions. Essentially debt financing usually takes the form of loans that must be repaid over a period of time, with a periodical amount of fixed or variable interest levied on the capital amount. Debt holders have a legal right to receive a return that is fixed in advance, regardless of the financial position of the borrower.

This position is particularly important should the company become insolvent.⁶³

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Debt holders are regarded as secured creditors and have a prior claim to the firm’s assets in the case of insolvency. However debt holders do not have control rights over the firm. Businesses can borrow money over the short term (less than one year) or long term (more than one year) basis. Debt may be sourced from a wide spectrum of potential lenders; domestic banks, pension funds, retirement annuity funds, insurance companies and also the foreign markets. The private equity industry generally pools funds from a group of investors comprising the above entities and high net worth individuals.

“The debt finance package for many mid-market and large acquisition finance transactions will comprise two or more layers of debt, typically comprising senior debt and mezzanine debt”.  

Larger or more complex acquisitions may also source debt funds from the issuance of high-yield bonds or payment in kind (PIK) notes, and the mezzanine debt may be sub-divided into senior mezzanine and junior mezzanine layers of debt. In large finance transactions the companies make use of a multi-layered finance package, thereby offering borrowers a flexible and relatively cheap source of financing.

There are key benefits that are derived from the use of debt finance, which includes the swift and easy implementation of procuring the finance and preserves confidentiality of the business. Debt finance can be put in place relatively quickly when compared with a securitisation finance structure or equity instruments. In certain tax regimes, if not all, the interest costs which accrue, or associated fees with the raising of the debt finance, can be deducted against taxable profits generated by the borrowing company. Debt financing creates flexibility in the structure, quantum and pricing of the finance which can be negotiated to suit the transaction on hand. Debt funding comprises various forms, and each has a particular purpose, in order to implement measures that restrict the bias in favour of debt funding. It is important to understand the nature of the concept; therefore certain forms have been selected for elaboration.

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4.3.1 Ranking of debt

Senior debt is the bedrock of any debt transaction and is the cheapest form of leveraged buyout debt. Seniority of debt governs the order of its repayment, and in the event of insolvency, the most senior debt will be repaid prior to any subordinated debt. Debt instruments are ranked as senior, second lien, mezzanine, high-yield, PIK (payment-in-kind) and hybrid debt. There is no fixed rule about what combinations of debt are appropriate for a particular market or industry and different transactions use a combination of debt instruments.

The common element is lenders want to be exposed to little or no risk on their investment. They lend on the basis of future projections to their debt being fully serviced. Further, as illustrated in the examples contained in Chapter 2, the lenders lend to the operating companies usually to be close to the income earning assets or secure same as collateral for the debt. "The main determinants of credit risks (for the lender) are the firm’s leverage ratio, its value volatility, equity returns and the time to maturity of the debt". A high debt-asset ratio may increase the probability of bankruptcy and thus create a cost of financial distress.

There is external debt and internal debt. External debt is sourced from banks or private equity funds, whereas internal debt is provided by either group finance company or shareholders. Debt is usually used in a business for growth purposes or provision of working capital. But the way that money is raised can have an enormous impact on the success of a business. Shareholder loans are also problematic as it is usually perpetual debt, payable on demand by the shareholder.

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4.3.2 Types of debt

Leveraged buyouts (“LBOs”):

“A leverage buyout is the acquisition of a business, typically a mature company, by a financial investor whose objective is to exit the investment after 3 – 7 years realising an Internal Rate of Return (IRR) of in excess of 20 (percent) on its investment”.  

LBOs are known for their heavy reliance on interest deductions and their use increased substantially until mid-2007. The post acquisition interest deductions can be so large as to eliminate corporate income tax payments for several years. There is a possibility that this increased rise in LBOs had an indirect effect in encouraging other firms to increase their borrowing capacity to defend against an LBO takeover. Many LBOs cross national borders and so are characterised by complex structuring intended to minimise their tax liability, and in some cases exploit opportunities for ‘double dipping’. Between 2003 and 2006, the amount raised by private equity funds, which arrange most LBO transactions, increased five-fold to around USD 230 billion.  

Bonds:

“A bond is a debt security, (that is) similar to an IOU. When you purchase a bond, you are lending money to a government, municipality, corporation, federal agency or other entity known as the issuer. In return for the loan, the issuer promises to pay you a specified rate of interest”.  

There are various types of bonds on offer; government bonds, municipal bonds, corporate

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69 Ibid. p6.

bonds and asset-backed securities.

**Loans:**

A loan contract is essentially a simple commercial agreement whereby "a lender advances a loan to a borrower who has to pay it back and pays interest" on the amount borrowed.\(^{71}\) A bilateral loan is a loan between a borrower and a single bank. Large loans are open to syndication, whereby a number of banks or lenders contribute to the total loan amount as a single bank may not, on its own, be willing or able to advance the whole amount. The essence of syndication is that two or more banks agree to make loans to a borrower on common terms governed by a single agreement between all parties.

**High yield notes:**

"High yield securities were previously referred to as 'junk bonds'. High yield securities have a high interest rate to compensate for their riskiness and are usually issued to fund an acquisition or to recapitalise or refinance the existing acquisition debt of the issuer."\(^{72}\)

**Project financing**

"Project financing is a specialised funding structure that relies on the future cash flow of a project as primary source of repayment, and holds the project's assets, rights and interests as collateral security."\(^{73}\)

This is usually structured through a special purpose vehicle and separate legal incorporation.

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\(^{72}\) Ibid, p258.

The establishment of a special project company and the predictability of the future cash flows are the most prominent characteristics of a project financing. Project financing is associated with large investments, usually in excess of R250 million.\textsuperscript{74}

**Debt re-structuring arrangements**

"The objective of corporate debt restructuring is a timely and orderly restructuring of corporate liabilities with a view to restoring the corporation's operation and financial viability."\textsuperscript{75}

Therefore companies enter into debt restructuring arrangements to avoid default on existing debt obligations or to take advantage of a lower interest rate. A company in financial distress essentially obtains more debt in order to extinguish the current debt. The primary advantage of debt restructuring is that it allows a business to gain control of its finances; usually debts carrying high interest rates can be transferred to another lender with a lower rate and extended re-payment terms. However, financially the company remains in the same position; highly indebted for future years and continues to claim an interest deduction.

### 4.4. Equity financing

Equity financing refers to funds that are obtained from investors in exchange for an ownership share in a business. The main advantage to equity financing is that the business is not obligated to repay the money. The holder of the shares is normally entitled to a proportion of the profits of the company.

Further, such holders are expected to wait for their reward, within reason, until the directors of the company decide that profits can be spared for distribution rather than reinvestment. Equity

\textsuperscript{74} Ibid.

holders receive a return that is variable, based upon the performance of the firm, and is limited to their shareholding. Suppliers of equity receive any residual claims after debt and other liabilities have been repaid, as well as quasi-equity instruments, preference shares. Equity holders have control and voting rights over the company.\textsuperscript{76}

The most important difference from the tax point of view is the fact that equity investment is designed to produce a return for the investor in the form of a distribution from taxable profits, while the return on a loan investment is for the payer; an expense which has to be met before the profits can be established.

\textbf{4.5. Preference shares}

Preference shares are a particular form of a hybrid financial instrument, as they contain aspects of both debt and equity. The most notable aspect of a preference share is the fact that the return is guaranteed. "The rationale behind the use of preference shares is that the investor receives an exempt return in the form of dividends calculated with reference to a percentage of the prime rate".\textsuperscript{77}

\textbf{4.6. Specific debt-equity rules}

The Australian tax system contains specific provisions that establish a debt-equity test for tax purposes. The rationale for the provisions was to overcome concerns regarding the mischaracterisation of corporate financing arrangements between debt and equity resulting from the increased use of various hybrid investment products.

The test for distinguishing debt interests from equity interests focuses on a single organising principle.


An instrument is classified as a debt interest where an issuer has an effectively non-contingent obligation to return an amount at least equal to the amount invested back to the investor.\textsuperscript{78} The test regards the economic substance of the rights and obligations arising from the arrangement, rather than mere reliance on the legal form of the arrangement.\textsuperscript{79} Therefore, if there is an unconditional obligation to return the funds borrowed, it is regarded as a debt interest.

The following five elements must be satisfied to qualify as a debt interest; 1) there must be a scheme, 2) the scheme must be a financing arrangement for the entity, 3) such entity or connected person receives a financial benefit, 4) the issuing entity must have an effectively non-contingent obligation to provide a future financial benefit, and 5) it must be substantially more likely than not, that the value of the financial benefit to be provided will be at least equal to, or exceed, the financial benefit received.\textsuperscript{80}

There are four specific instances where an instrument is classified as an equity instrument: 1) a person holds an interest in the company as a member or stockholder of the company, 2) an interest that carries a right to a variable or fixed return from the company if either the right is contingent on the economic performance of the company or a part of the company's activities, 3) an interest that carries a right to a fixed or variable return from the company if either the right itself or the amount of the return is at the discretion of the company, or 4) an interest issued by the company that gives its holder a right to be issued with an equity interest in the company.\textsuperscript{81}

\textsuperscript{78} Available at http://www.ato.gov.au/businesses/content.aspx?menuid=0&doc=/content/00194622.htm&page=3&H3.

\textsuperscript{79} Section 974-10(2) Income Tax Assessment Act No. 38 of 1997.

\textsuperscript{80} Section 974-20 Income Tax Assessment Act.

\textsuperscript{81} Section 974-75(1) Income Tax Assessment Act.
There is a tie-breaker clause that applies to hybrid interests that are both debt and equity interests where both debt and equity tests are satisfied. The tie-breaker test provides that the interest is deemed to be a debt interest.\textsuperscript{62} The effect of the debt-equity rule is that interest paid on loans will only generally be deductible where the loans qualify as debt interests, as defined.

4.7. Role of the private equity industry

It is important to recognise that there is a growing and established private equity industry in South Africa and they play a significant role in the raising of debt finance from domestic and foreign investors. The private equity industry has R97.6 billion in funds under management at 31 December 2010.\textsuperscript{63} The fundamental operation of private equity firms is to acquire full or partial ownership in unlisted companies that have high growth potential.\textsuperscript{64} The majority of capital raised by the private equity industry is used in leveraged buyout or debt financed transactions.

“Private equity (may be defined as) the equity financing of unquoted companies at many stages in the life of the company, from start-up to expansion, to management buy-outs and buy-ins of established companies.”\textsuperscript{65}

The rationale behind private equity transactions is that the private equity firm buys in order to sell. “The transactions are highly leveraged [meaning that] there is a very substantial amount of debt which is vulnerable to slight downturns in the business or to increases in interest rates.”\textsuperscript{66}

\textsuperscript{62} Available at http://www.ato.gov.au/businesses/content.aspx?menuid=0&doc=/content/13798.htm&page=4&4H.

\textsuperscript{63} KPMG & SAVCA, p5.


Private equity firms engage in these transactions because the possible profits are so high, and as they "normally [generate a] 2 per cent commission and a 20 per cent return on profits above certain thresholds, there might be an incentive to gamble". The revenue authorities should keep a watchful eye on the private equity industry so as to keep abreast of developments and learn from the Danish experience, as discussed in Chapter 5.

4.8. Conclusion

The ideal situation is to create tax neutrality between debt and equity financing for companies. "The concept of neutrality is generally based on economic reasoning and is also often explained by the principles of fairness." Further, the concept of neutrality is associated with fiscal policy whereby, "tax neutrality is perceived as a situation where the alternative tax measures do not result in impacts on the societal allocations or incentives for various forms of financing".

The current tax treatment afforded to debt and equity funding certainly do not foster a tax neutral approach, and debt can be viewed as being incentivised, as opposed to equity. However, the lack of legislation which specifically defines debt and equity is also problematic. Until there are set boundaries as to the classification, instruments will be used interchangeably to take advantage of any tax benefits. Therefore debt equity rules should be enacted in conjunction with restrictions on the interest deduction.

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87 ibid, p22.


89 ibid.
CHAPTER 5. INTERNATIONAL COMPARATIVE ANALYSIS

5.1. Introduction

"Inter-company (cross border) debt financing is one of the most important instruments of international tax planning for enterprises and groups."\(^{90}\)

Transactions are usually structured as follows; the holding company or group finance company, which is often situated in a low tax or an exempt jurisdiction, extends a loan to a subsidiary situated in a high tax jurisdiction. The subsidiary is the profit earning group-company that is the recipient of an excessive loan. The interest charged by the holding company is above the standard interest rate, thereby resulting in the subsidiary being entitled to claim a deduction for the entire interest expense and shifting profits to the holding company tax-free. Therefore the subsidiary reduces its taxable income to a substantially smaller amount, or nil.

Therefore the necessity to enact anti-avoidance legislation arose to restrict the tax planning activities became an imperative for most countries. This resulted in the development of thin capitalisation rules. Further, the impetus for thin capitalisation rules has increased with the advent of globalisation, which was spurred by the aggressive growth of multinational enterprises. However, the "drafting of anti-avoidance legislation is one of the biggest challenges of modern tax law."\(^{91}\)

As financial planning becomes more sophisticated and easily adaptable to changing legislation, the revenue authorities often lag behind the financing trends.

Therefore it has been said that,


"... anti-abuse legislation has over time become a challenging issue for tax authorities, which [tries] to balance tax opportunities on the one hand, and tax restrictions on the other, within the constraints of retaining a competitive advantage, compared to other jurisdictions."  

A particular area of avoidance arises in the use of excessive leveraging by companies; firstly either due to inter-company debt targeted at shifting profits to low tax jurisdictions as illustrated above, or secondly, through third party debt which allows for an interest deduction to be claimed without incurring corresponding taxable interest income. Many countries use a combination of regulations and laws to combat excessive financial leveraging within their system, whilst trying to attract or retain much needed foreign investment.

5.2. Thin capitalisation and the restriction of the deductibility of interest

An entity that is excessively leveraged, when compared with its equity ratio, is known to be thinly capitalised. When companies borrow from third parties there is a general presumption that the natural commercial constraints will apply to determine the quantum of debt that can be extended to the borrowing party and the interest rate charged. The paradigm that exists is "corporate tax systems permit the deduction of interest payments from the corporate tax base, whereas the equity returns to investors are not tax deductible."  

Therefore in most jurisdictions there has been a shift in tax policy considerations to prevent outflowing interest payments from leaving the jurisdiction granting the deduction as untaxed income. Therefore domestic tax legislation restricts the deductibility of interest payments by domestic companies that are payable to their foreign connected persons.

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Further, multinationals have taken cognisance of the leeway presented in the tax laws to structure their financing strategies to manipulate the cross-border corporate tax rates, in the wake of increasing tax competition. This was one of the contributing reasons for the emergence of thin capitalisation rules; to prevent the asymmetrical result in revenue collections. Therefore “these financing strategies allow [for the reduction of] the total tax burden of a group of companies significantly”. The high proportion of debt to equity is a feature of the company's or the group's capital structure. From a fiscal viewpoint, such transactions result in the corporate tax base of a country being essentially eroded. Thin capitalisation is a consideration in cases where loans are obtained from related parties; the loans are continuously used within the company and the ratio of the loans balanced against the shareholders’ equity is significantly high, possibly in comparison with similar companies operating in the same sector.

Many countries have thin capitalisation rules to prevent subsidiaries from being capitalised with ‘excessive debt’ sourced from another jurisdiction or to deny the deduction for interest incurred on such debt. However, the determination of what is ‘excessive’ poses a challenge for all countries. Therefore a fixed rate ratio has been adopted to serve as a guide in limiting debt to certain a multiple of equity within a company. Many countries limit debt financing by granting a deduction with reference to the permitted fixed ratio.

There are two conflicting considerations in the setting of thin capitalisation rules in any jurisdiction. On the one hand, the fixed ratio has the potential to secure the domestic corporate tax base, particularly in high tax countries, by limiting international profit-shifting via intra-company debt. On the other hand, binding thin capitalisation rules increases the effective tax rate from the perspective of highly mobile multinational firms and this may have a detrimental effect on foreign direct investment. It is interesting to note that countries have not reached consensus as to what is an acceptable fixed ratio for debt funding, because it is difficult to

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determine if the ratios are in fact effective. It is an area of tax law that is constantly being revised to improve its effectiveness. This is illustrated from the list below, wherein various fixed ratios have been adopted across a number of jurisdictions.

It is important note that if the company’s debt-to-equity ratio exceeds any of the thresholds allowed in each of the jurisdictions below, the excess interest expenses will be denied or carried forward to be deducted in subsequent tax years.

List of thin capitalisation ratios adopted in various jurisdictions.\textsuperscript{98}

- Australia: 3 to $1^{99}$
- Belgium: 1 to 1 ratio applies to loans granted by individual directors and shareholders to the company.\textsuperscript{100}
- Brazil: 2 to $1^{101}$
- Canada: 2 to $1^{102}$
- Netherlands: 3 to $1^{103}$
- United Kingdom: No statutory fixed ratio, however the tax authorities may consider debt to equity ratios that exceed 1 to 1 and interest cover of less than 3 to 1 as not an arm’s length transaction. The deduction of interest in these instances will therefore be


\textsuperscript{99} Ibid, p19.

\textsuperscript{100} Ibid, p32.

\textsuperscript{101} Ibid, p42.

\textsuperscript{102} Ibid, p54.

denied.\textsuperscript{104}

- United States: 1.5 to 1\textsuperscript{105} (merely adopted as a safe harbour)

It is interesting to note that the United Kingdom has modified its thin capitalisation rules three times between 1994 and 2004.\textsuperscript{106} The German thin capitalisation rules have also undergone changes three times between 2000 and 2007.\textsuperscript{107} This clearly illustrates that countries are constantly trying to remain competitive in this arena to attract foreign investment and close loop holes.

5.3. \textit{Thin capitalisation rules in South Africa}

The thin capitalisation rules regulate cross-border transactions between connected multinational entities and their South African subsidiaries. The rules form part of the transfer pricing regulations in accordance with the Organisation for Economic Co-operation & Development ("OCED") guidelines, which consider thin capitalisation as part of the international transfer pricing mandate.\textsuperscript{108} The rules limit the deduction of interest expenses on excessive debt funding, thereby protecting the South African economy against distortions resulting from heavily geared foreign investment.\textsuperscript{109}

The thin capitalisation rules play a significant role, as South Africa does not currently have a withholding tax on interest payable to non-residents. Therefore the interest income paid to foreign investors or their cross border connected persons does not attract any tax. The current debt to equity ratio of 3 to 1 is applied, which is comparable with Australia and the Netherlands. However, internationally there has been a shift to decrease the ratio to even lower levels, with

\textsuperscript{104} Ibid, p494.

\textsuperscript{105} Ibid, p504.


\textsuperscript{107} Ibid, p30 – 33.

\textsuperscript{108} OECD’s Transfer Pricing Guidelines for Multi-National Enterprises and Tax Administrations.

the optimal ratio being 1 to 1. Companies that fall within the 3 to 1 safe harbour are entitled to a full deduction for the interest and finance charges incurred on the debt financing, subject to the requirements being satisfied as contained in section 24J of the Income Tax Act or the general deduction formula as contained in section 11(a) of the Income Tax Act, whichever may be applicable.

The thin capitalisation rules are contained in section 31(3) of the Income Tax Act, and are triggered when financial assistance is granted, directly or indirectly by a person who is a non-resident to a connected person that is tax resident in South Africa. Financial assistance is said to have been granted to such resident when the investor has a direct or indirect interest and the investor is entitled to receive 25% or more of the dividends, profits or capital, or is entitled to directly or indirectly exercise 25% or more of the voting rights of the recipient.\footnote{Olivier, L. & Honiball, M. (2008). \textit{International Tax: A South African Perspective}. Cape Town: Siberlink, p587.}

The interest expense will not be deductible between the connected parties to the extent that the underlying debt financing would not have economically existed had the financing been arranged at arm’s length between unrelated parties. The transfer pricing regulations have been amended in 2010 to incorporate the arm’s length principle. As a result of the thin capitalisation rules forming part of the transfer pricing rules, the arm’s length principle is therefore applicable.
The current transfer pricing rules were "causing uncertainties as the literal wording of the section focuses on separate transactions as opposed to a focus on the overall economic substance and commercial objectives of an arrangement".\footnote{Stiglingh, M. et al. (2011). Sike: South African Income Tax. Durban: LexisNexis, p590.}

Therefore the new rules are applicable to transactions concluded on or after 1 October 2011. However, there is no clear guidance regarding the application of the new rule. Further, the SARS Practice Note 2 has been removed from the system, pending the publication of a new Practice Note. The new arm’s length principle is comparable with the standard adopted in the United Kingdom.

The domestic thin capitalisation rules are restricted in their application to cross border debt funding between related parties. Generally the natural commercial constraints should dictate the relationship between an independent lender and borrower acting at arm’s length, whereby the risk levels of the borrower are considered, as well as their ability to repay the debt. Therefore there is no need to have thin capitalisation rules for external funding transactions.

However, it would appear that the excessive leverage transactions that seek to undermine the tax base are structured between independent parties acting at arm’s length. Both the lender and borrower in these transactions are able to secure different and important tax benefits. Therefore the international focus has also shifted to not only limiting the deductibility of interest in transactions between connected persons, but also between independent parties contracting at arm’s length.

\subsection*{5.4. International developments}

Certain jurisdictions were selected for evaluation regarding the mechanisms which have been adopted in order to regulate the issue of excessive leveraging. These mechanisms are intended curb the effects of excessive leveraging that seek to undermine the corporate tax base of those countries.
The main criticism levied against thin capitalisation rules is the argument that it is very difficult to determine one fixed ratio that is fair and effective for all firms operating across different industries. This argument is not without merit, as a singular debt-to-equity ratio for all businesses is inherently problematic and can be viewed as unfair. The measures adopted in each country seek to achieve the same objective; however by different means.

5.4.1 United States

"The tax-driven expatriation of US corporations is a troubling phenomenon"\textsuperscript{112} which led to the development of the 'earnings stripping' rules. There are two broad forms of earnings stripping: Firstly, when the US corporation relocates its tax residency to another jurisdiction to curb taxation or have no tax payable on its profits. This resulting in a 'corporate inversion', which is defined as when,

"a new foreign corporation, typically located in a low tax or no tax country, [that replaces] the US parent corporation of a multinational enterprise. The US corporation then [becomes] a subsidiary of the new foreign parent [company]."\textsuperscript{113}

Secondly, earnings stripping is said to occur when the resultant US subsidiary pays excessive interest to the related foreign corporation, thereby repatriating its profits in the form of interest. A key driver to the phenomenon of repatriation of profits has been the high corporate tax rates in the United States.


\textsuperscript{113} Ibid.
The corporate tax rates are set at a progressive rate basis, dependant on the taxable income generated by a corporation. The rates vary between 15 and 35% for taxable income exceeding USD 18 333 million. Thin capitalisation rules were first introduced in the United States in 1989 with the enactment of section 163(j) of the Internal Revenue Code, to combat the issue of earnings stripping by multinational enterprises.\textsuperscript{114} The section applies when the ratio of debt-to-equity of a corporation at the end of a tax year exceeds 1.5 to 1.\textsuperscript{115}

Should the ratio be satisfied and,

\begin{quote}
\textit{``...the interest expense is greater than 50 percent of the adjusted taxable income of the business, that portion above 50 percent is not tax deductible. Adjusted taxable interest is calculated by adding back net interest expense, depreciation, amortization, depletion and a net operating loss deduction to taxable income''}\textsuperscript{116}
\end{quote}

The excess interest portion that is disallowed will be allowed to be carried forward into future tax years.

The original enactment applied to debt extended from related parties, which was subsequently amended in 1993 to include debt extended from unrelated parties if the debt was guaranteed by a foreign or tax exempt entities. The United States applies a ‘facts and circumstances’ approach in determining whether a corporation is thinly capitalised and therefore the above ratio is merely used as a safe harbour measure.\textsuperscript{117} There are no legislative limitations on the general excessive interest expenditure incurred between third parties and corporations, either at the domestic or foreign levels.

\textsuperscript{114} Internal Revenue Code of 1986, United States.


\textsuperscript{116} Ibid.

Even though the United States had adopted the anti-stripping rules and “its widespread use ... the evidence on the effects of [these] restrictions on corporate financing and investment decisions is generally lacking”. \textsuperscript{118}

In 2009 the “Obama Administration proposed a new set of international laws, designed ... to generate additional tax revenue”.\textsuperscript{119} While the 2009 proposal was recently withdrawn, the overhaul of international tax laws is imminent.

“[The] 2009 proposal would have tightened restrictions on interest deductibility, but it would only apply in very limited situations”.\textsuperscript{120} Therefore the above proposal, even though withdrawn, is an indication that the United States considers the unrestricted interest deduction as problematic for the economy and for the corporate sector. In light of the recent down grading of the credit rating to AA+ by Standard & Poor, the United States government will certainly be reviewing its current tax system to in order to increase their revenue collections for future years.\textsuperscript{121}

5.4.2 Germany

The interest barrier rules were introduced in the course of the 2008 German Business Tax Reform process. Prior to 1 January 2008, Germany imposed a debt-to-equity ratio of 1.5 to 1 under its thin capitalisation legislation. The debt-to-equity ratio has subsequently been replaced with a general limitation on the deduction of interest expenses. The decision to overhaul the thin capitalisation regime was designed to “improve the competitiveness of firms in Germany, to foster investment (and) to increase Germany’s attractiveness to foreign investors”.\textsuperscript{122} The


\textsuperscript{120} Ibid.


‘interest barrier’ was enacted “to counter abusive transfers of profits outside the German tax jurisdiction”.\textsuperscript{123}

“Germany introduced an interest barrier which allows the deduction of interest (provided that the) company’s net interest expenditure does not exceed 30% of the company’s Earnings before Interest Taxes Depreciation and Amortization” (‘EBITDA’).\textsuperscript{124}

The net interest expenditure is calculated as the difference between the interest expenses minus the interest earnings. If a company’s interest expenditure exceeds the 30% barrier, the exceeding amount is carried forward by the company as an interest carry forward. The interest carry forward can be deducted in a subsequent tax year, should the net interest expense be smaller than 30% of the EBITDA. Since the introduction of the interest barrier in 2008 the exemptions have undergone significant amendment due to the global economic crisis, such that the unused taxable EBITDA is allowed to be carried forward for a maximum of five fiscal years.\textsuperscript{125}

EBITDA is essentially a valuation concept that is used to analyse and compare the profitability between companies and industries. It is an indicator for a company’s financial performance that is calculated as follows: \textit{EBITDA = Revenue – Expenses (excluding tax, interest, depreciation and amortisation)}.

The German legislation currently provides for three exceptions to the interest barrier rule. Firstly, if the net interest amounts do not exceed EUR 3 million, all interest expenses incurred will be deductible. The threshold limit serves as a relief to small and medium sized companies, as companies exceeding the \textit{de minimis} EUR 3 million threshold will fall within the scope of the interest barrier. Secondly, an escape clause has been provided, in that the interest barrier is


\textsuperscript{125} \textit{Ibid}, p14 – 15.
only applied to companies belonging to a group of related companies. Thirdly,

"the interest barrier does not apply to a company that forms part of (an international) group of companies and if the ratio of equity to total assets of such company is equal or higher than the same ratio for the group".  

A difference of up to 2% within the equity ratio comparison is disregarded, and will not trigger the interest barrier rule. In other words, if the subsidiary is less leveraged than the worldwide business, the subsidiary is not constrained by the interest limitation rule.

The German interest barrier rule appears to have certain advantages over thin capitalisation rules. The interest barrier does not distinguish between long or short term liabilities, nor between resident and non-resident lenders. Importantly, the interest barrier does not distinguish between debt financing granted by third parties or related entities. The limiting of interest deductions appears to be more effective by directly addressing the real concern of tax authorities, i.e. the reduction of corporate tax receipts.

The interest deduction limitation avoids the issue as to whether a single debt-to-equity ratio is correct for all types of businesses. Some industries rely on more debt to fund operations when compared with other industries or sectors, and the same debt-to-equity fixed ratio for all sectors may be arbitrary and ineffective. The interest barrier rules "cover a wide range of finance activities [in comparison with] the U.S. earnings stripping rule" as the focus is more targeted.

The interest barrier applies to pure domestic debt financing and is not limited only to cross


border debt financing.\textsuperscript{130}

"The German interest barrier massively restricts the tax deductibility of interest expenses for German tax purposes and deeply cuts into the financing structures of German enterprises and investors".\textsuperscript{131}

5.4.3 United Kingdom ("UK")

As stated above, the UK's thin capitalisation rules have undergone amendment three times due to its continued regulation of highly leveraged financing structures, which began in the 1990s.\textsuperscript{132} From 1 April 2004, "thin capitalisation was brought within the main transfer pricing legislation".\textsuperscript{133} The legislation introduced the application of the arm's length principle to regulate excessively leveraged financing structures between related companies. According to HM Revenue & Customs,

"... the arm's length borrowing capacity of a UK company is the amount of debt which it could and would have taken from an independent lender as a stand-alone entity rather than as part of a multinational group".\textsuperscript{134}

Therefore, in order to establish whether or not the interest payable on a loan is deductible, it is necessary to establish two criteria. Firstly, how much the company would have been able to borrow from an independent lender; and secondly, compare this amount with the amounts


\textsuperscript{131} Ibid, p98.


\textsuperscript{133} HMRC INTM542010 – The main thin capitalization legislation. Available at: http://www.hmrc.gov.uk/manuals/intmanual/intm542010.htm.

actually borrowed from group companies. Therefore the basic requirement is that such a transaction will be treated as if it had occurred on an arm’s length basis between independent enterprises.

"The legislation requires that the particular facts and circumstances of a transaction should be considered in order to determine the arm’s length interest rate that should be applied."  

Therefore the usual safe harbour rules have been replaced with a subjective ‘facts and circumstances’ enquiry. In addition to the ‘arm’s length principle’ adopted, a new regime was introduced to restrict the deductibility of finance expenses of groups of companies. The new ‘worldwide debt cap’ regime applies for accounting periods beginning on or after 1 January 2010. The debt cap regime is applicable after any transfer pricing adjustment has been made. The purpose of the debt cap is to restrict the UK tax deductions for financing costs to the amount of the consolidated group’s gross external financing costs. The regime is designed to prevent groups of companies from eroding the UK tax base via interest deductions where the consolidated group as a whole does not suffer an equivalent cost to external lenders.

The worldwide debt cap rules apply to a group of companies, with particular reference to large groups of companies. These groups either employ 250 or more people, or have an annual turnover of £50 million, and an annual balance sheet total of £43 million or more. The worldwide debt cap consists of two tests; a gateway test and the more detailed calculation of the worldwide debt cap. The gateway test is based on balance sheet levels, both for the worldwide

gross debt and UK net debt.

The first problem is that UK members of overseas headed groups may not know the likely closing group balance sheet debt figure until the financial period is over. In some cases it will be impossible to determine whether or not the gateway test will be failed until the balance sheet figures are available. The impact of currency fluctuations can be significant where the consolidated balance sheet is in a different currency. Failing the gateway test results in the balance of the rules not being applicable.

A further calculation is required to compare the group’s gross consolidated finance expense with the ‘tested expense amount’, being the sum of all UK relevant group companies that have net finance expense. Any UK relevant group company with net finance expenses of less than £500 000 is excluded.

5.4.4 Italy

From 1 January 2008 Italy abandoned the debt-to-equity ratio in favour of income statement limitations. The approach adopted was closely modelled after the structure adopted in Germany. The 30% limitation applies to financial statements prepared according to Italian GAAP, and not taxable income.\textsuperscript{140} It also applies to interest paid to non-related parties, such as banks. The same rules apply to both domestic and international firms.

5.4.5 Denmark

In the 2007 tax year, the corporate tax rate was reduced from 28% to 25% and new thin capitalisation rules were introduced. The new rules have been described as 'very complicated and detailed'. The amendments to the thin capitalisation regime were sparked by large Danish companies that were acquired by private equity funds involved in aggressive tax planning, and as such, the "debt leveraged acquisitions ... led to a (substantial) reduction of Danish tax revenues". An investigation into the selected companies revealed that corporate income taxes decreased from DKK 2.4 billion to DKK 0.4 billion, following the acquisitions by the private equity firms, thereby indicating the prevalence of debt funding by the private equity industry. Prior to the new rules becoming effective Denmark maintained a debt-to-equity ratio of 4 to 1, which is higher compared with other jurisdictions.

Denmark adopted an approach to limit the deductibility of interest by using a set of three limitations. These methods were individually successful in reducing the tax deductibility of interest expenses. Interestingly, the new limitations applied to debt extended from unrelated parties. The first restriction limits the deduction of interest on debt extended from related parties and maintains the existing debt equity ratio of 4 to 1. Interest expenses that exceed the ratio are therefore not deductible. However, the rules will not apply to interest expenses that are less than DKK 10 million or to loans from private individuals. Should a company provide proof that

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144 Ibid.


146 Ibid.


148 Ibid.
a similar loan facility could be obtained from a third party, the above ratio will not apply.\textsuperscript{149} This limitation also extends to third parties if the loan is secured by related party assets.

The second limitation establishes an interest deduction limit which is based on the value of qualifying assets. Companies are allowed to deduct net financing expenses only to the extent that the interest expense does not exceed a standard rate of interest based on selected qualifying assets.\textsuperscript{150} In 2009 the interest rate was 6.5\%, which is adjusted annually. The interest rate is applied upon the tax value of assets at year end to calculate the interest ceiling limitation applicable to a particular company.

\begin{quote}
"Fixed assets are valued net of accumulated depreciated, non-depreciable assets are valued at cost plus the cost any improvements, internally developed intangible assets are not valued unless the costs are capitalized for tax purposes, and inventory, receivables and work-in-progress are valued net of any reserves."\textsuperscript{151}
\end{quote}

That amount calculated is compared with the net financing expenses; which is "the sum of taxable interest income less deductible interest expenses, excluding interest on trade accounts payable and trade receivables, trading losses, loan losses" and foreign exchange gains and losses.\textsuperscript{152} This rule applies to debt financing obtained from both related and third parties. Interest expenses that exceed the limitation are non-deductible and cannot be deferred. The rule applies when net financing expenses exceed 21.3 million DKK (2010). The \textit{de minimis} figure is adjusted annually.

The third limitation caps the net financing expenses based on the firm’s Earnings Before Interest

\begin{flushright}
\textsuperscript{149} Ibid.
\end{flushright}
and Taxes (EBIT). The net financing expenses may not exceed 80% of EBIT. The thin capitalisation rule was extended to include an interest stripping rule, restricting a firm’s interest deduction to 80% EBIT. Similar reforms were adopted in Germany and Italy, however, the limit on interest expenses is set at 30% EBITDA. "The US limits interest expenses to 50% of adjusted taxable income but only if the 1.5 – 1 debt equity ratio is exceeded". In Denmark the small and medium sized enterprises will not be affected by the interest limitations as they are perceived not to have net interest expenses exceeding DKK 20 million. However, it is said that the impact will be felt by large companies with high leverage, typically companies held by private equity firms, industrial buyers or Danish based multinational companies.

5.4.6 Netherlands

The thin capitalisation rules were implemented with effect from 1 January 2004. There is a restriction on the deductibility of interest on “loans provided by a taxpayer to a group company or related company excessively financed by debt capital”.

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153 Ibid, p45.
154 Ibid, p46.
156 Ibid.
A company is deemed to be excessively leveraged if its average annual debt level exceeds a 3 to 1 debt to equity ratio for tax purposes, and the excess is greater than EUR 500 000.\textsuperscript{157} The interest expenses payable on the excessive debt will therefore be denied. “If a Dutch corporation incurs debt to fund profit distributions, fund investments in related entities or acquire a related entity, the associated interest expense may not be tax deductible”.\textsuperscript{158} However, there are two exceptions to the rules; if the loans are obtained for sound business reasons, and if the corresponding interest income is taxed at a rate of at least 10% or more.\textsuperscript{159}

**Dutch tax agenda for 2012:** The following proposal by the Dutch authorities is in accordance with the current trend of governments to close tax loopholes in the current economic climate. On 15 September 2011, the Ministry of Finance in the Netherlands released the budget proposals for the 2012 tax year. “The proposed measures aims to stimulate the investment climate in the Netherlands, codify existing policy and curb excessive borrowings in relation to Dutch acquisitions”.\textsuperscript{160}

The proposal seeks to disallow interest expenses incurred on excessive borrowing transactions that facilitate company acquisitions. The acquisition transactions are entered into between a Dutch company and a Dutch target company, and subsequently results in a fiscal consolidation or a merger between the acquiring and target. The interest expense incurred on the acquisition transaction will be deductible against the stand-alone taxable income of the acquiring company.\textsuperscript{161}

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\textsuperscript{159} Ibid. p32.


\textsuperscript{161} Ibid.
"In effect, for the purposes of these rules, the fiscal unity is disregarded".\textsuperscript{162} Therefore the interest expenses will not be deductible against the taxable income of the target company. Further, the proposed law will apply to interest expenses incurred on both external or third party debt and on intra group debt.\textsuperscript{163}

The proposed rules will not apply to the extent that the interest expenses do not exceed EUR1 million or if the debt to equity ratio of the fiscal unity (refers to the acquiring and target company) does not exceed 2 to 1.\textsuperscript{164} The threshold is set fairly low at EUR 1 million and the debt equity ratio is marginal, which is indicative of the drive to prevent tax leakages.

\section*{5.5. Allowance for corporate equity (ACE)}

The ACE system "is interesting in that it has been on and off tax reformers' agendas since the 1980s".\textsuperscript{165} The objective of the ACE is to address the difference "in the treatment of debt and equity" investment.\textsuperscript{166} Therefore, by adopting the ACE approach, firms will be similarly placed whether they use equity or debt financing. It is established that the general deductibility of interest expenses creates a distortion in finance structures as equity returns are non-deductible.

The earlier idea was to abolish the deductibility of actual interest payments and to replace it by an allowance for the normal return, applied to the book value of the entire firm's capital. The ACE is slightly different in that it maintains the current deductibility of actual interest payments. It adds a further step whereby the notional return on equity is to be deductible against corporate profits.\textsuperscript{167} "(T)he ACE provides a deduction for equity, equivalent to interest in computing the


\textsuperscript{163} Ibid.

\textsuperscript{164} Ibid, p2.


\textsuperscript{166} Ibid, p231.

company's taxable profits".  

The deduction under the ACE mechanism is based on the nominal, and not the real, rate of interest. "It is this feature of the ACE that makes it robust against inflation – so that it can have a neutral impact on investment decisions without needing any explicit inflation adjustment". 

The most attractive feature of the ACE is the tax neutrality created between debt and equity finance. "Firms will thus be indifferent between debt and equity finance, at least regarding the corporate tax implications". Therefore the need for thin capitalisation rules will become redundant. Under the ACE regime, "(t)he method of tax depreciation is irrelevant" and "the system is unaffected by inflation". Even though the ACE approach offers a balanced tax treatment, the major resultant effect of the regime requires an increase in the corporate tax rate to maintain the same revenue yield. The counter argument would be to grant the deduction for equity distributions but broaden the tax base for revenue collection. Further, in granting a deduction for equity returns, multinational companies may still shift their profits to other jurisdictions.

5.5.1 Brazilian ACE variant

Fundamental corporate tax reform was implemented in Brazil during 1996, which resulted in the adoption of an ACE variant. The variant allows the notional interest only to be deducted when distributions are actually paid out to shareholders, and not on the retained profits. Further, Brazil has labelled the ACE as remuneration of equity. The effects of this model are different

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from the application of the standard ACE approach.\textsuperscript{173}

5.5.2 Belgium

In 2005 the Belgian tax law enacting the notional interest deduction was passed, which is available to all companies and to Belgian branches of foreign companies. The new rules intended to firstly, ensure equal treatment of debt and equity funding, and secondly, to provide a successor to the Belgian coordination centres (which were fully terminated from 1 January 2011).\textsuperscript{174} The notional interest deduction provides for a tax deduction for fictitious interest owed on the corporation’s equity as it appears in the balance sheet.

Therefore the calculation is based upon a percentage of the ‘qualifying equity’ of a Belgian company. The ‘qualifying equity’ is multiplied by the monthly average interest rate for 10 year linear government bonds in the second year preceding the assessment year.\textsuperscript{175} The deduction is based on the company’s equity, the share capital subject to certain adjustments, and the retained earnings of the preceding year. The deduction is granted annually and can be offset against operational or financial income, an excess amount of the deduction is available to be carried forward for seven years.

The notional interest deduction results in a yearly deduction from the tax base equal to a percentage: 4.47% for 2010 year of assessment, and 3.8% for 2011 year of assessment of the company’s adjusted equity.\textsuperscript{176}

\textquote{The measure thus allows for obtaining tax relief for what is deemed an arm’s length


interest rate calculated on the adjusted equity for which no charge is reported in the profit and loss statement."\textsuperscript{177}

The deduction is not granted to investment companies with a variable capital, investment companies with a fixed capital, companies investing in debt claims, or cooperative participation companies.\textsuperscript{178}

\textbf{5.6. Comprehensive business income tax (CBIT)}

The CBIT eliminates the fiscal discrimination by enacting a neutral approach towards the financing structure of a company by disallowing the deduction of interest expenditure. The allowance for corporate equity system obtains the same result by granting equity holders an allowance equal to a notional risk-free return on equity.\textsuperscript{179} The disallowance of the interest deduction applies to most firms, including financial companies (banks). Due to the harsh economic effect of this mechanism on companies, it is proposed that the corporate tax rate be reduced.

The disadvantage of the CBIT model is that it raises the cost of capital on debt financed investments. This results in the opposite effect of the ACE system, as the CBIT is dependent upon the broadening of the tax base to raise corporate tax revenue.\textsuperscript{180} Interestingly, thin capitalisation is a form of CBIT, even though there is no outright disallowance of an interest deduction. There is a limitation on the deduction equivalent to the debt to equity ratio and the exceeding interest expense is denied.\textsuperscript{181}

\textsuperscript{177} Ibid.


\textsuperscript{180} Ibid, p16.

5.7. **Taxation of financial arrangements (TOFA)**

The Australian TOFA reforms were introduced in two stages during the 2001 and 2003 tax years. The TOFA was enacted to reduce the influence of tax considerations on how financial arrangements are structured and applied in practice, with an emphasis on other non-tax factors, such as evaluating risk when making financing choices. TOFA provides a comprehensive framework to address the economic substance of financial arrangements. “A major motivation of the reforms to the taxation of financial arrangements was to ensure that different forms of financial instruments are taxed according to their economic substance, rather than their legal form”.

Prior to the reforms, it was recognised that the tax law placed too much emphasis on the legal form, as opposed to the economic substance of the financial arrangements. This resulted in inconsistencies arising between the tax treatments of different types of transactions that have similar economic consequences. It was found that the inflexible form based regulations could not keep pace with financial innovation, thus creating opportunities for tax deferral and tax arbitrage.

Stage one of the TOFA reforms was the enactment of a thin capitalisation system and rules that classified financial instruments issued by entities as either debt or equity, based on the instruments economic substance rather than legal form. The new rules set out a test for distinguishing debt interests from equity interests by focusing on a single organising principle, whereby an instrument is regarded as a debt interest where an issuer has an effectively non-contingent obligation to return an amount at least equal to the amount invested back to the investor. If the thin capitalisation rules apply, an entity is required to calculate its debt capital and compare that figure to its maximum allowable debt. Should the entity’s debt capital be

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183 Ibid.
more than its maximum allowable debt, the entity’s debt deductions may be denied.\textsuperscript{184}

The thin capitalisation rules are contained in division 820 of the legislation and the object of the division is to ensure that various specified entities do not reduce their tax liabilities by using an excessive amount of debt capital to finance their Australian operations.\textsuperscript{185} The entities specifically referred to in the legislation include Australian entities that operate internationally, Australian entities that are foreign controlled, and foreign entities that operate in Australia. An important exclusion is contained in division 820-35 which provides that the provisions do not apply to any deductions of an entity for an income year if the total debt deductions of that entity and all its associate entities for that year do not exceed AUD $250,000.

Further, foreign entities that have no investment or presence in Australia are excluded from the thin capitalisation regime. The rules apply differently, depending on whether the entity is: an inward investing entity or outward investing entity, a general entity or a financial entity, or an authorised deposit-taking institution. Each of these categories has specific rules that must be utilised to calculate the maximum allowable debt amount.

An inward or outward investing entity is to calculate its adjusted average debt and then compare it to the maximum allowable debt as prescribed under the legislation. Debt deductions will be disallowed to the extent that the amount of adjusted average debt used to fund an entity’s Australian operations exceeds the prescribed maximum allowable debt.

The maximum allowable debt for outward investing entities is the greatest of the following amounts\textsuperscript{186}:

- The safe harbour debt amount / safe harbour ratio of 3 to 1,\textsuperscript{187}


\textsuperscript{185} Income Tax Assessment Act No. 38 of 1997 (hereinafter referred to as "ITAA 1997").

\textsuperscript{186} Section 820-90 ITAA.

\textsuperscript{187} Section 820-95 ITAA.
• The arm’s length debt amount, or

• The worldwide gearing debt amount.\textsuperscript{188}

The maximum allowable debt for inward investing entities is the greater of the safe harbour debt amount or the arm’s length debt amount.\textsuperscript{189}

TOFA mandatory rules apply to the following entities: authorised deposit-taking institutions, securitisation vehicles, and financial sector entities that have an aggregated turnover of AUD $20 million or more in the previous year’s income, superannuation entities, managed investment schemes, and foreign entities similar to managed investment schemes if the value of their assets is $100 million or more. Stages two, three and four of the TOFA reforms are not relevant for the present purposes and will not be discussed further.\textsuperscript{190}

\textsuperscript{188} Section 820-110 ITAA.

\textsuperscript{189} Section 820-90 ITAA.

\textsuperscript{190} Stage 2 addresses anomalies in the way tax applies to foreign currency gains and losses. Stage 3 addresses how tax applies to hedging transactions and stage 3 regulates the tax timing treatments of financial arrangements other than hedging financial arrangements.
5.8. Conclusion

It has been suggested that the more effective approach to adopt is the mechanism Germany and Italy have selected in limiting the interest expenses incurred to a percentage of EBITDA. The Italian and the German tax systems no longer have thin capitalisation rules in force as the new rules have made thin capitalisation rules redundant. Domestic and cross-border interest expenses will be dealt with under a unified regime.

The thin capitalisation rules have been substituted by rules that restrict interest deductions, irrespective of a permitted debt-to-equity ratio in those countries.\(^{191}\) Further, in order for the interest restriction to be effective, it should apply equally to related and unrelated third party debt financing arrangements.

Various jurisdictions are trying to combat the same problem of excessive interest deductions being claimed from the fiscus; however, the approaches adopted are different and have been tailored to address that jurisdiction’s particular concerns. Each jurisdiction has the underlying intention of trying to remain more competitive than the next, while trying to achieve a dual purpose.

Firstly, the fiscus seeks to prevent a tax leakage of revenue by clamping down on transactions that are designed to specifically take advantage of tax benefits. Secondly, the fiscus has a duty to create an environment that attracts foreign investment and promotes business interests. The success of the mechanisms that have been adopted, as discussed above, will be evaluated in future tax years; however, it is guaranteed that these mechanisms will be subject to continued change.

CHAPTER 6. RECOMMENDATIONS

6.1. Introduction

“The financing behaviour of investors is crucial for designing thin capitalisation rules” and other reforms that seek to achieve a particular objective.192 The National Treasury has clearly indicated its intention in reforming the landscape with regard to the debt-equity issues that currently exist.193 The reforms introduced in terms of section 45 transactions are merely the beginning of a larger process of reform. However, such reforms must not be created in a vacuum and the interests of the business community must be seriously considered.

Global economic downturns are cyclical and exist for certain periods of time. However, markets will not remain at depressed levels indefinitely, and the companies will start to engage in expanding business operations and acquiring assets once again. Therefore the revenue service should be prudent in preparing for the future upswing in business in an attempt to enact legislation and create a complementary regulatory system.

There is an argument that could be made for a reduction in the corporate tax rate if interest caps are adopted in order to minimise the impact on business. A reduced corporate tax rate would encourage foreign direct investment into South Africa and also be a relief mechanism to small and medium companies. As the same, the corporate tax rate is applicable to all companies, with the exception of companies that qualify for the turnover tax regime. There has been an increasing tax race between countries to reduce the tax rates applicable for corporate entities.


"The decline in (the) statutory corporate tax rate is a well documented phenomenon. It is usually attributed to international tax competition and a higher degree of capital and profit mobility".\textsuperscript{194}

In the 2007 tax year, Denmark reduced its corporate tax rate to 25\%, and at the same time introduced new thin capitalisation rules. Taxpayers were not overburdened with restrictive new rules and a high corporate tax rate, therefore compromise reforms seems to be an ideal approach in which both the fiscus and the taxpayer benefit.

"The loans for refinancing debts kept the highly indebted large corporations afloat and provided them with a chance to work towards restructuring their remaining debt".\textsuperscript{195}

The allowance created for companies to obtain additional debt, used in conjunction with reduced corporate tax rates, provided a comprehensive approach by government in assisting large companies to survive during the rescission.\textsuperscript{196} Therefore reducing corporate tax rates immediately increases a company’s income and boosts their profitability.

6.2. **Recommendations**

The following options are proposed to facilitate discussion on measures that could be adopted in the light of the South African tax dispensation. Perhaps certain options could be adopted in conjunction with other measures.


6.2.1 Option 1

The interest deduction could be granted on a sliding scale that is based on the turnover brackets of a company. This companies that have a turnover of R3 million or less, the interest expenses incurred will be deducted in full, provided that other requirements set out in section 11(a) or 24J of the Income Tax Act are satisfied. The turnover of R3 million or less promotes small businesses, and accords with the governments the current incentives for small business enterprises. Companies that have a turnover of R3 million to R5 million will be entitled to claim a deduction of 80% of its interest expenditure incurred. Companies that have a turnover in excess of R5 million will be entitled to claim a 50% deduction on the interest expenditure incurred.

The above suggested turnover brackets are an illustration of how the system could be implemented on a sliding scale, and are subject to analytical data from the South African Revenue Service ("SARS") to verify companies and their respective turnovers. The turnover based deduction will be effective and easy to administer from the regulatory side of the SARS.

An exception could be created such that if companies can provide proof that the interest income is paid to a taxable entity, that company will be entitled to claim the full deduction on the interest expenditure incurred. Therefore that recipient entity will account for the interest as income and such income will be subject to income tax. If the interest is paid to an exempt entity, or payable to a non-resident that is not subject to tax, the interest expense incurred will be deductible according to the sliding scale regime proposed above.

6.2.2 Option 2

An approach similar to the interest barrier adopted in Germany in 2008 could be adopted in South Africa. The German approach restricts the deduction of interest expenditure to 30% of the company’s EBITDA. There are certain exemptions that apply; namely, interest expenses that do not exceed a cap of EUR 3 million are fully deductible, the interest barrier is only applicable to group companies, and the interest barrier does not apply to a company that forms part of a multinational enterprise if the ratio of equity to total assets of such German company is
equal to or higher than that ratio for the group.

The South African comparable would be an interest barrier restricted to 30% of the company’s EBITDA. The *de minimis* exclusion that could be adopted must be set at a fairly high value, like the German model of EUR 3 million, thereby excluding small to medium sized companies as it would hardly ever have a net interest expense for more than the *de minimis* amount. According to Goritzer,\(^{157}\) the interest barrier is more advantageous for companies expecting high future profits on a constant basis. This leads to high EBITDA and hence increases the possibility to deduct the interest expense. Additionally companies may increase their annual depreciation rate, which also contributes to a high EBITDA. The interest barrier links the interest deduction directly to a company’s performance, whilst a thin cap only focuses on a company’s debt ratio. Therefore the interest barrier may become too restrictive during an economic crisis, where only low profits or even losses are expected. The unfair result is a company would not be allowed to deduct interest because of low profits even though it is not excessively debt financed.\(^{158}\)

Further, the interest barrier cannot be restricted to connected persons or groups of companies as third party financing is also a concern in the South African business environment.

6.2.3 Option 3

The General Anti-Avoidance Rules that are contained in sections 80A to 80L of the Income Tax Act can be relied upon to tackle the issue of excessive leveraging in transactions that are intentionally abusive. An additional provision could be inserted, or the current wording could be tightened, to cater for the debt financed transactions that are entered into where the company is in an insolvent position.

The company is leveraged for future years of assessment and creates additional assessed


\(^{158}\) *Ibid*, p22.
losses. Further, the legislation could cater for finance transactions that are intentionally concluded to erode the corporate tax base in respect of future years’ assessments. However, this enquiry would be based on a facts and circumstances approach, and proving such intention in court would be very difficult.

6.2.4 Option 4

A deduction for interest incurred to acquire shares could be allowed, thereby reducing the preference in favour of debt. From 1 April 2012 dividends will be subject to the new Dividends Tax regime and will be subject to tax at a rate of 10%. The proposed granting of an equity deduction will reduce transactions that are purely entered into to get around the current non-deductibility aspect, and therefore make the proposed amendments to section 45 reorganisation transactions redundant.

According to Shaviro,\textsuperscript{199} the heart of the issue regarding the treatment of debt and equity is the almost ubiquitous practice of allowing interest payments, but not the cost of equity finance, as a deduction against corporate income tax. The original rationale for this was a legalistic one, the view being that the corporation is so entwined with its shareholders that payments to them should not be deductible, whereas payments on debt are to true third parties and so should be deductible. Therefore, in economic terms, both kinds of payment represent a return to capital and it is their combined treatment at corporate and personal levels that matters.\textsuperscript{200}

The above is a valid consideration; however, if a deduction is not granted in respect of equity payments, taxpayers will continue to structure transactions to get around the non-deductibility aspect. If the interest deduction was restricted, an equity deduction could be made available.

6.2.5 Option 5


\textsuperscript{200} Ibid.
The United Kingdom adopted a worldwide debt cap that is applicable to groups of companies. The interest deduction of the resident company is restricted to the amount of the external financing costs of the entire group. Therefore, if the resident company has interest expenses in excess of the finance expenses of the group, such interest expense are disallowed. South African companies that form part of multi-national groups could rely on the group’s assets to secure finance from a third party lender. South Africa could adopt a similar debt cap which restricts the interest deduction of the South African company to that of the group. However this approach could be adopted in conjunction with another reform.

6.2.6 Option 6

The general restriction on the deductibility of interest to be adopted should be applied to debt financing sourced from connected and third party lenders. Section 1 of the Income Tax Act provides for a definition of ‘connected person’; for the present purposes, a connected company is any company as catered for in subsection (d) of the definition. Connected companies have an interest in under-charging or over-charging each other in lending transactions, possibly in an attempt to conceal profits. Third party lending is governed by commercial constraints, whereby interest expenses are levied at a market related rate. The problem lies in the fact that companies are excessive leveraged and therefore entitled to claim larger interest deductions.

In attempting to curb the tax bias in favour of debt financing, it is proposed that the restriction on the deductibility of interest be extended to financing obtained from connected and third party lenders. Should such approach be adopted, the thin capitalisation regime would be rendered redundant and there would be no need to have a debt-equity ratio.
6.2.7 Option 7

It is proposed that South Africa enact specific debt-equity rules as adopted by Australia. The debt-equity rules would eliminate characterisation issues as to whether an instrument is debt or equity. Further, it would hamper the designing of sophisticated hybrid instruments that seek to manipulate aspects of debt or equity in order to secure a tax benefit. The test will evaluate the economic substance of the rights and obligations arising from the arrangement as being the important element, as opposed to the mere reliance on the legal form of an arrangement.

The Australian tax system identifies a critical aspect of a debt instrument to be the distinguishing characteristic; the non-contingent obligation to return to the investor an amount at least equal to the amount invested. The aspect of a ‘non-contingent obligation’ on the part of the issuer to repay the investor at a fixed or variable time accords with the general characteristic of a debt. There are four instances that are specifically classified as constituting an equity interest, and should an interest meet such criteria, it will be deemed as equity. The benefit of having debt-equity rules is the certainty that it creates from a tax law perspective. Taxpayers can identify whether the instrument will be treated as debt or equity, and whether an interest deduction may be claimed. A default position could also be adopted that if an instrument satisfies the criteria for classification as debt and equity, such instrument will be presumed to be a debt.

6.3. Criticisms

The following criticisms may be raised on measures that will not be viable options for the South African tax system.

6.3.1 Criticism 1

The ACE will not be a viable option for South Africa, even though that it is acknowledged that the ACE system is a more neutral approach than current corporate tax systems to investment and financial structures. The ACE will result in a narrower tax base and a reduction in corporate tax revenue when compared with current systems.
The approach will require higher taxes elsewhere in the tax system to balance the government budget, possibly requiring an increase in the corporate tax rate at a time when tax competition between countries forces the corporate tax rates to be lowered.

Since debt and equity are treated similarly under an ACE, multinationals would no longer have an incentive to adjust their intra-company debt-equity structures if all countries adopt such a system. However, if only one country adopts an ACE, multinationals may find it attractive to locate their equity in that location since returns will be at least partly untaxed.\footnote{De Mooij, R.A. (2011). *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions* International Monetary Fund Staff Discussion Note SDN/11/11. Available at: http://www.imf.org/external/pubs/cat/longres.aspx?sk=24810, p11 & 12.}

The ACE essentially allows corporations to deduct interest on debt, but also their return to equity, thus making the ACE tax neutral and restoring the debt-equity ratio. However, this mechanism is highly unpopular as it reduces corporate revenue. By allowing a deduction for both interest and the normal rate of return on equity, the ACE system charges no tax on projects with a return that matches the cost of capital.\footnote{Ibid, p16.} The Netherlands cabinet has decided not to proceed with the notional net deduction (the ACE approach) because a proposed 4% of the equity being deductible would result in a substantive budgetary loss for the country.\footnote{Temme, M. (2011). *The Netherlands: Dutch Tax Agenda – Observed from a Transfer Pricing Perspective* KPMG. Available at: http://www.us.kpmg.com/microsite/taxnewsflash/tpi/2011/TNFTP11 25Netherlands.html.}

It is interesting to note that there is a trend across various jurisdictions that intend to limit the deductibility of interest. The Netherlands proposes to limit the deduction on third party loans and has abandoned its position that only intra-group financing poses a problem.
6.3.2 Criticism 2

The thin capitalisation rules cannot be formulated in isolation, but must be implemented in the light of other provisions in the legislation; for instance corporate tax rate, tax on dividends, and capital gains.\textsuperscript{204} A domestic thin capitalisation rule could not be adopted on the same ratio of 3 to 1 as the current thin capitalisation rule that regulates cross border transactions. Countries are heading towards a reduced ratio of 1 to 1, and the effectiveness of a fixed rate ratio is questionable. Further, a single rate cannot be applied to all industries as it does not accord with the principle of tax neutrality.

6.3.3 Criticism 3

It is not proposed that the CBIT approach be adopted for the South African tax climate. The CBIT proposes a neutral approach towards the financing structure of a company by disallowing the deduction of interest expenditure incurred. Interest expenditure is revenue in nature and is according deductible. The issue is not the deductibility of interest as an expense, but the quantum in which it is deducted is questionable.

Further transactions are specifically entered into to secure such deductions, however the CBIT proposes a radical reform. The complete disallowance of interest expense deductions will have a detrimental effect on business, especially the small to medium sized companies. It will also have a consequential negative impact on the finance industry as it will result in an increase in the finance costs.

6.4. Conclusion

There are various approaches that can be adopted to tackle the specific problem of excessive interest deductions being claimed by taxpayers. South Africa has the benefit of considering reforms that have been adopted in other jurisdictions and evaluating the success or failure of such reforms. The particular reform that is designed must be both effective and complementary to our tax system.
CHAPTER 7. PROPOSED REFORMS FOR 2012

The Draft Taxation Laws Amendment Bill for 2011 was first published for public comment on 2 June 2011. The Bill initially proposed an 18-month suspension of section 45 of the Income Tax Act with immediate effect.\textsuperscript{205} The purpose of the suspension was to temporarily close the abusive transactions that were structured using section 45 as a tax-free mechanism to obtain interest deductions linked to excessive debt structures.

However, due to various consultations held on the suspension and the affect on the business community, it was decided that the suspension will no longer be followed through. Instead a revised short term approach has been proposed in the final Draft Taxation Laws Amendment Bill, published on 25 October 2011, such that a new section 23K will be introduced to control the interest deductions associated with debt used to fund transactions in terms of the section 45 and 47 reorganisation provisions.

The rationale for the change in policy was stated as follows:

\textit{"… the rollover rules were never intended to enable interest deductions when those deductions would not otherwise be available."}\textsuperscript{206}

This specifically refers to transactions that are structured to claim a deduction for the acquisition of shares which is precluded under current legislation. Ultimately, if the interest incurred on a loan to acquire shares was permitted, perhaps taxpayers will not be devising structures to work around the non-deductibility aspect.

\textsuperscript{205} Clause 75 of the Draft Taxation Laws Amendment Bill 2011.

Further, it has been acknowledged that these aggressive transactions involve large amounts of debt finance which are entered into to create a revenue mismatch. The amendment proposes that "interest deductions in respect of debt used to procure, enable, facilitate or fund section 45 and 47 reorganisations will be controlled". The law is also extended to cover interest deductions that arise from refinance arrangements or debt that acts as a substitute to initial debt. The denial of the interest deductions is restricted to the acquiring company. It has been further provided that "if the interest is non-deductible by the payor, the holder of the debt instrument will be treated as receiving exempt income"; this applies to holders of debt instruments and payors that are part of a group company.

Under the proposed section, interest deductions will not be automatically available to the taxpayer engaging in a section 45 transaction. In order for an acquiring company to obtain a deduction for the interest expenses incurred, taxpayers will have to apply to the South African Revenue Service ("SARS") for a directive that grants approval of the deduction. The following criteria have been envisioned in determining whether approval should be granted by the Commissioner during the pre-approval process:

"(i) the level of debt in relation to the level of equity of the acquiring company, (ii) the estimated interest expense in relation to the estimated income of the acquiring company ..., (iii) the debt terms and economic effects of the debt having regard to the debt versus equity features of the debt instrument, (iv) the relationship between the acquiring company and the holder of the debt instrument and (v) any other further criteria that the Minister may prescribe."

The above listed criteria are very simple; however it will allow the SARS to track the funding and its economic effects. It also provides for inter-group debt to be regulated. If SARS are of the

208 Ibid, p50.
209 Ibid.
210 Ibid.
211 Ibid, p51.
opinion that any of the criteria are unsatisfactorily answered, the application will be rejected and
the taxpayer will be unable to deduct the interest expenses incurred.

The regulatory environment that will be set up on the part of the SARS includes regulations that
provide which transactions will be excluded from the pre-approval process, as well as a
committee to review the pre-approval applications. We according await the regulations to obtain
clarity as which transactions are being specifically targeted. The concern for taxpayers will be
the time delay in awaiting an initial response from the SARS, providing additional information if
required and final responses, and the efficiency of the process is questionable. SARS will also
have an additional power to impose conditions to the approval granted.

Further, the approval will be restricted to ‘the facts in existence at the time of the approval
request’.\textsuperscript{212} Therefore should the facts change in a subsequent year from the time that approval
was granted, the taxpayer will have to re-apply for approval. Possibly a further delay will be
encountered, and in some instances taxpayers will either stop claiming the deduction or
continue claiming the deduction and recommence claiming a deduction. The process seems to
be unworkable and the impact of this stop-start process will be interesting, especially if there is
an overlap of tax periods.

The proposed section will be applicable in respect of assets acquired on or after 3 June 2011,
and the amendment has a sunset clause until 1 January 2014.\textsuperscript{213} The temporary approach to
the issue is problematic because when this system is actually implemented properly, and the
elementary processes are polished, the proposed section will no longer be effective. The
already strained resources of SARS that will be utilised in getting the process started will appear
to have been wastefully spent.

Importantly, investors and the business community require certainty as to the taxation laws of a
country, and as this is a temporary measure with the anticipation of larger reforms at an

\textsuperscript{212} National Treasury & SARS, (2011). \textit{Explanatory Memorandum on the Taxation Laws Amendment Bill}

\textsuperscript{213} \textit{Ibid}, p52.
unknown date with an unknown reach, it hampers business confidence in South Africa.

The main issue with regard to the proposed section is it is specifically targeted at reorganisation transactions, which is a narrow approach to an overarching problem. There may be widespread abuse of the reorganisation transactions; however, it would be more comprehensive to have legislation that addresses the substance of this issue, namely the deductibility of interest and debt-equity rules. Even though the aggressive use of the reorganisation provisions will be curtailed, taxpayers can continue to structure their transactions according to conventional finance arrangements and claim the interest deductions. Therefore the policy change to prevent tax leakage is somewhat amiss.
CHAPTER 8. CONCLUSION

8.1. Role of government

The time has arrived for governments to take courageous steps and not bow to the will of business or be afraid to take steps that are not being taken by fellow governments. While it is accepted that the global financial crisis was triggered by other external factors, the tax system is not completely blameless.

The IMF has conducted a survey as to "where our tax systems have failed us" and the survey has found "tax fingerprints on high leverage, on complexity, on the lack of transparency of financial arrangements and on risk taking". These aspects generate to one fundamental issue; namely, debt-equity and the lack of effective regulation. Perhaps if tax systems had adopted a strict approach on the preference of debt over equity, such high leverage ratios would have been curbed.

There is a call on "legislators [that] need to level the playing field between debt and equity, which could be done in one of two ways". The playing fields can be levelled by either eliminating the deductibility for interest, and some countries have in recent years taken decisive steps to tighten interest deductibility, or take the opposite approach whereby interest deductions remains intact, but allow a deduction for a notional return based on book equity. The deduction of a notional return is known as an Allowance for Corporate Equity (ACT), which is similar to the conventional deduction of interest by a company.

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215 Ibid.
"Tax plays an important role in shaping a nation's economy". The extreme situation is without tax revenue government will ultimately face financial collapse and the economy of a country will fail. If a government collects insufficient revenue it is unable to fulfil its mandate on service delivery, the provision of education, social welfare grants and the required infrastructure for business development. The Minister of Finance has released press statements which specifically state that South Africa is losing revenue due to excessive debt in the system. Therefore tax reforms that will restrict the deductibility of interest are inevitable from a revenue perspective, and to ensure that companies will be financially less vulnerable.

There is a growing trend in other countries to raise revenue in order for sovereigns to meet their debt repayments and other obligations. The recent debt crisis in the United States to raise the debt ceiling and the ongoing turmoil in the European countries are clear indications of the pressure on governments that cannot meet their sovereign debt obligations. Therefore reforms that protect the tax base of a country will remain a priority on the legislature's agenda.

8.2. Balance between competing interests

There are two interests at stake when tax reform is proposed, especially when the reform addresses corporate tax issues. Government (which comprises the revenue authority) has the objective of preserving the corporate tax base, because government is dependent on companies paying their taxes. On the other hand, the company intends increasing profits and reducing its tax liability by claiming tax deductions and other benefits afforded in legislation.

When government proposes reforms to close tax benefits, companies will be forced to start paying more taxes; such companies often threaten to relocate their tax residence to low tax or no tax jurisdictions. Therefore government bears the risk of corporate migration, as capital that is highly mobile can easily be moved across countries, as companies refuse to bear the tax

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burden. “So the real burden of the tax is going to be passed on to whatever can’t move to escape it”.

The approach that should be adopted in South Africa is a balanced approach which takes into consideration both the interests of government and the business industry. Therefore tax reforms that will restrict the deductibility of interest, which negatively impacts on business, must be balanced against perhaps a reduction in the corporate tax rate or additional allowances granted on the depreciation of assets.

Even when governments are hesitant to propose reforms that will curtail companies, there is evidence that other countries are adopting similar reforms. In a report produced by Buettner and others between 1996 and 2004, the share of OECD countries applying thin capitalisation rules that deny the interest deductibility beyond a certain threshold for the debt-to-equity ratio grew from less than 50% to more than 75%. Certain tax issues share global concerns and the debt-equity issue is certainly an issue that it being addressed in most countries. This is evidenced by the various reforms discussed in Chapter 5.

Government must balance their short-term revenue goals against the need to create an attractive investment environment, as seen in countries like Germany and the United Kingdom who have modified their regulations with the changing economic climate as they seek to achieve both objectives. Businesses are flexible and responsive to change, and are in a position to tailor their capital structures in order to achieve their business objectives.


There will be an argument raised that restricting the deduction of interest will impact negatively on the growth of business in South Africa. While this argument is not without merit, South Africa is in a key position because it is perceived to be the financial gateway into the African continent.

Therefore companies will use their South African base to expand into the African market; however, the company could relocate its tax residence. South Africa is part of a growing body of countries that are constantly seeking to close loopholes, and therefore the reforms proposed are not exclusive to South Africa. Further, the restrictions to be imposed should be set a high threshold level, whereby small and medium sized entities will fall below such a threshold and the target is excessively leveraged large companies.

8.3. **Sustainable business environment**

The debt bias in the tax system creates significant inequities, complexities and economic distortions. Highly leveraged companies are not conducting business in a sustainable manner. Sustainability, in the context of a business, can be described as adopting business strategies and activities that meet the needs of the enterprise and its stakeholders today, while protecting, sustaining and enhancing the business resources that will be required in the future. “More importantly, there is no theory to indicate what a sustainable debt threshold is.”

Excessive debt within a company places that company in a financially unstable position which threatens its continued existence. If the company is unable to service its debt obligations, it faces the risk of being liquidated because the assets of the company will not be sufficient to settle outstanding debts. Further, the stakeholders, like the employees of the company, are also placed at risk because they face unemployment.

When companies are liquidated it has a negative impact on the economy and will ultimately lead instability in the global economy as more companies find themselves in this position. Therefore companies that have excessive debt funding impact a larger environment than just its business operations.

Project financing is usually obtained by companies for large investment purposes and is characterised by excessive leveraging. The state utility Eskom received a US$ 3.75 billion loan in March 2010 from the World Bank to fund the building of a power station, development of renewable energy, and low-carbon energy efficiency components. Eskom’s funding plans have taken another step forward with the signing of a EUR100 million (ZAR980 840 000) Credit Facility agreement between Eskom and the Agence Française de Développement (AFD). This loan forms part of the seven-year R300 billion funding plan that was announced previously by Eskom. The interest deductions being claimed on these long term loans would certainly be large enough to substantially reduce or eliminate any tax liability.

According to its company profile, Neotel is a telecommunications network operator that caters for the needs of wholesale, business and home customers. Investec was appointed as joint mandated lead arranger both for Neotel’s initial R2 billion bridge facility in May of 2007, and also facilitated the long-term project finance facility. Investec had raised R4.4 billion of senior, subordinated and mezzanine debt for Neotel during the height of the credit crisis. The financing arrangements in respect of the Eskom and Neotel projects are very large and the question that arises is, if the interest deduction were curtailed, would companies raise funding from other sources in conjunction with debt as opposed to exclusive debt financing? These are just two companies that have been illustrated against the backdrop of multiple players in industry that could also be laced with excessive debt.

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221 World Bank.  


Government “policies should create the conditions for balanced and sustained economic growth, fiscal sustainability and financial stability across the globe.” Government achieves such objective by closing tax loopholes that undermine the tax base.

8.4. The future

It has been established that the tax system does contain an inherent bias towards debt financing by allowing a deduction in respect of interest expenditure incurred. Interest is a finance charge, and accordingly a revenue expense, that is deductible against taxable income. Companies have exploited the open-ended interest deduction by making their capital structures excessively leveraged. This action creates its own set of complexities for the company, apart from eroding the corporate tax base. Tax systems in general should be designed to be neutral, raising revenues whilst minimising distortions imposed on the economy. However, achieving neutrality in tax legislation poses a challenge to all jurisdictions, especially with increasing tax competition. Transactions should be structured to attain an optimal commercial result, and not structured to secure a tax advantage; the tax system should remain in the background and not at the forefront of decision making.

The ripple effects have been felt throughout the global economy of the over-indebtedness of companies and individuals, which has stunted growth and crippled developed and emerging economies alike. The resultant debt problems have created real risks of disruption of activity as stressed corporates have difficulties meeting their working capital needs in order to secure production. This has led to a weaker capacity to service existing debt obligations, and further deteriorated the corporate’s balance sheet. Further, the slowdown of activity has contributed to growing unemployment and other social pressures. The corporate debt problems and the resulting increase in non-performing loans endanger the already weakened banking system and

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Gurria, A. (2010). Requirements for economic policy OECD. Available at: http://www.oecd.org/document/57/0,3746,en_21571361_44315115_46324793_1_1_1_1,00.html.

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further reduce the ability of banks to extend credit, thus slowing down the recovery further.\footnote{225}

Therefore there is a call on government to take decisive action going forward, implement reforms in the tax legislation that will reduce tax preferences, eliminate distortions, and create an environment for sustainable business practices. Even with the present grim reports the economic tide will turn, in a recent newspaper article the chief executive of Standard Bank for corporate and investment banking said that “competition for deal making and to raise debt and capital funding was intensifying in Africa”.\footnote{229}

The government has indicated that it will consider reform of the debt-equity area in tax commencing with the 2011 tax amendments. Now is an opportune time to act to prepare for future business growth and expansion. Tax reforms that will restrict business activity are a short term inconvenience against long term rewards.

The past cannot be changed, revenues lost cannot be gathered, and corporate debt will remain; however, legislative amendments going forward have the power to change the present circumstances and build a stronger corporate sector for South Africa.

\footnote{225}{Grigorian, D.A. & Raei, F. (November 2010) \textit{Government Involvement in Corporate Debt Restructuring: Case Studies from the Great Recession} International Monetary Fund (WP/10/260), p3.}

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**Case law:**

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*CIR v Genn & Co (Pty) Ltd* 20 SATC 113 (1955 (3) SA 293 (A))

ITC 1820 (2007) 69 SATC 163

*IRC v Duke of Westminster* (1936) 19 TC 490