South Africa introduces interest deduction limits on debts owed to non-residents

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In brief

Over the past several years, the South African (SA) revenue authorities have become increasingly concerned about various corporate tax arrangements. One such arrangement utilized excessive deductions, where income was effectively shifted to a no-tax or low-tax jurisdiction or converted to a different type of income in another jurisdiction. These deductions are typically characterized as interest, royalties, service fees, or insurance premiums. The authorities were most concerned with excessive interest deductions.

In response, the SA government has introduced — effective January 1, 2015 — domestic legislation that implements some of the expected recommendations of Action 4 of the G20-OECD Base Erosion and Profit Shifting (BEPS) project. The legislation provides deductible interest limitations on debts owed to persons not subject to SA tax.

In detail

Background

SA taxpayers often enter into transactions in which deductible interest paid by SA residents to non-residents and other exempt persons is not taxed in the hands of the recipient.

These are mainly debts between entities of the same economic group. Usually, because the entities are connected, an instrument's actual terms do not determine its substance because the parties will change the instrument's terms as the need arises. Therefore, even if an instrument has no equity features, excessive debt between these entities remains a concern to the fisc, especially if the creditor falls outside the SA tax net.

Application of the interest deduction limitation

To address this concern, the new legislation limits the aggregate deductions for interest associated with debt between certain entities when there is a 'controlling relationship' between the foreign lender and the SA borrower. The limits will apply regardless of the debt's terms. A controlling relationship exists when the foreign lender directly or indirectly owns at least 50% of the equity shares or voting rights in the SA borrower, or vice versa. If the interest is not subject to SA tax in the hands of the foreign lender (e.g., not subject to SA withholding tax) in the tax year when it is incurred by the SA borrower, the interest will be subject to an interest limitation.

A formula-based restriction

The new law — section 23M of SA's Income Tax Act — imposes a formula-based restriction on interest deductions when:

- the payer (borrower) is an SA resident
- the recipient (lender) and the borrower are in a 'controlling relationship'
- either or both the borrower or the lender is a company, and
- the lender is not subject to tax in SA on the interest income in the same year when the borrower incurs the interest.

Therefore, if the foreign lender is in any event taxed in SA (e.g., lending through a SA branch), the interest cap will not apply. SA's new withholding tax on interest, effective in March 2015, also will represent a qualifying SA tax. To qualify the foreign lender must incur the withholding tax in the same tax year that the SA borrower incurs the interest expense.

The provision will apply to interest incurred on or after January 1, 2015.

The formula

The interest limitation is often described as basically 40% of earnings before interest, taxes, depreciation and amortization (EBITDA). More specifically, however, the formula takes into account:

- all interest received / accrued to the debtor

plus

- 40% of the debtor's 'adjusted taxable income'

reduced by

- any interest incurred by the debtor, not subject to section 23M.

'Adjusted' taxable income at the end of any tax year is determined before — i.e., requires add-backs and reductions for — interest income and expenditure, capital allowances and claw-backs/recoupments, and any assessed loss carried forward from the previous year.

The 40% cap on adjusted taxable income could increase to as much as 60% in tandem with any increase in SA's official base rate of interest.

Non-deductible interest excess

Any interest that is not deducted (i.e., in excess of the limitation) may be carried forward to the next year and deemed to be interest incurred in that year. The intent is that the interest carried forward will then be eligible for deduction in the next year, again subject to the annual limitation. There is no limit on the number of years non-deductible interest may be carried forward.

Exclusions

The interest deduction limitation does not apply if:

- the actual loan in question is simply an on-lending of funds the creditor obtained from a '*lending institution*' (i.e., any foreign bank comparable to regulated SA banks) that is not in a controlling relationship with the debtor, and
- the interest rate falls within specified limits.

Interaction with other rules

There is still uncertainty as to how section 23M will interact with SA's rules on transfer pricing and thin capitalization. The SA tax authorities have stated that both sets of provisions remain fully applicable to cross-border debt. However, the impact of one upon the other has not yet been clarified.

The takeaway

When foreign lenders provide interest-bearing debt to related SA borrowers, taxpayers should take account of these new interest restrictions on the SA borrower.

The interest-cap formula is roughly 40% of the tax version of EBITDA.

The new interest-cap formula applies together with, and in addition to, the existing transfer pricing and thin capitalization rules.

If the foreign lender is taxed in South Africa, the interest cap will not apply. Also, back-to-back on-lending of funds that originate from unrelated third-party banks could be excluded from the new interest-cap rules.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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