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Submission File

5 June 2014

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National Treasury
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0001

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Dear Ms Mputa,

SUBMISSIONS ON SECTION 23M

In respect of s23M of the SA Income Tax Act¹ (“ITA”), we present herewith our submissions as follows:

- (A) Our primary submission is that s23M is essentially superfluous and, as such, should be withdrawn in its entirety.
- (B) In the alternative (if s23M is not deleted), then we submit that its current provisions contain multiple anomalous, unfair and unintended results —and that s23M therefore requires substantial amendment. We set out the specifics of our alternative submission in more detail further below.
- (C) As a further alternative, given that National Treasury might prefer to engage in further consultations in relation to either or both of our submissions above, we submit that (at the very least) the proposed effective date of s23M should be delayed by at least one year —i.e. to 1 January 2016.

¹ Act No 58 of 1962



DETAILED SUBMISSIONS

(A) Primary submission: S23M should be deleted in its entirety

1. As we see it, the objectives of s23M —i.e. the scrutiny and restriction of interest-deductions— are in any event already adequately addressed by the combination of:
 - (i) the transfer pricing and thin capitalisation rules in s31 ITA, in relation to cross-border debt-funding; and
 - (ii) the interest-restriction rules in s23N ITA, in relation to domestic funding arrangements.
2. In relation to cross-border debt, we submit that there does not appear to be any abusive tax avoidance arrangement that is targeted by s23M that is not already targeted by s31. The two provisions therefore address exactly the same issues (as far as we can see). In fact, we confirm that the co-existence of the two provisions is cause for substantial uncertainty and confusion, both in SA and abroad.
3. As regards domestic debt, we recognise that s23N only becomes applicable in the context of so-called “*reorganisation*” or “*acquisition*” transactions. However, it is our understanding that the potentially abusive debt arrangements that National Treasury and SARS wish to target are precisely those that typically arise through reorganisation and/or acquisition deals. Thus, the debts targeted by s23M (in the domestic SA environment) are essentially the same debts that are in any event caught by s23N ITA.
4. Although it is clear that s23M is actually broader than, and does go beyond the range of, s31 and s23N, we do not see this as a reason to retain s23M. Rather, this broader ambit in fact results in the unintended targets and anomalies that are covered in our alternative submission (B) below.
5. In summary, our submission is that s23M is unnecessary and would serve no separate purpose in SA’s fight against abusive tax avoidance schemes —so s23M should simply be deleted.
6. Should you wish to undertake further consultation, i.e. if there are concerns that the combination of s31 and s23N might not be sufficient to address avoidance schemes, we would be happy to engage directly with National Treasury.



(B) Alternative submission: S23M should be substantially amended

7. If s23M is retained, our alternative submission is that it requires substantial further amendment—in order to address the anomalies, inequities and unintended consequences that result from the current version of s23M.

8. In our detailed commentary, we set out six (6) specific issues that require further consideration and amendment:

(i) The “connected person” test is inappropriate

9. We submit that the targeted “controlling relationship” defined in s23M(1) should not be the “connected person” threshold, but rather a much higher requirement—such as the 70% “group of companies” relationship.

10. It should be noted that the initial test contained in the 2013 draft legislation was 70%. This 70% eliminated a fair number of problems but for BEE. No consultation period was given for this much harsher threshold, which was added only after the hearings. It has generally been understood that tax legislation is not unilaterally tightened after the comment period.

11. The purpose of the thin capitalisation/EBITDA rules is to have objective protection when the creditor and debtor are in a single economic unit. In these circumstances, the parties are free to choose debt or shares without economic consequence. However, if a BEE minority exists, the majority funder is not indifferent as to whether the investment is in the form of debt or shares. Debt has seniority over shares. Equity values must be shared under the BEE codes.

12. The connected person test constitutes an extremely low threshold, especially in the case of consortiums. All trust beneficiaries and partnership members are connected to one another no matter how small the interest. Holders of a mere 20% are connected if not a company as defined in the Companies Act (e.g. pension funds), and companies can also be connected with a mere 20% if no holder holds a majority interest. We note that many foreign-owned structures with BEE minorities will be effected by section 23M even though the debt is real.

13. The test fails to recognise the nature of debt intensive-businesses. Certain capital intensive companies (especially in the case of mining) are increasingly reliant on debt for external finance. This debt is borrowed in a group through a centralised treasury operation and passed through to many group members. A proportionate share of this debt should be allocable to SA.



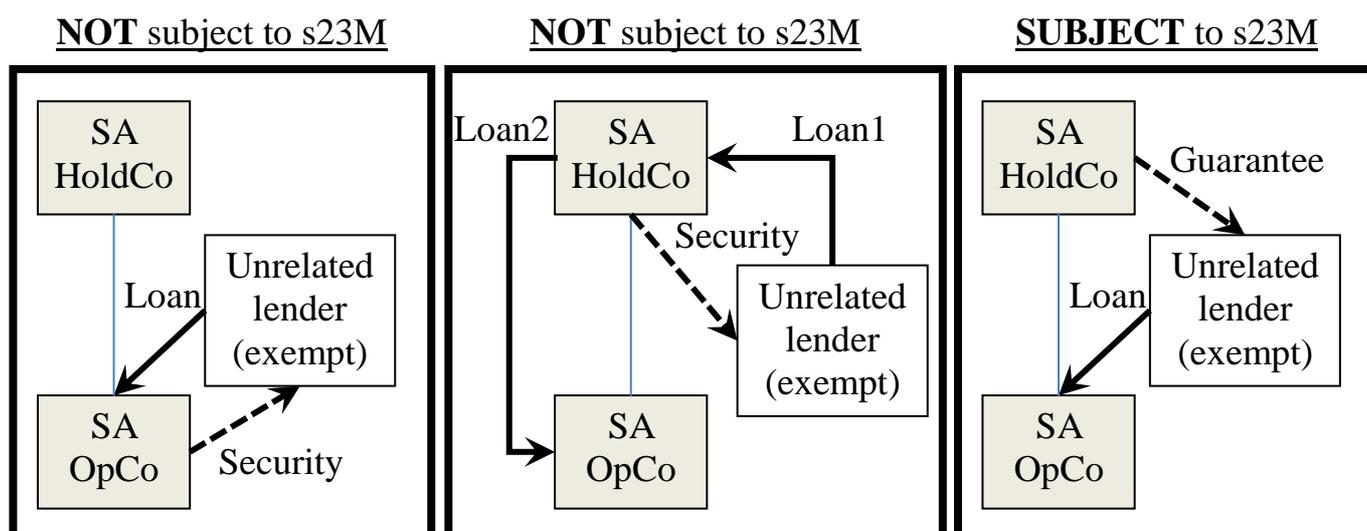
(ii) *Guarantees*

14. We submit that s23M(2)(b)(ii) should be deleted.

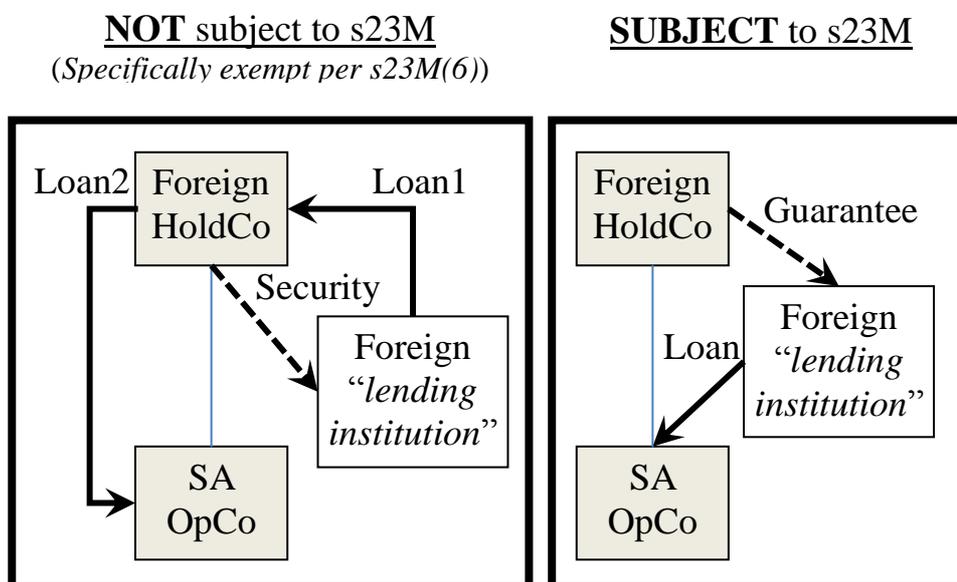
15. We recognise the need for broadening the rules to include back-to-back arrangements where the actual “ultimate” borrower and lender are in fact part of the same economic group (i.e. item (i) of s23M(2)(b)). However, we do not see how guarantees (item (ii)) would fall into the same category. After all, if the actual funds flow only between the unrelated lender and the borrower, it is not clear what mischief would arise.

16. The taking of security is an undeniable reality of financing transactions, more so where the lender and guarantor are unrelated. And the requirement for parental guarantees is simply another (very common) example of standard security requirements. Even if there is some suggestion that guarantee arrangements could be used for tax avoidance purposes (which we fail to see in this instance), our critical submission is that the overwhelming majority of the victims of this rule will be non-tax-avoidance arrangements between unrelated third parties.

17. Consider the following real-life example. If an operating company borrows from an unrelated third-party financier (who happens to be tax-exempt, e.g. a pension fund), then s23M will not apply to the resultant interest. The fact that the lender takes security directly from the borrower does *not* change the fact the loan is outside s23M. However, if the lender—who is unrelated to the borrower—requires extra security in the form of a guarantee from the borrower’s parent, then the loan *would* be caught by s23M.



18. As illustrated above, we question also whether a parental guarantee is very different from a back-to-back arrangement where the ultimate lender is a third-party. We note that s23M(6) specifically —and entirely appropriately— recognises this concept, but then it also exposes the inequity of the guarantee test. Thus (for example), if a foreign holding company borrows from an unrelated third-party bank, and then that holding company on-lends those funds to its SA-resident subsidiary, then s23M(6) could specifically exclude that arrangement from s23M². But on the other hand, if that same third-party bank lends directly to the SA-resident company and the foreign parent simply guarantees that loan, then s23M will apply.



(iii) Relationship between s23M and thin capitalisation

19. It is submitted that debt that is subject to s23M should be excluded from the ambit of s31 ITA.
20. It is not clear how s23M is to be applied in relation to the thin capitalisation rules of s31. Which applies first? For example, if some interest is disallowed under the thin capitalisation rules, the interest should not count against s23M (s23M(3) talks about “*interest incurred*”, not deductible interest).
21. Furthermore, on the one hand, if a taxpayer undertakes an in-depth and robust transfer pricing review and concludes that the loan arrangements are entirely “arm’s length”, it

² Subject to the interest-rate requirements in s23M(6)(ii).



seems very unfair that the arrangements could still fall foul of the mechanical operation of s23M. On the other, if s23M is positioned as an “objective” test, then it seems unfair for that a taxpayer that remains below the s23M formula restrictions should still be required to demonstrate the cross-border borrowings are also “arm’s length”.

(iv) Specific computation inequities

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| 22. In s23M(1), the concept of “ <i>adjusted taxable income</i> ” does not fully reflect cash-flows. Assessed losses brought forward should be excluded from adjusted taxable income. |
| 23. In s23M(5) the adjustment to the 40% limit should simply be linked to movements in the repo rate. There is no basis, we submit, for only recognising interest-rate increases once the repo rate breaches 10%. |

(v) Delay of subsection (6)

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| 24. We submit that s23M(6) should not be delayed for a year after the rest of s23M comes into effect. |
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25. As far as we can see, there is no basis for delaying this provision. It is simply unfair, in our view.

(vi) Recognition of foreign tax

26. The legislation contains no relief for amounts subject to a comparable level of foreign tax. The net result is effective cross-border double taxation, i.e. the same interest flow that is subject to tax as income in the foreign lender’s jurisdiction would be disqualified from deduction as an interest expense in SA.

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| 27. We submit that the “ <i>subject to tax</i> ” requirement in item (aa) of s23M(2) must also extend to include foreign tax. |
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(C) Second alternative submission: S23M should be delayed

28. As explained above, it is our view that s23M requires significant and *urgent* attention. However, we recognise that National Treasury may be interested in further broad consultation in this area and, as such, we submit that (at the very least), s23M should be delayed for at least one year.

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| 29. We submit that the effective date of s23M should be deferred to 1 January 2016, or later. |
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Please do not hesitate to contact us, should you have any questions regarding the above.

Yours faithfully

Piet Nel CA(SA)

PROJECT DIRECTOR: TAX

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