

An analysis of Section 23M in light of the OECD guidelines relating to thin capitalisation

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Mini-dissertation submitted in **partial** fulfillment of the requirements for the degree *Magister Commercii* in **South African and International Taxation** at the Potchefstroom Campus of the North-West University

Supervisor: Prof P van der Zwan

May 2015

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MAGISTER COMMERCII (SOUTH AFRICAN AND INTERNATIONAL TAXATION)

at the

POTCHEFSTROOM CAMPUS

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DECLARATION

I declare that: “*An analysis of Section 23M in light of the OECD guidelines relating to thin capitalisation*” is my own work; that all sources used or quoted have been indicated and acknowledged by means of complete references, and that this mini-dissertation was not previously submitted by me or any other person for degree purposes at this or any other university.

SIGNATURE

DATE

ACKNOWLEDGMENT

I would like to thank God for giving me the knowledge and endurance to complete my dissertation. I would not be where I am today if I did not have Him in my life, guiding me and helping me through everything that I have achieved thus far.

I would like to thank my supervisor, Professor Pieter van der Zwan, for all the guidance and contributions that he provided me with during the course of this study. I am sincerely grateful for every second of his time that he gave up to contribute to my study.

Furthermore, I would like to thank each and every single one of my close friends and family members, especially my mother, father, sister and grandmother, who have always supported and motivated me during every moment of my studies. To my husband, Nico, I would like to express my sincerest gratitude for his constant encouragement, love and support throughout the completion of my studies. Without the generous support of all these wonderful people in my life, I would not have been able to complete this assignment. I am truly blessed!

ABSTRACT

Base erosion in the form of profit shifting has become an increasing concern internationally as well as in South Africa. A significant type of base erosion in South Africa is in the form of excessive interest deductions where income is effectively shifted to a no-tax or low-tax jurisdiction. One of the key developments affecting the South African tax laws was the introduction of provisions that target base erosion and profit shifting. Included in these provisions is section 23M, which limits the deduction of interest paid to persons in whose hands the interest received is not subject to tax in South Africa. It was, however, identified that section 23M may target the same interest risks that the new section 31 thin capitalisation provisions address. Section 23M was said to be the enactment of thin capitalisation.

Although one of the purposes of tax treaties is to encourage international trade and investment, there is also discriminatory taxation, which runs counter to that purpose and therefore the prevention of such discrimination is important when dealing with tax treaties. The Organisation for Economic Cooperation and Development's (OECD) Model Tax Convention contains a handful of special criteria in article 24, which must not lead to different or less favourable treatment with regard to taxation.

It was found that the non-discrimination article, in particular articles 24(4) and 24(5), may prevent the application of a thin capitalisation regime if the provisions are in contrast with the OECD non-discrimination provisions. Article 24(4) and article 24(5), however, contain an exception that the non-discrimination provisions would not be applicable provided that the thin capitalisation regimes are compatible with the arm's length principles of article 9. If section 23M was therefore found to be an arm's length transaction, the article 24(4) and (5) non-discrimination provisions would without further consideration, not be applicable. It was, however, found that section 23M does not consider the factors that should be considered when an arm's length transaction is applicable, but merely applies the same formula to each company regardless of the size of the company or the industry sector. As a result of this, it appears as if section 23M is arbitrary in nature and therefore would not represent an arm's length transaction. The exception would not be applicable and would therefore increase the potential non-compliance with the non-discrimination provision.

The objective of this study was to determine whether any aspect of section 23M would be contrary to the OECD guidelines relevant to thin capitalisation and in particular the non-discrimination provisions. It was, however, found that although it appears as if section 23M's primary focus is on cross-border transactions, the provisions do not directly discriminate on the basis of residence. As a result of the discrimination being indirect discrimination and the fact that the cause of section 23M being applicable is not foreign ownership, but rather due to the creditor not being subject to tax, it was concluded that the OECD non-discrimination provisions would not be applicable to section 23M.

Keywords:

- Article 24;
- Thin capitalisation;
- Section 23M;
- Non-discrimination;
- Limitation of interest deductions;
- Arm's length principle;
- Excessive interest;
- Profit shifting; and
- Base erosion.

List of abbreviations:

Abbreviation	Meaning
DTA	Double Tax Agreement
ITA	South African Income Tax Act
OECD	Organisation for Economic Co-operation and Development
OEEC	Organisation for European Economic Co-operation
OECD MTC	Organisation for Economic Co-operation and Development Model Tax Convention
SARS	South African Revenue Services

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CHAPTER 1: BACKGROUND AND OBJECTIVES OF THE STUDY

1.1. BACKGROUND

While debt capital is an important tool for investment, debt capital can also create opportunities for base erosion as the deductible interest paid to foreign (and other exempt) persons represents a risk to the fiscus because of the deduction/exemption mismatch (National Treasury, 2013). Taxpayers took advantage of this opportunity, which was one of the reasons for tax systems to introduce anti-avoidance measures that would prevent this intentional and excessive mismatch. One of the most common anti-avoidance measures used by the tax authorities is the thin capitalisation rules, which are designed to prevent companies that are part of multinational groups from shifting large amounts of profits offshore, often to low tax jurisdictions, in order to reduce the group's effective tax rate (Badenhorst, 2013).

The international consensus on transfer pricing dates back more than 75 years, to the League of Nations' 1933 Draft Convention on the Allocation of Business Profits between States (Owens, 2009). South Africa introduced thin capitalisation rules, which form part of transfer pricing, in 1995. Under these rules, which were contained in section 31(3) of the South African income tax act (ITA), the Commissioner was empowered to have regard to the international financial assistance rendered and if it was considered excessive in proportion to the particular lender's fixed capital in the borrower, the interest, finance charges or other consideration relating to the excessive financial assistance was disallowed (Charalambous, 2013). Thin capitalisation provisions are essential in a tax system to combat tax avoidance, but also to discourage excessive debt funding (Legwaila, 2012). At the end of the day, a balance is required between attracting debt capital and the protection of the tax base against base erosion (National Treasury, 2013).

Historically, a company was said to be 'thinly capitalised' when its equity was less than the prescribed rate in comparison with its debt capital and therefore in terms of the SARS Practice Note 2, a debt/equity ratio that did not exceed 3:1 was acceptable for the purposes of section 31(3) of the ITA (Els, 2013). In order to align thin capitalisation rules with the views of the Organisation for Economic Co-operation and

Development (OECD), changes were made to incorporate thin capitalisation rules into the transfer pricing rules, thereby providing that thin capitalisation rules are now adjusted to incorporate the arm's length principle. The 'old' rules and Practice Note No. 2 have been repealed and are only applicable to years of assessments commencing before 1 April 2012 (SARS, 2012). The thin capitalisation rules were changed and are effective for years of assessment starting on or after 1 April 2012, and the new requirements now form part of the general transfer pricing provisions.

While thin capitalisation rules attempt to limit the effects of base erosion via interest deduction by restricting the amount of debt financing that can be used to fund an operation, there are also other options to address expensive debt, such as an earnings stripping rule, which allows interest deductions only up to a certain fraction of earnings. The rule is based on interest deductions and not the amount of debt; therefore, it can counter both excessive amounts of debt (such as thin capitalisation rules) and expensive debt (such as transfer pricing rules) (Anon, 2013). Section 23M, the provisions of which will be effective from 1 January 2015, is in line with earning stripping rules as the provisions for the limitation of interest deductions are based on a defined percentage of the company's earnings before interest, tax, depreciation and amortisation (EBITDA). Section 23M provides for a restriction of the deduction for interest incurred in respect of debt owed to a connected person if the creditors are not subject to tax (Horak, 2013).

In New Zealand, research was conducted on the possibility of a potential conflict between the thin capitalisation rules and the OECD model article on non-discrimination (Elliffe, 2012). According to the research conducted by Elliffe (2012), it was stated that the potential conflict between these domestic thin capitalisation rules and the non-discrimination article in double tax agreements arises because the thin capitalisation rules target entities or companies that are owned by residents of the other contracting state. The fundamental reason for this is that hidden capitalisation is usually only a problem cross-border (Elliffe, 2012). While the rules of section 23M do not strictly speaking discriminate on the basis of residence, but rather on the basis of whether the recipient is subject to tax, this issue would arise in a situation where South Africa has surrendered its right to tax interest arising from a South African source in terms of a negotiated treaty (Mandy, 2014). Although interest

withholding tax has been introduced into the ITA, the proposed change is frequently reduced to zero under most South African tax treaties (National Treasury, 2013). It seems at odds with this position that South Africa should then unilaterally be able to introduce legislation that penalises the debtor as a result of the application of such a treaty (Mandy, 2014). Thin capitalisation/section 23M appears to be an issue when cross-border transactions are involved, in particular when companies are owned or controlled by non-residents; therefore, these provision may be in contravention of the article 24 non-discrimination provisions, in particular articles 24(4) and (5).

1.2. PROBLEM STATEMENT

The following research question can be formulated as the problem statement: Would any aspects of section 23M be contrary to the OECD guidelines relevant to thin capitalisation and in particular the non-discrimination provisions?

1.3. OBJECTIVES

To address the problem statement in paragraph 1.2 above, the following objectives are formulated to answer the problem statement.

1.3.1. Main objective

To determine whether any aspect of section 23M would be contrary to the OECD guidelines relevant to thin capitalisation and in particular the non-discrimination provisions.

1.3.2. Secondary objectives

The main objective in paragraph 1.3.1 above was achieved by completing the following secondary objectives

- to determine what the provisions of section 23M entail, how this compares to the old section 31(3) and how thin capitalisation has developed over the years (discussed in Chapter 2);
- to determine the provisions set out in the OECD guidelines relevant to thin capitalisation and in particular the non-discrimination provisions (discussed in Chapter 3); and
- to evaluate the provisions of section 23M against the OECD guidelines relevant to thin capitalisation and in particular the non-discrimination provisions (discussed in Chapter 4).

1.4. RESEARCH METHOD

The way in which reality is viewed (ontological assumption) would be a relativist view, as it is viewed by the author that a fact or situation that is observed to exist or happen could have multiple interpretations. Relativists do not claim that their positions are true in some absolute sense. They simply argue for their positions by employing the intellectual resources that are sanctioned by the 'scientific culture' of the present age and/or by attempting to change the evaluative criteria, aims, or methods of contemporary intellectual disclosures (Anderson, 1986:157). The author has therefore analysed the intellectual resources available in order to come to a certain conclusion based on the information provided. The conclusion may not be the same as someone else's as there could be multiple interpretations by different people.

In the social world, individuals and groups make sense of situations based on their individual experience, memories and expectations. Meaning is therefore constructed, and constantly re-constructed through experience over time, resulting in varied interpretations (Goduka, 2012:127). Interpretivists consider that there are multiple realities (Denzin & Lincoln, 2007:32). The research paradigm in which the research was conducted was one of an interpretivist paradigm because, during the research of the dissertation's topic, the author obtained a better understanding of the provisions contained within section 23M as well as the provisions of the OECD section 24 non-discrimination and whether section 23M would be contrary to the

OECD guidelines relevant to thin capitalisation and in particular the non-discrimination provisions. Every author may, however, have a different view and interpretation.

Doctrinal research is described as the traditional or 'black letter law' approach and is typified by the systematic process of identifying, analysing, organising and synthesising statutes, judicial decisions and commentary. It is typically a library-based undertaking, focused on reading and conducting intensive, scholarly analysis (McKerchar, 2008). The methodology followed during the research was based on a literature review. An analysis of the relevant provisions within the Act and OECD reports was performed. The research approach that was followed was purely a theoretical research approach as the author considered the relationship between rules/provision within different acts and interpretations and what the combined effect would be. The author therefore analysed the intellectual resources available in order to come to a certain conclusion based on the information provided. This conclusion is merely the author's interpretation/evaluation based on the current and relevant information available.

1.5. OUTLINE OF CHAPTERS

The following chapters are included in the mini-dissertation. A brief overview of each chapter's contents is provided below.

1.5.1. Chapter 2: Development of thin capitalisation and section 23M

In Chapter 2, a brief background is provided on how transfer pricing and thin capitalisation were introduced internationally as well as in South Africa. The introduction of section 31 together with the changes and developments that have taken place over the years was discussed. An analysis has been done on section 23M, which applies to interest incurred on or after 1 January 2015, which is said to target base erosion and profit shifting in the form of interest deduction limitations.

1.5.2. Chapter 3: OECD guidelines relevant to thin capitalisation and in particular the non-discrimination provisions (Article 24)

The OECD has certain guidelines relevant to thin capitalisation, which is the limiting of debt on which deductible interest payments may be made. The OECD has indicated that thin capitalisation rules typically operate by means of one or two approaches, i.e. limitation of debt on which deductible interest payments may be made, including the 'arm's length' approach and the 'ratio' approach and limitation of deductible interest with reference to its ratio to another variable, which includes the approach called earnings stripping. The guidelines given by the OECD will be discussed within this chapter as well as an analysis of whether section 23M is compatible with the arm's length approach.

Article 24 of the OECD model prohibits discrimination in certain areas and may prevent the application of thin capitalisation rules and therefore also the provisions of section 23M. A brief background is provided on the article 24 non-discrimination provisions and thereafter more detail is provided on articles 24(4) and (5) of the OECD model, as these are the provisions that are relevant to the discussion.

1.5.3. Chapter 4: Analysis of section 23M compared to the OECD model on non-discrimination

In Chapter 4, the interaction between section 31 and section 23M was discussed along with the likelihood that both provisions may target the same debt. Section 23M is thereafter analysed against the specific components of the non-discrimination provisions, in particular articles 24(4) and 24(5).

1.5.4. Chapter 5: Conclusion

Chapter 5 provides a summary of the research carried out along with the author's findings and conclusion with regard to the declared objective.

CHAPTER 2: DEVELOPMENT OF THIN CAPITALISATION AND SECTION 23M

2. INTRODUCTION

Internationally, interest is generally deductible for income tax purposes, while dividends are not deductible. It is therefore often beneficial for multinational groups to fund overseas operations by way of debts as opposed to equity, as debt will produce a tax-deductible return, while equity will produce an after-tax dividend return (Olivier & Honiball, 2011:649). As a result of such multinational groups taking advantage of the tax beneficial way of funding (debt funding), certain tax provisions had to be brought into the legislation to combat excessive interest deductions. Consequently, thin capitalisation rules were brought into South Africa in 1995. More recently, a new section (section 23M) was introduced into the tax legislation and it was noted that this section serves a similar purpose to the thin capitalisation and transfer pricing rules contained in section 31 of the Act (Mazansky, 2013).

In this chapter, the study will commence with a review of the origin and development of thin capitalisation as well as a review of section 23M. The study will continue to evaluate how the newly introduced section 23M compares to the old section 31(3), and whether section 23M would be subject to the same provisions as thin capitalisation, in particular the OECD non-discrimination article.

2.1. DEVELOPMENT OF THIN CAPITALISATION

2.1.1. Background to transfer pricing and thin capitalisation

Since the beginning of the 20th century, tax authorities have struggled to preserve the integrity of their tax systems due to the leakage of tax revenues via operations or entities situated in low-tax jurisdictions (Vincent, 2005:411). The international consensus on transfer pricing dates back more than 75 years, to the League of Nations' 1933 Draft Convention on the Allocation of Business Profits between States (Owens, 2009:1). By the late 1950s, the Fiscal Committee of the Organisation for European Economic Co-operation (the predecessor organisation to the OECD) was working on a new model tax convention, and they appointed a working group to

“consider the definition and apportionment of profits between the head office of an undertaking, its permanent establishment and its subsidiary companies” (Owens, 2009:2). In 1963, the arm’s length principle made its way to article 9 of the OECD Model Tax Convention and later, in 1980, the United Nations also adopted the arm’s length principle, which is reflected in article 9 of the United Nations Model Double Taxation Convention between Developed and Developing Countries (OECD, 2012a:1). The wording of article 9(1), which sets forth the arm’s length principle, has remained unchanged since the 1963 Draft Convention. Paragraph 2 of article 9, which deals with corresponding adjustments, was added in the 1977 model, thereby balancing the article by explicitly incorporating in it the objective of eliminating the economic double taxation that can result from transfer pricing adjustments made by the application of article 9(1) (Owens, 2009:2). The OECD transfer-pricing guidelines, released in their revised format in 1995, were the culmination of efforts by the international tax community to review the existing standards and adapt it to the realities of the modern business world. The OECD guidelines reaffirmed the use of the arm’s length principle and elaborated upon its application (Vincent, 2005:411). To summarise, the report on *Transfer Pricing and Multinational Enterprises* was released by the OECD in 1979, thereafter *Three taxation issues* was released in 1984 and *Thin Capitalisation* in 1987. In 1995, the report *Transfer Pricing Guidelines for Tax Administration and Multinational Enterprises* replaced the 1979 report. Between 1995 and 2000, the guidelines were expanded to include guidance on intangibles, cross-border services, cost contribution arrangements and advanced pricing arrangements (Owens, 2009:2).

As a result of a progressively globalised economy there has been a vast number of changes and challenges within the economy and therefore it is necessary for the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD TPG) to be revised and updated with new guidance on a regular basis (OECD, 2012a:1). While exchange control regulates the flow of funds from South Africa, the gradual relaxation of the exchange control rules has provided greater flexibility and freedom for the movement of funds offshore (PWC, 2012b:169). Due to the ongoing relaxation in exchange control regulations, as well as international investments and the need for protection of the South African Tax

base due to an increase in trade, thin capitalisation and transfer pricing provisions were introduced into the South African income tax legislation in 1995.

Over the past several years, tax schemes by some corporates have become an increasing concern locally, in South Africa, as well as globally. A recent OECD paper notes that “while there are many ways in which domestic tax bases can be eroded, a significant source of base erosion is profit shifting” (National Treasury, 2013:1). One of the most significant types of base erosion in South Africa comes in the form of excessive deductions by some corporates with income effectively shifted to a no-tax or low-tax jurisdiction (National Treasury, 2013:1). Like in many other countries, excessive deductible interest is of the greatest concern in this regard (National Treasury, 2013:1). Base erosion, in the form of interest deductions, occurs in situations where the borrower is entitled to an interest expense tax deduction and the lender is entitled to an exemption from tax with regard to the interest income or will be taxed at a lower rate. This is due to the provisions within the ITA detailed as follows: Deductions of expenditure and in this case interest are allowed in terms of section 24J(2) of the ITA, which states that there shall be allowed as a deduction from the income by any person from carrying on a trade if that expenditure is actually incurred in the production of income (South Africa, 1962). Notable parties eligible to receive exempt interest are pensions and foreign persons. The ITA (No. 58 of 1962) states in section 10(1)(h) that an amount of interest that is received by or accrues to any person that is not a resident (foreign person) is exempt unless that person carried on a business through a permanent establishment in the Republic (South Africa, 1962). This exemption is roughly matched within the South African tax treaty network, which often exempts foreign residents from taxation in respect of South African-sourced interest, unless that interest is attributable to a South African permanent establishment (National Treasury, 2013:43). As a result of the exemption/deduction mismatch, corporates started using this as a tax-free mechanism, abusing the legislation to obtain excessive interest deductions. Tax leakage from excessive debt was a global phenomenon and various countries were introducing measures to control interest deductions on excessive debt (Keep & Makola, 2014:193). Consequently, most countries have thin capitalisation provisions to limit the amount of debt funding in relation to equity funding (Olivier & Honiball, 2011:649). Thin capitalisation is described by De Koker (2002) as follows:

“Thin capitalization, often regarded as a category of transfer pricing, relates to the funding of a business with a disproportionate degree of debt in relation to equity so as to provide the foreign investor the benefit of having the interest income derived therefrom exempt. While, at the same time, conferring upon the company the tax advantage relating to the deductibility of the interest payments on the debt (as opposed to the non-deductibility of dividends distributed on equity capital). Consequently, thin capitalization provisions are applied to limit the deductibility of interest on the excessive debt funds, thereby protecting the South African economy against distortions resulting from heavily geared foreign investments.”

Thin capitalisation, as a specific form of transfer pricing, was adopted by the OECD council on 26 November 1986 and they released a tax report on this matter. It was noted that while the United States (US) was one of the first countries that imposed thin capitalisation rules, many countries have followed since then (Buettner *et al.*, 2008:2). As noted above, thin capitalisation was introduced into South Africa in 1995. On 14 May 1996, the South African Revenue Services (SARS) issued a SARS Practice Note no 2, with retrospective effective date of 19 July 1995, which maintained the general ‘safe harbour’ debt-to-equity ratio of 3:1 as applied by Exchange Control and ensured continuity in this regard (Olivier & Honiball, 2011:650). These thin capitalisation provisions were found in section 31(3). In 2010, changes to South Africa’s thin capitalisation rules, which were subsequently further amended in 2011 in the Tax Law Amendment Act, were legislated. Thin capitalisation rules are now dealt with in the same manner as transfer pricing in that the wording is aligned more closely with the wording of Article 9 of the OECD Model Tax Convention. These new rules are effective for years of assessment commencing on or after 1 April 2012.

2.1.2. Introduction of section 31

Transfer pricing and thin capitalisation rules were introduced into the South African income tax legislation with effect on cross-border transactions entered into on or after 19 July 1995 (Horak, 1995:1). The Commissioner of SARS was empowered

under the rules to have regard to the financial assistance provided, by scrutinising the transaction in question (Badenhorst, 2013). At that stage, no indication was provided in the legislation as to the determination of an acceptable ratio of shareholder debt to equity, but there were indications that the revenue authorities would continue to apply the exchange control requirement that shareholders' debt should not exceed the equity by a ratio of more than 3:1 (Horak, 1995:1). Interest paid or payable on the financial assistance was therefore disallowed if the funding was considered excessive with regard to the lender's fixed capital in the borrower (Badenhorst, 2013).

In anticipation of a possible relaxation in exchange controls, the commission of inquiry into certain aspects of the tax structure of South Africa recommended in its first and second interim reports that transfer pricing provisions be introduced into the ITA, *inter alia*, to counter thin capitalisation practices that may have adverse tax implications for the South African *fiscus* (SARS, 1996:1). If a foreign investor was to fund a local entity by way of low equity and heavy debt and moreover charged high rates of interest, the interest (if deductible) would effectively drain profit out of the South African tax net – bearing in mind that interest payable to non-residents is generally tax free in South Africa (Ernst & Young, 1996). This possibility caused concern not only to SARS, but also to revenue services world-wide that had introduced similar rules (Ernst & Young, 1996). Practice Note No 2, dated 14 May 1996, was brought in and the provisions of section 31 applied to any services, including the granting of financial assistance, supplied on or after 19 July 1995. Section 31 (1) and (2) contained measures to counter transfer pricing schemes and subsection (3) specifically aimed at countering thin capitalisation schemes (SARS, 1996:1). The 'old' section 31(3) of the ITA contained the following provisions:

- “(3)(a) Where any person who is not a resident (hereafter referred to as the investor) has granted financial assistance contemplated in paragraph (c) of the definition of “services” in subsection (1), whether directly or indirectly, to –*
- (i) any connected person in relation to the investor who is a resident;*
 - or*
 - (ii) any other person (in whom he has a direct or indirect interest) other than a natural person, which is a resident (hereafter referred to as*

the recipient) and by virtue of such interest, is entitled to participate in not less than 25 per cent of the dividends, profits or capital of the recipient, or is entitled, directly or indirectly, to exercise not less than 25 per cent of the votes of the recipient,

and the Commissioner is, having regard to the circumstances of the case, of the opinion that the value of the aggregate of all such financial assistance is excessive in relation to the fixed capital (being share capital, share premium, accumulated profits, whether of a capital nature or not, or any other permanent owners' capital, other than permanent capital in the form of financial assistance as so contemplated) of such connected person or recipient, any interest, finance charge or other consideration payable for or in relation to or in respect of the financial assistance shall, to the extent to which it relates to the amount which is excessive as contemplated in this paragraph, be disallowed as a deduction for the purpose of this Act.

(b) For the purposes of paragraph (a), financial assistance granted indirectly shall be deemed to include any financial assistance granted by any third party who is not a connected person in relation to the investor, a connected person contemplated in paragraph (a) or the recipient, where such financial assistance has been granted by arrangement, directly or indirectly, with the investor and on the strength of any financial assistance granted, directly or indirectly, by the investor or any connected person in relation to the investor, to such third party.”

When referring to the ‘old’ section 31(3), as detailed above, it can be said that the thin capitalisation provisions applied where financial assistance was granted by a non-resident directly or indirectly to a connected person in relation to that non-resident whom is a resident. It would also apply to any other person other than a natural person, which is once again a resident and in which the non-resident is entitled to participate in not less than 25 per cent of the dividends, profits or capital of the recipient, or is entitled, directly or indirectly, to exercise not less than 25 per cent of the votes of the recipient. It is therefore important to note that a resident/non-resident relationship had to exist between connected parties. In paragraph (b),

financial assistance granted indirectly is said to include financial assistance granted by a third party whom has no connection with the investor or the recipient, but a guarantee arrangement has been established between the third party and the investor. If the Commissioner was of the opinion that the financial assistance was excessive in relation to the fixed capital, then the amount of interest that was considered to be excessive would be disallowed as a deduction for the purpose of the Act.

In order to determine which portion of interest relates to excessive financial assistance in relation to an investor in respect of a year of assessment, the following formula was applied:

$A = B \times (C - D)$, in which:

'A' represents the disallowable interest, limited to interest incurred during such year in respect of financial assistance granted on or after 19 July 1995;

'B' represents the total interest incurred during such year in respect of all financial assistance, contemplated in subsection (3), in existence during such year (whether or not such financial assistance was granted before, on or after 19 July 1995);

'C' represents the weighted average of all interest-bearing financial assistance that was in existence during such year (whether or not such financial assistance was granted before, on or after 19 July 1995); and

'D' represents the greater of

- * three times the fixed capital of the resident or recipient as at the end of the relevant year of assessment; and

- * the weighted average of all interest-bearing financial assistance granted prior to 19 July 1995, which existed during such year (SARS, 1996:4).

Paragraph 6.2 of Practice Note No 2, however, indicated that where a taxpayer could justify a level of financial assistance that was higher than the guideline ratio of financial assistance to fixed capital or a higher interest rate under special circumstances, the taxpayer may approach the Commissioner to exercise his discretion in terms of section 31. This would, generally, be of a temporary nature and a period may be specified within which the 3:1 ratio would need to be restored or the interest rate reduced (SARS, 1996:6).

Effective safe harbours can eliminate a material portion of the cost and time in complying with or enforcing rules that would otherwise govern the controlled transaction (KPMG, 2013). The 3:1 debt-to-equity safe harbour ratio therefore made it easy to comply with the thin capitalisation rules and taxpayers knew with a degree of certainty that if they ensured that they fell within the 3:1 ratio that they would be entitled to the full deduction of the interest that was associated with the debt portion, without a great deal of cost and time with respect to enforcing the rules associated with thin capitalisation. This change caused a great deal of uncertainty when SARS considered that these thin capitalisation rules contained in section 31(3) lacked the views of the OECD, which states that thin capitalisation should form part of international transfer pricing provision (Ernst & Young, 2011). Section 31 was consequently updated to incorporate the views of the OECD. These changes are considered in more detail in the next part of this chapter.

2.1.3. Changes to section 31

Section 31, when introduced in 1995, was closely based on the transfer pricing legislation in the United Kingdom (UK) at the time, and had remained largely unchanged through its roughly 15 years of existence (Sonnenbergs, 2010). SARS believed that the thin capitalisation rules were not aligned with the views of the Organisation for Economic Co-operation and Development ('OECD') in that thin capitalisation rules should form part of transfer pricing principles (taxENSight, 2010). The new section 31 does not make provision for a separate safe harbour ratio that measures financial assistance in relation to equity anymore. Financial assistance therefore now forms part of the transfer pricing provision. It was noted that the SARS Practice Note 2 – which dealt with intra-group financial assistance – does not apply under the new version of section 31, as the practice note dealt primarily with the safe harbour calculation, which has now been eliminated. The fact that SARS will now look more widely at inbound funding arrangements to evaluate whether there is a genuine “business need or reason or commercial benefit for additional finance” is an important difference between the old and new rules (Joubert, 2013:30-31).

For years of assessment commencing on or after 1 April 2012, the 'new' section 31(2) of the ITA, which also governs thin capitalisation (SARS, 2012), states as follows:

"31(2) Where—

a) any transaction, operation, scheme, agreement or understanding constitutes an affected transaction; and any term or condition of that transaction, operation, scheme, agreement or understanding—

i) is a term or condition contemplated in paragraph (b) of the definition of 'affected transaction'; and

ii) results or will result in any tax benefit being derived by a person that is a party to that transaction, operation, scheme, agreement or understanding,

the taxable income or tax payable by any person contemplated in paragraph (b)(ii) that derives a tax benefit contemplated in that paragraph must be calculated as if that transaction, operation, scheme, agreement or understanding had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm's length."

The term 'affected transaction' is defined in the ITA as follows:

***"affected transaction"** means any transaction, operation, scheme, agreement or understanding where-*

a) that transaction, operation, scheme, agreement or understanding has been directly or indirectly entered into or effected between or for the benefit of either or both—

i)

aa) a person that is a resident; and

bb) any other person that is not a resident;

ii)

aa) a person that is not a resident; and

bb) any other person that is not a resident that has a permanent establishment in the Republic to which the transaction, operation, scheme, agreement or understanding relates;

iii)

aa) a person that is a resident; and

bb) any other person that is a resident that has a permanent establishment outside the Republic to which the transaction, operation, scheme, agreement or understanding relates; or

iv)

aa) a person that is not a resident; and

bb) any other person that is a controlled foreign company in relation to any resident,

and those persons are connected persons in relation to one another; and

b) any term or condition of that transaction, operation, scheme, agreement or understanding is different from any term or condition that would have existed had those persons been independent persons dealing at arm's length;"

As noted in the 'old' section 31 provisions, the new section 31 provisions also require there to be a resident/non-resident relationship between connected persons. However, included in the statement "any transaction, operation, scheme, agreement or understanding" is the granting of financial assistance, which was previously dealt with in its own subsection within section 31. If the terms and conditions of the transaction, operation, scheme, agreement or understanding and therefore also financial assistance are not the same as the terms and conditions that would have existed had the persons involved in the transaction been independent persons dealing at arm's length and this would result in a tax benefit, then the taxable income would need to be calculated as if that transaction, operation, scheme, agreement or understanding had been entered into at arm's length terms and conditions between independent persons. Thin capitalisation rules will therefore now be based on whether the financial assistance is at arm's length and not whether it falls within the 3:1 safe harbour ratio. The 3:1 ratio remains relevant in that SARS will continue to

refer to it as following a 'risk-based approach' (SARS, 2012). However, the ratio to be used will no longer be of interest-bearing debt relative to 'fixed capital', as defined in the old SARS Practice Note 2 (Joubert, 2013:30-31). It has been suggested in the SARS draft interpretation note that "in selecting cases, SARS will consider transactions on which the Debt:EBITDA ratio of the South African taxpayer exceeds 3:1 to be of greater risk" (SARS, 2012).

It was noted that, in applying the arm's length principle for thin capitalisation, it is necessary to test the level of debt the company receives compared to its arm's length capacity, this being the level of debt it could have borrowed from an independent lender, as a stand-alone entity, under similar terms and conditions (Miller, 2011). In theory, an arm's length thin capitalisation analysis seems easy, one must analyse what a company could borrow and how much it would borrow taking into account its capital structure, the purpose for the loan and other relevant factors (Stelloh, 2014). However, in practice, it is easier said than done as it is not that easy to find the relevant and reliable data that you need in order to substantiate your reasoning as to why the financial assistance is at an arm's length between independent persons. From an overall perspective, the new transfer pricing rules seem to be a substantial improvement, bringing South Africa closer to international best practices and aligning section 31 with the provisions in the tax treaties concluded by South Africa (Sonnenbergs, 2010).

2.2. SECTION 23M: LIMITATION OF INTEREST DEDUCTIONS

The National Treasury has indicated that the current methods to limit excessive interest owed to exempt persons (the new section 31) are largely incomplete (National Treasury, 2013:1). The National Treasury also added that "The 3:1 debt equity rule had to be changed in favour of a more facts and circumstances approach so as to satisfy international transfer pricing standards. The 3:1 debt limit also allowed for debt levels that are far too great with the prior rule arguably encouraging debt limits to the 3:1 level. As for cross-border interest withholding, the proposed charge is frequently reduced to zero under most South African tax treaties". Because interest, such as royalties, management and technical fees, generates local deductions, it gives rise to potential base erosion. As a result of this risk, provisions

had to be brought into the Act in order to combat the base erosion risks. Withholding tax on interest is a form used to protect the tax base and was to be effective for interest that is paid or payable on or after 1 January 2015 (National Treasury, 2013:1). The introduction of interest withholding tax has, however, been delayed until 1 March 2015 in terms of the Taxation Laws Amendment Bill (Ger & Isherwood, 2014). A final withholding tax on interest will be levied, at a rate of 15 per cent on the amount of any interest paid by any person to or for the benefit of any foreign person to the extent that the amount is regarded as having been received or accrued from a source within the Republic in terms of section 9(2)(b) (Oguttu, 2014). The taxpayer may, however, also be exempt from withholding tax on interest, if the foreign person has submitted to the person making the payment a declaration in a form prescribed by the Commissioner that the foreign person is exempt from the withholding tax on interest or if the interest is subject to that reduced rate of tax as a result of an applicable double tax treaty (Oguttu, 2014). There may therefore still be numerous circumstances where interest paid to foreign taxpayers is exempt from taxation and therefore still being a risk for base erosion and profit shifting.

It was noted that the introduction of provisions targeting base erosion and profit shifting is one of the key developments affecting South African tax law and practice in the past year (Keep & Makola, 2014:192). Included in the provisions to target base erosion and profit shifting is section 23M, which limits the deduction of interest paid to persons in whose hands the interest received is not subject to tax in South Africa. Section 23M has been brought into the ITA and is said to become effective for years of assessment 1 January 2015 and onwards. Section 23M represents an enactment of thin capitalisation rules (Stiglingh *et al.*, 2014:744). The interest limitation will be subject to a defined formula as contemplated in sections 23M(2) and (3).

The National Treasury and SARS have published proposals for the purpose of limiting the deductibility of interest payments. The proposed new rules clearly view tax arbitrage as an evil that must be combated – yet government seems to fail to take into account that in many instances they themselves introduced and legislated the rules that gave rise to the arbitrage. Government is effectively saying, “We will deny you, Mr Borrower, a deduction for interest paid because the recipient is exempt – and we are not concerned that we made the recipient exempt in the first place”

(Bravura, 2013:1). One of these new rules is section 23M, combating tax arbitrage in the form of interest deduction limitations. It appears as if, although section 31 does limit excessive interest deduction, it does not account for all types of transactions that fall within the risk of base erosion; therefore, the National Treasury identified four recurring concerns that were included in the original proposal in order to curb excessive interest deductions. The four recurring concerns include: Hybrid debt, connected person debt, transfer pricing and acquisition debt (National Treasury, 2013:2). It was noted that the National Treasury contends that these interest deduction limitations are necessary to avoid the erosion of the South African tax base (Lewis, 2014).

The provisions of the newly introduced section 23M will require a specific calculation, which is likely to result in the deferral of at least a portion of the interest deduction in the hands of the borrower where this person is in a controlling relationship with the non-resident lender (Betts, 2014). The deduction for interest paid or incurred in respect of the debt will be limited to 40 per cent of the debtor's taxable income (with certain adjustments) and to the extent that interest paid or incurred on debt between group entities exceeds the limitation, the excess can be carried forward for up to five years (Bekker, 2013). The thin capitalisation provision, contained in section 31, in essence, limits a taxpayer's interest deduction based on the arm's length principle, while section 23M, which is similarly focused on the limitation of interest deductions, imposes a limitation based on a defined formula detailed within the ITA. Section 23M specifically applies in respect of debts owed to persons not subject to tax. It is submitted that these two provisions have similar purposes and may target the same interest deduction.

2.2.1. Section 23M(2) of the Income Tax Act

Prior to the 2014 Tax Law Amendments Bill, section 23M(2) of the ITA stated the following:

- “2) Where an amount of interest is incurred by a debtor during a year of assessment in respect of a debt owed to-*
- a) a creditor that is in a controlling relationship with that debtor; or*

- b) a creditor that is not in a controlling relationship with that debtor, if-
 - i) that creditor obtained the funding for the debt advanced to the debtor from a person that is in a controlling relationship with that debtor; or
 - ii) the debt advanced by that creditor to that debtor is guaranteed by a person that is in a controlling relationship with the debtor, and the amount of interest so incurred is not during that year of assessment-
 - aa) subject to tax in the hands of the person to which the interest accrues; or
 - bb) included in the net income of a controlled foreign company as contemplated in section 9D in the foreign tax year of the controlled foreign company commencing or ending within that year of assessment,

the amount of interest allowed to be deducted may not exceed the amount determined in subsection (3)."

During the progress of the study, there were, however, certain amendments made to section 23M and, among others, included in the 2014 Taxation Laws Amendment Bill was the amendment to subsection (2), which now reads as follows:

“(2) Where an amount of interest is incurred by a debtor during a year of assessment in respect of a debt owed to—

- (a) a creditor that is in a controlling relationship with that debtor; or*
- (b) a creditor that is not in a controlling relationship with that debtor, if that creditor obtained the funding for the debt advanced to the debtor from a person that is in a controlling relationship with that debtor,*

and the amount of interest so incurred is not during that year of assessment—

- (i) (aa) subject to tax in the hands of the person to which the interest accrues; or*

(bb) included in the net income of a controlled foreign company as contemplated in section 9D in the foreign tax year of the controlled

foreign company commencing or ending within that year of assessment; and

(ii) disallowed under 23N,

the amount of interest allowed to be deducted may not exceed the amount determined in accordance with subsection (3).”

The Taxation Laws Amendment Bill scraps a problematic provision in section 23M, which would have resulted in interest payable to unrelated third parties, which are not subject to tax, being caught by the limitation provisions simply by virtue of the loan being guaranteed by a person that is in a controlling relationship (Ger & Isherwood, 2014). Subsection 2(b)(ii), which relates to guarantees placed on the loans by persons in controlling relationships with the debtors has therefore been removed from section 23M. There has also been an inclusion with regard to section 23N, which, in essence, means that if the interest was disallowed under section 23N, it may not be disallowed again under section 23M. It should, however, be noted that at the time of submission of the dissertation, the 2014 Taxation Law Amendments Bill was not finalised as an Amendments Act.

2.2.1.1. Debtor must be a resident

The term ‘debtor’ was originally described in section 23M as meaning “*a debtor that is a resident*”. Another amendment included in the 2014 Taxation Laws Amendment Bill was the amendment to the definition of ‘debtor’, which now reads as follows:

“‘debtor’ means a debtor who is—

(a) a person that is a resident; or

(b) any other person who is not a resident that has a permanent establishment in the Republic in respect of any debt claim that is effectively connected with that permanent establishment.”

It is important that the debtor should be a resident as the issue at hand relates primarily to inbound financial assistance transactions; therefore, financial assistance being granted to a resident of South Africa. Resident debtors would usually obtain a

deduction of interest paid on the financial assistance while the foreign lender would most likely not be subject to tax on the interest received. The heading, however, may seem obvious at first, but the bigger issue is with respect to debtors not covered by the provisions. For instance, prior to the 2014 Taxation Law Amendments Bill, a South African branch of a non-resident would not have been a debtor as defined and any interest incurred by such branch would not be subject to the interest limitation (Mandy, 2014). As discussed above, the definition was subsequently changed to include other persons who are not residents that have a permanent establishment in the Republic in respect of any debt claim that is effectively connected with that permanent establishment.

2.2.1.2. Controlling relationship

'Controlling relationship' is defined in section 23M of the ITA as meaning "a relationship between a company and any connected person in relation to that company". A *'connected person'* in relation to a company is, in turn, defined as:

- *"in relation to a company any other company that would be part of the same group of companies as that company if the expression "at least 70 per cent" in the definition of "group of companies" in this section were replaced by the expression "more than 50 per cent";*
- *In relation to any other company if at least 20 per cent of the equity shares in the company are held by that other company, and no shareholder holds the majority voting rights in the company; and*
- *In relation to any other company if such other company is managed or controlled by any person who or which is a connected person in relation to such company or any person who or which is a connected person in relation to that other company" (South Africa, 1962).*

The definition of a 'controlling relationship' has, however, also been amended and is included in the 2014 Taxation Laws Amendment Bill. The definition of 'controlling relationship' now reads as follows:

*“**controlling relationship**’ means a relationship where a person directly or indirectly holds at least 50 per cent of the equity shares in a company or at least 50 per cent of the voting rights in a company is exercisable by a person.”*

The connected person requirement has therefore now been removed from the definition of a controlling relationship together with an increase in the threshold. The 50 per cent requirement is a significant increase in the threshold from the existing provisions, which treated all connected persons as being in a controlling relationship with the company (Ger & Isherwood, 2014).

The need for the controlling relationship aspect is necessary as persons that are independent from each other would not necessarily enter into transactions that are not at an arm's length, while connected persons may want to manipulate their taxable income by means of profit shifting and therefore entering into transactions that are not at arm's length, which would create excessive interest deductions. Section 23M will impose a general limitation on interest deductions where payments are made to offshore investors (i.e. creditors), or local investors who are not subject to tax in South Africa, which are in a controlling relationship with a South African resident debtor (KPMG, 2014:3). This limitation does, however, not apply if the interest is included in the net income of a controlled foreign company as contemplated in section 9D in the foreign tax year commencing or ending in the year of assessment in which the interest deduction is claimed by the debtor (National Treasury, 2013:37).

There are, however, certain situations where the interest limitation rule will still apply to debt owed to persons who are not in a controlling relationship, and these include (National Treasury, 2013:37):

- If that person obtains the funding of the debt from a person with a controlling relationship in relation to the debtor; or

- If the debt is guaranteed by a person with a controlling relationship with the debtor.

2.2.1.3. Interest not subject to tax

'Tax' is defined in section 1 of the ITA as meaning "*tax or a penalty imposed in terms of this Act*". In effect, what it means is that if the interest is subject to either the normal tax or the withholding tax on interest, the interest deductions will not be limited in the hands of the debtor (Mandy, 2014). The second issue that needs to be considered is what is meant by 'subject to tax'. The concept of 'subject to tax' is not defined in the proposed section 23M and it is submitted that the interest in question will fall within the scope of the provisions if the taxpayer qualifies for an exemption or if the interest is not derived from a South African source (Horak, 2013:1). For example, if interest is deemed to be from a South African source under section 9, qualifies for an exemption under section 10(1)(h), but is subject to the proposed withholding tax on interest under the proposed new Part IVB of Chapter II of the ITA, such interest should qualify as 'subject to tax', notwithstanding the exemption. However, if the interest qualifies for an exemption from such withholding tax under a Double Tax Agreement (DTA), it would still qualify as 'not subject to tax' (Horak, 2013:1). Mandy also stated that notwithstanding that an amount of interest may, for example, constitute gross income, it will not be regarded as being subject to tax if it is exempted (Mandy, 2014). If, however, an amount of interest is included in gross income and is fully offset by amounts that are deductible and in turn results in there being no tax liability, it will still be regarded as being subject to tax.

Paragraph 8.6 of the commentary on the sub-articles in Article 4 of the Model Tax Convention concerning the definition of residents explains that "*paragraph 1 refers to persons who are 'liable to tax' in a contracting state under its laws by reason of various criteria. In many states, a person is considered liable to comprehensive taxation even if the contracting state does not in fact impose tax. For example, pension funds, charities and other organisations may be exempted from tax, but they are exempt only if they meet all of the requirements for exemption specified in the tax laws. They are, therefore, subject to the tax laws of a contracting state. Furthermore, if they do not meet the standards specified, they are also required to pay tax*" (OECD, 2010a:85). It is also possible for section 23M to be applicable to

pension funds as in certain circumstances pension funds may also not be subject to tax on interest. Pension funds, however, need to comply with a fair amount of requirements before they are not subject to tax and therefore in most cases the probability of a pension fund falling within the provisions of section 23M appears to be improbable. It therefore appears as if section 23M's primary focus would be on that of cross-border transactions.

2.2.2. Section 23M(3) of the Income Tax Act

Section 23M(3) of the ITA states:

“3) The amount of interest allowed to be deducted in respect of all debts owed as contemplated in subsection (2), in respect of any year of assessment must not exceed the sum of-

- a) the amount of interest received by or accrued to the debtor; and*
- b) subject to subsection (5), 40 per cent of the adjusted taxable income of that debtor,*

reduced by any amount of interest incurred by the debtor in respect of debts not contemplated in subsection (2).”

Together with all the other amendments to section 23M, subsection (3) has also been amended by the substitution in subsection (3) for paragraph (b) of the following paragraph:

“(b) a percentage of that adjusted taxable income of that debtor to be determined in accordance with the formula—

$$A = B \times C/D$$

in which formula—

- (a) ‘A’ represents the percentage to be determined;*
- (b) ‘B’ represents the number 40;*
- (c) ‘C’ represents the average repo rate plus 400 basis points; and*
- (d) ‘D’ represents the number 10,*

but not exceeding 60 per cent of the adjusted taxable income of that debtor,

reduced by so much of any amount of interest incurred by the debtor in respect of debts other than debts contemplated in subsection (2) as exceeds any amount not allowed to be deducted in terms of section 23N.”

The percentage is therefore not set at 40 per cent any more, but is now calculated using a formula. At present, with the repo rate being 5.75, the percentage would calculate to being 39 per cent, which is in line with the original 40 per cent (BDO, 2014).

2.2.2.1. Deductible interest limitation

When interest paid or incurred in respect of debt owed to persons in a controlling relationship with a debtor is not subject to tax in the hands of the beneficial owner, the prescribed formula should be used to determine the annual limitation with regards to the aggregate deductions for that interest paid or incurred (National Treasury, 2013:39).

The draft explanatory memorandum on the Taxation Laws Amendment Bill, 2014 summarises adjustable taxable income as follows (National Treasury, 2014a:20):

Starting point	Taxable income
Less	Interest received/accrued
	CFC income
	Recoupments
Plus	Interest incurred
	Depreciation and amortisation

For this purpose, adjusted taxable income, as referred to above, is defined in the ITA as meaning:

taxable income –

(a) *“Reduced by –*

(i) *Any amount of interest received or accrued;*

- (ii) *Any amount included in the income of a person as contemplated in section 9D(2);*
 - (iii) *Any amount recovered or recouped in respect of an allowance contemplated in this Act in respect of a capital asset as defined in section 19; and*
- (b) *With the addition of –*
- (i) *Any amount of interest incurred; and*
 - (ii) *Any amount allowed as a deduction in terms of this Act in respect of a capital asset as defined in section 19 for purposes other than the determination of any capital gain or capital loss.”*

The interest that is disallowed and therefore in excess of the limitation in the current year will be carried forward to the following year, where this interest will then be treated as being interest that was incurred in that following year. SAICA submitted a submission on section 23M with certain issues/inquiries into certain aspects of section 23M, and among others was the issue with regard to assessed losses being brought forward in the calculation of ‘adjusted taxable income’, and SAICA is of the view that this should be excluded from adjusted taxable income in order to fully reflect cashflows (SAICA, 2014). The National Treasury has acknowledged that taxable income as determined at the end of any year of assessment may have been reduced by the set off of an assessed loss carried forward from the previous year and that taking previous years’ assessed losses into account, further limits the base on which the overall limitation of interest deduction is calculated (National Treasury, 2014a:22). In the 2014 Tax Law Amendments Bill, it was therefore proposed that the adjusted taxable income be amended to exclude the previous years’ assessed losses from the current year’s adjusted taxable income (National Treasury, 2014a:22). Section 23M of the ITA, 1962, is hereby amended – by the addition in subsection (1) to the definition of ‘adjusted taxable income’ after paragraph (b)(ii) of the following paragraph:

“(iii) any assessed loss or balance of assessed loss allowed to be set off against income in terms of section 20;”

2.3. COMPARISON BETWEEN SECTION 23M AND THIN CAPITALISATION PROVISIONS

Section 23M has some of the same characteristics as that of thin capitalisation regimes, among others that the result of both section 23M and thin capitalisation is the limitation of excessive interest deductions. The notable differences or like characteristics are as follows:

Thin capitalisation (Section 31)	Section 23M
<u>Resident/non-resident relationship</u>	
Section 31 specifically states in the definition of an ‘affected transaction’ that there should be a resident/non-resident relationship.	Section 23M does not specifically state this requirement. It has, however, been noted that the provisions of section 23M would most likely apply when there is a resident/non-resident relationship involved. The only requirement is that the debtor should be a resident.
<u>Connected persons</u>	
Section 31 specifically required the parties to be connected in relation to each other.	Section 23M requires there to be a controlling relationship, which includes in its definition the connected person requirement (as originally stated before removal).
<u>Tax benefit</u>	
Section 31 will be applicable when, among others, the terms and conditions of a transaction result in a tax benefit being derived by a person that is party to the transaction.	Section 23M has the provision ‘subject to tax’, and therefore if an amount of interest received by a recipient is not subject to tax, the provisions of section 23M may apply. Although it is not specifically stated in the section, the non-taxable interest received appears to be an implied ‘tax benefit’ that is obtained.

<u>Debt limitation approach</u>	
In the 'new' section 31 provisions, the approach taken is that of an arm's length principle. If the terms of a loan are not the same as what they would have been if the parties involved were independent persons dealing at arm's length, then the excessive interest is disallowed. This is more in line with OECD requirements.	Section 23M appears to follow an earnings stripping approach based on a defined percentage of the EBITDA. The approach leans towards being arbitrary in nature.

From the above table, it can be seen that although worded differently, both these provisions appear to combat the same tax risks and therefore section 23M may be considered to be similar to a thin capitalisation regime in many instances.

2.4. CONCLUSION

In summary, transfer pricing was introduced in the 1930s; thereafter, in 1963, the OECD introduced the arm's length principle in article 9 of the OECD model tax convention. Paragraph 2 of article 9 was added in 1977, which eliminates the economic double taxation that can result from transfer pricing adjustments. The revised format was released in 1995, this also being the year that transfer pricing was introduced into South African income tax legislation. Practice Note No 2 was released on 14 May 1996 and was applicable to cross-border transactions entered into on or after 19 July 1995. In 2010, the National Treasury started to relook the thin capitalisation provisions and found that the thin capitalisation rules were not aligned with the views of the OECD and, therefore, after a long period of uncertainty by many taxpayers, SARS released the draft interpretation note titled 'Determination of the taxable income of certain persons from international transactions: Thin Capitalisation' in 2012. These provisions eliminated the use of the 3:1 debt-to-equity safe harbour ratio and indicate that thin capitalisation now forms part of the transfer pricing within section 31 of the income tax legislation.

Shortly after the changes within the thin capitalisation provisions, there was an introduction of provisions that target base erosion and profit shifting. Included in these provisions is section 23M, which limits deductions of interest paid to persons whom are not subject to tax on the interest received. The provisions of section 23M appear to combat the same problem areas as thin capitalisation and are said to be the enactment of the thin capitalisation rules. Excessive interest poses a recurring risk if the creditor and debtor form part of the same economic unit, as the terms of the funding arrangement are most likely irrelevant as both parties can freely charge the terms to serve the overall interest of the group (National Treasury, 2013:43). It appears as if the main difference, apart from the method in which the excessive interest deductions are calculated, between section 31 and section 23M would be that section 31 specifically applies when there is a transaction between a resident and a non-resident who are connected persons, while section 23M does not strictly speaking discriminate on the basis of residence. Section 23M applies when the recipient of the interest is not subject to tax and the reason for the connection with thin capitalisation is that usually it is a non-resident that is not liable for tax on interest received, thereby creating the same resident/non-resident relationship as with thin capitalisation. Due to the connection between the two provisions within the ITA, the study has gone into the background of thin capitalisation and section 23M, in order to establish how these provisions compare to each other and to identify any further issues that may arise. One apparent issue that may arise with the section 23M provisions is the formula as defined in section 23M, which would need to be explored in order to determine whether a section 23M transaction could be considered to be at an arm's length. This is needed because, if section 23M possibly did not comply with the arm's length principle, it could be questioned whether the section 23M limitation would be in line with the treaty non-discrimination. Chapters 3 and 4 provide a review of the OECD guidelines to thin capitalisation and in particular engage in the review of the provisions of the non-discrimination article and how these may affect the application of section 23M.

CHAPTER 3: OECD GUIDELINES RELEVANT TO THIN CAPITALISATION AND IN PARTICULAR THE NON-DISCRIMINATION PROVISIONS (ARTICLE 24)

3. INTRODUCTION

Foreign direct investment is an important factor in improving economic growth and therefore when compiling tax policies and in particular transfer pricing policies, the people involved always need to consider how to protect their domestic tax base without disinsentivising foreign direct investments (PWC, 2012a:6). In order to protect the possible damaging consequence that profit shifting could have on foreign investments and international trade, the OECD released guidelines on transfer pricing that were published in 1979. This was later revised and updated in 1995 and again in 2010. Guidance on thin capitalisation, which in essence forms part of transfer pricing, was issued in 1987 by the OECD (Owens, 2009:2). Although South Africa is not a member of the OECD, South Africa is still one of the many non-member economies with which the OECD has working relationships and uses the OECD models as guidelines within the South African tax policies (Carta, 2011). Prevention of discrimination is important when dealing with any double tax treaty as one of the purposes of tax treaties is to encourage international trade and investment, but discriminatory taxation runs counter to that purpose (Alary & Wilson, 2011). The way that the OECD has dealt with this issue is by not only introducing one general non-discrimination provision to cover all possible forms, but to also define quite accurately a handful of special criteria that must not lead to different or less favourable treatment with regard to taxation (Haslehner, 2009:3). These non-discrimination provisions are found within the OECD Model Tax Convention article 24.

This chapter reviews the guidelines on thin capitalisation issued by the OECD, in particular the approaches that are generally followed when limiting the amount of debt on which deductible interest payments may be made and the arm's length principle, which is of particular relevance in this regard. This chapter goes on to deal with article 24 of the OECD Model Tax Convention, which sets out the provisions of non-discrimination and in particular articles 24(4) and 24(5), which are most relevant to the study in progress. This part of the chapter concentrates on the purpose and

development of the particular non-discrimination provisions as well as an analysis of the specific provisions contained within articles 24(4) and 24(5). The discussion is required to be able to analyse whether section 23M in fact would fall within the same provisions as thin capitalisation and whether the non-discrimination provisions will have an effect on section 23M, the same way as it may have on thin capitalisation.

3.1. OECD GUIDELINES RELEVANT TO THIN CAPITALISATION, IN PARTICULAR THE ARM'S LENGTH PRINCIPLE

The OECD defines thin capitalisation as follows:

“A company is typically financed (or capitalized) through a mixture of debt and equity. “Thin capitalisation” refers to the situation in which a company is financed through a relatively high level of debt compared to equity. Thinly capitalized companies are sometimes referred to as “highly leveraged” or “highly geared”” (OECD, 2012b:3).

	EQUITY	DEBT
	Own resources	Other party resources
Financier (provider of funds)	Shareholders → Payment = equity contribution	Lenders → Payment = loan
Financed (recipient of funds)	Company Return to financier = dividends or increase in share value	Company Return to financier = interest Normally a deductible expense in the jurisdiction of the payer

Figure 3.1: Equity compared to debt finance

Source: OECD: Thin capitalisation legislation – A background paper for country tax administration (2012:3)

The OECD uses the above figure to illustrate the difference between equity financing and debt financing. Equity financing is the payment of equity contributions in return for after-tax dividends; while debt financing represents the payment of a loan amount in return for interest that would normally be tax deductible, therefore leading to a

lower taxable profit. Debt is therefore usually more of a tax efficient way of financing than that of equity financing and is therefore frequently used as a financing mechanism. This is also the case for South African companies. Based on this, it is therefore important that thin capitalisation provisions are in place to ensure that there is no excessive deduction/exemption mismatch, as discussed in Chapter 2. Elliffe indicated that “tax authorities are concerned with this tax-driven preference for debt finance and have devised a number of approaches to deal with what they regard as the problem of hidden capitalisation” (Elliffe, 2012:1). The OECD has indicated that thin capitalisation rules typically operate by means of one of two approaches.

These include:

- a) Determining a maximum amount of debt on which deductible interest payments are available (discussed in 3.1.1.); and
- b) Determining a maximum amount of interest that may be deducted with reference to the amount of interest (paid or payable) (discussed in 3.1.2.).

3.1.1. Limitation of debt on which deductible interest payments may be made

The OECD refers to two broad approaches that are generally followed when limiting the amount of debt on which deductible interest payments may be made. Different approaches are taken by individual countries and the OECD merely provides guidelines on both approaches.

- i. **The ‘arm’s length’ approach:** Under this approach, the maximum amount of ‘allowable’ debt is the amount of debt that an independent lender would be willing to lend to the company, i.e. the amount of debt that a borrower **could** borrow from an arm’s length lender. The arm’s length approach typically considers the specific attributes of the company in determining its ‘borrowing capacity’ (that is, the amount of debt that the company would be able to obtain from independent lenders).

The ‘arm’s length’ approach can also encompass a determination of the amount of debt that a borrower would have borrowed if the lender had been an independent enterprise acting at arm’s length. (OECD, 2012b:8).

- ii. **The ‘ratio’ approach:** Under this approach, the maximum amount of debt on which interest may be deducted for tax purposes is established by a pre-determined ratio, such as the ratio of debt to equity. The ratio or ratios used may or may not be intended to reflect an arm’s length position (OECD, 2012b:8).

3.1.1.1. The arm’s length approach

The arm’s length principle is used as a guideline by the OECD with regards to transfer pricing. It is said that when 2 or more companies form part of the same corporate structure and transact with each other, that the transfer price between these companies should be the same as if these companies were in fact independent (Neighbour, 2002). The arm’s length principle can be found in article 9 of the OECD Model Tax Convention and states the following:

“Article 9(1): Where

- a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or*
- b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,*

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly. (OECD, 2003).”

The arm’s length principle is therefore enforced by replacing the actual terms under which a controlled transaction was executed with arm’s length terms usually enforced between independent persons and then for tax purposes recalculating the profits to represent an arm’s length. Section 31(3), read together with its

accompanying practice note, was based on a 3:1 debt-to-equity ratio prior to its amendment. These thin capitalisation provisions were amended, as stated in the draft interpretation note on thin capitalisation, to be based on the same principle as the remaining transfer pricing provisions, which is the arm's length principle.

The arm's length principle adds to the challenges within South Africa, as the arm's length principle requires comparable transactions to be used in the analysis of how the arm's length transaction has been determined and there appears to be a lack of local comparable transactions to be used in South Africa. The lack of local comparables is a recurrent problem throughout the developing world, often forcing tax administrations to use non-domestic comparables and adjust for local market differences (PWC, 2012a:8). It was noted by Elliffe that "the problem with this approach, acknowledged by the OECD, is that these types of rules suffer from an absence of clarity and therefore do not create certainty for taxpayers" (Elliffe, 2012:2). The HM Revenue & Customs states that "the complexities of applying the arm's length principle in practice should not be underestimated. Because of the closeness of the relationship between the parties there can be genuine difficulties in determining what arm's length terms would have been – especially where it is not possible to find wholly comparable transactions between unconnected parties" (UK, s.a.). "However, formulary apportionment makes it difficult to reach agreement on the inputs to the formula, particularly between parent companies in wealthy countries and subsidiaries in poorer ones, while the arm's length principle avoids these pitfalls as it is based on real markets" (Neighbour, 2002). Neighbour added that a benefit of the arm's length principle is that it is flexible enough to meet new challenges, such as global trading and electronic commerce.

According to the Singapore Inland Revenue Authorities :

"the arm's length principle requires the transaction with a related party to be made under comparable conditions and circumstances, as if the transaction is with an independent party. It is founded on the premise that where market forces drive the terms and conditions agreed in an independent party transaction, the pricing of the transaction would reflect the true economic value of the contributions made by each entity in that transaction. Essentially, this means that if two related parties derive profits at levels above or below the comparable market level solely by reason of the special relationship

between them, the profits will be deemed as non-arm's length. In such a case, tax authorities that adopt the arm's length principle can make the necessary adjustments to the taxable profits of the related parties in their jurisdictions so as to reflect the true value that would otherwise be derived on an arm's length basis" (Inland Revenue Authority of Singapore, 2006:5).

The application of the arm's length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises (OECD, 2010b:9). Attributes or 'comparability factors' that may be important when determining comparability include the characteristics of the property or services transferred, the functions performed by the parties, the contractual terms, the economic circumstances of the parties, and the business strategies pursued by the parties (OECD, 2010b:9). In order to therefore determine the arm's length of a transaction, each individual transaction would need to be interpreted separately, considering all the factors listed above, as each individual transaction may have a different result with regard to each factor.

There are, however, advantages and disadvantages when using the arm's length principle, and some of these advantages and disadvantages are listed below:

Advantages

The use of the arm's length principle provides for a much closer approximation of the amount of debt that a corporation could have borrowed at arm's length and thereby removes the asymmetrical treatment between companies that are members of multinational enterprises and those that are not (OECD, 2012b:9). The principle therefore does not place all companies into a general classification and bases the limitation of an interest deduction for a small company on the same terms as with a larger company (OECD, 2012b:9). Each individual company is assessed based on the characteristics of that company. A smaller developing company may require more debt than an already established company in the same industry and therefore should be evaluated differently when determining what the amount of debt is that the company could have borrowed. The arm's length principle is therefore beneficial in that it is tailored to facts and circumstances of each individual case. Unlike a fixed

ratio approach, an arm's length approach recognises that different industries have different capital requirements and it acknowledges that debt requirements are not consistent across industries (Hanlon, 2000:12). It is founded on the premise that when market forces drive the terms and conditions agreed to in an independent party transaction, the pricing of the transaction would reflect the true economic value of the contributions made by each party to the transaction (Deloitte, 2013:4). Another advantage of the arm's length principle is that it may allow the elimination of double taxation through the application of a tax treaty, if the treatment is accepted by both treaty partners that the approach represents the application of the arm's length principle. The arm's length principle is widely accepted by governments, no doubt because it is a simple concept and is unbiased between taxpayers (Wundisch, 2003:108).

Disadvantages

The use of the arm's length principle does, however, have certain disadvantages, as the principle requires many resources and skills, which, as mentioned earlier on in the study, are not always available when determining the arm's length of a transaction. There may be no satisfactory evidence from which to deduce an arm's length price and, if there is, this may be difficult to interpret, or may serve only to indicate that the arm's length price lies somewhere within a range of prices (Wundisch, 2003:108). Tax auditors would need to understand how a third party lender would determine the maximum amount of debt that they would lend to a specific taxpayer. Tax authorities would therefore need the help of experts to determine what the specific characteristics of a group affiliate are in order to determine the appropriate amount of debt. The arm's length principle would therefore place an extensive administrative burden on both the taxpayer and the tax authorities (OECD, 2012b:9).

As discussed in Chapter 2, the thin capitalisation rules in South Africa have been amended in order to be more in line with the views of the OECD, therefore following the arm's length approach.

3.1.1.2. The ratio approach

It was noted that “thin capitalization rules can be generally classified as objective or subjective. Objective rules use a quantitative measure, such as a debt-equity ratio, to limit interest deductions. Subjective rules are qualitative and require a firm to limit its interest deductions if the amount of interest is unreasonable according to facts and circumstances” (Farrar & Mawani, 2008:4). The ‘old’ thin capitalisation rules set out in the ‘old’ section 31(3) and the related practice note, were based on the ratio approach, and therefore an objective approach. South Africa had the 3:1 debt-to-equity safe harbour ratio, indicating that if a company’s debt to equity was within the range of this safe harbour ratio, then SARS would not require the company to make any thin capitalisation adjustments. A fixed debt-to-equity ratio is easy to implement, but treats firms equally independent of sector specifics, e.g. the need for outside capital or productivity (Mardan, 2013:2).

There are, however, advantages and disadvantages when using the ratio approach, and some of these advantages and disadvantages are listed below:

Advantages

The ratio approach is beneficial in that it provides a great deal of certainty to taxpayers as it is based on a predetermined ratio, thereby allowing taxpayers to know with certainty that they will not be penalised if they are within the predetermined ratio; unlike with the above arm’s length principle, where a taxpayer may never be certain whether the tax authorities will agree with their methods of calculation. As the ratio approach works according to a set ratio that is used by all taxpayers, it would reduce compliance costs for companies and taxing authorities. It is simple to implement and reduces the resource cost of tax authorities because all taxpayers are treated according to the same principles (OECD, 2012b:12).

Disadvantages

The ratio approach is in contrast with the arm’s length approach as it does not necessarily reflect economic reality and it does not always take into account specific

market situations or industries (OECD, 2012b:12). It therefore treats all enterprises the same, regardless of whether the enterprises do not fall within the same industry or whether the enterprise is a developing company that may need more debt than an already established company. The approach may result in the inconsistent treatment of members of multinational enterprises in comparison to independent companies. It may also be difficult to establish a satisfactory criterion to define a safe harbour ratio and it can therefore potentially produce results that may not be consistent with the arm's length principle (Deloitte, 2009:5). The fixed ratio approach has the potential of becoming out of alignment with the actual position that lenders may adopt because of changing economic conditions and there may be a requirement of keeping up to date with changing economic conditions, which would be necessary to ensure that a fixed ratio does not become outdated in contemporary times (Hanlon, 2000:12)

The thin capitalisation safe harbour ratio of 3:1 has been removed from the thin capitalisation provisions, but may still be used by SARS to assess the risk of thin capitalisation adjustments being required. SARS has suggested that it may, however, also consider transactions in which the Debit:EBITDA ratio of the South African taxpayer exceeds 3:1 to be of a greater risk (SARS, 2012).

3.1.2. Limitation of interest with reference to the amount of interest

Instead of defining a fixed ratio, another way to implement a thin capitalisation rule is to restrict interest deduction based on a company's earnings before interest, taxes, depreciations and amortisation (EBITDA) (Mardan, 2013:1). Mardan added that this approach, called earnings stripping, may overcome the problem of the fixed ratio treating all firms equally independent of sector specifics; as in the case of earnings stripping, the threshold for tax deductibility is determined by the productivity of the firms and is therefore variable. The rules limit interest deductibility when the net interest expense exceeds a defined percentage of the EBITDA (Fatica, Hemmelgarn and Nicodème, 2012:11).

Section 23M limits interest paid by reference to a defined percentage (+/- 40 per cent) of the company's EBITDA and can therefore be said to be a form of prevention of earnings stripping. This once again may confirm the fact that section 23M

provisions may have a similar effect as thin capitalisation provisions as provisions aimed at preventing earnings stripping are merely another way to limit interest deductibility.

Section 23M is based on a defined formula, which may in some instances, but not necessarily all, represent an arm's length. Together with the question as to whether section 23M is an arm's length transaction, one should also consider whether section 23M and section 31 would apply to the same interest and, if so, which section is applied first and would the application of section 31 read together with section 23M have an impact on whether section 23M could be regarded as being at arm's length. It is important to determine whether section 23M would represent an arm's length transaction as this would have an impact on the outcome of the study due to the exception included in the non-discrimination provisions, as discussed in 3.2. below. In Chapter 4, the author explored whether section 23M is applied on an arm's length principle as well as an analysis as to whether section 23M could be considered to be an arm's length transaction when read together with section 31. The result would have a significant impact on the overall objective of the study, being whether the aspects of section 23M would be contrary to the OECD non-discrimination provisions.

3.2. TREATY NON-DISCRIMINATION (ARTICLE 24)

As discussed in Chapter 2, it appears as if section 23M's primary focus would be on cross-border transactions. As a result of this, section 23M may therefore fall foul to the non-discrimination provisions as set out in article 24 of the OECD model convention due to the potential contrasting treatment of a transaction based on whether a resident or non-resident is involved. Discrimination means unequal treatment in situations that are identical or comparable (Charnoz, s.a.). Article 24 of the OECD model convention is merely a specific enunciation of the general principle of equality. This principle requires that similar situations shall not be treated differently unless differentiation is objectively justified (Purohit, 2008). At the end of the 19th century, the principle of non-discrimination was applied in international fiscal relations well before the appearance of the classic type of double taxation conventions (OECD, 2010b). Article 24 of the OECD model convention, however, is

a more recent development, appearing first in the OECD draft model (1963) where it has remained unchanged (Elliffe, 2013). The first objective of the non-discrimination provision is to prevent a treaty partner from granting to foreign nationals treatment that is “other or more burdensome” than that granted to its own nationals, provided that the former are in the same or substantially similar circumstances as the latter. Its second objective is to ensure that companies are not treated differently based on whether the capital is held by its own nationals rather than those of the other contracting party (Brown & O’Brien, 2006:4).

Article 24 of the OECD model convention prohibits discrimination in certain areas, these being as follows: A contracting state must:

1. not subject nationals of another contracting state to more burdensome taxation than to nationals of the first mentioned contracting state had they been in the same circumstance;
2. not subject a permanent establishment of an enterprise of a another contracting state to ‘less favourable’ tax treatment than with respect to a domestic enterprise that carries on the same activities;
3. not allow the same deductions of interest, royalties and other disbursements when the expenses are paid by a domestic company to a resident of another contracting state as when the expenses are paid under the same conditions to another domestic company;
4. not subject enterprises that are foreign owned to ‘more burdensome’ taxation than if the enterprise was domestically owned. The non-discrimination article is designed to prohibit discriminatory taxes levied against foreign nationals or their businesses and appears in almost every tax treaty (Talk Tax, 2007).

In circumstances where the deduction of interest is disallowed due to a company being controlled by a non-resident as apposed to allowing the deduction when the company is controlled by a resident company, article 24 of the OECD Model may disallow the application of thin capitalisation rules (Elliffe, 2013:9). Article 24(4), which deals with the non-discrimination on deductibility of certain expenses, is one of the non-discrimination provisions that may be applicable when thin capitalisation regimes are imposed. Article 24(5) of the OECD model is another non—

discrimination article which may prevent the application of thin capitalisation regimes when the capital of a resident company is owned or controlled, wholly or partly, directly or indirectly, by a non-resident and less favourable treatment is enforced on the resident company than if it was a non-resident (Elliffe, 2012:4). Unlike article 24(4), which has an exception for the arm's length principle, article 24(5), when read, does not have this exception. The arm's length exception that is included in Article 24(4) states that if a thin capitalisation transaction is at arm's length, then the provisions of article 24(4) do not prohibit the application of these thin capitalisation rules, but if the transaction is not at arm's length, then the treatment may be prohibited. The commentary on the sub-articles in article 24 concerning non-discrimination explains in paragraph 74 that:

“paragraph 4 does not prohibit the country of the borrower from applying its domestic rules on thin capitalisation insofar as these are compatible with paragraph 1 of article 9 or paragraph 6 of article 11. However, if such treatment results from rules that are not compatible with the said articles and that only apply to non-resident creditors (to the exclusion of resident creditors), then such treatment is prohibited by paragraph 4” (OECD, 2010a:350).

Another form of discrimination protection is included in section 9 of the Constitution of the Republic of South Africa (no. 108 of 1996), which includes legislation to prohibit 'unfair discrimination'. Section 9(3) of the Constitution of the Republic of South Africa, 1996 states that “The state may not unfairly discriminate directly or indirectly against anyone on one or more grounds”. Section 9(5) further states that “Discrimination on one or more of the grounds listed in subsection (3) is unfair unless it is established that the discrimination is fair”. Prior to the 2014 Taxation Law Amendment Bill, Mandy (2014) had said that “there is little doubt that section 23M discriminates against South African resident in favour of non-residents and it is difficult to see how such discrimination could be fair, particularly given the objective of protecting the South African tax base against excessive interest deductions as South African branches of non-residents are as much a part of the tax net as South African resident companies”. As discussed in Chapter 2, the meaning of the word debtor was subsequently amended to include any other person who is not a resident that has a permanent establishment in the Republic in respect of any debt claim that

is effectively connected with that permanent establishment, thereby including South African branches of non-residents.

While the rules of section 23M do not strictly speaking discriminate on the basis of residence, but rather on the basis of whether the recipient is subject to tax, this issue would arise in a situation where South Africa has surrendered its right to tax interest arising from a South African source in terms of a negotiated treaty (Mandy, 2014). Thin capitalisation and section 23M appear to be an issue when cross-border transactions are involved, in particular when companies are owned or controlled by non-residents; therefore, these provisions may be in contravention of the article 24 non-discrimination provisions, in particular articles 24(4) and (5).

3.2.1. Article 24(4) – “deduction non-discrimination clause”

Article 24(4) was not originally included in the non-discrimination provisions in the OECD draft convention of 1963. The concept was, however, added as a separate paragraph in the 1977 model.

Article 24(4) of the OECD MTC states the following:

***Article 24(4)** – Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 12, apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State. (OECD, 2003).*

The commentary on the sub-articles in article 24 concerning non-discrimination explains in paragraph 73 that the paragraph (article 24(4)) is designed to end a particular form of discrimination resulting from the fact that, in certain countries, the

deduction of interest, royalties and other disbursements are allowed without restriction when the recipient is resident, but is restricted or even prohibited when he is a non-resident (OECD, 2010a:349). Paragraph 4 therefore ensures that if interest is deductible when being paid to a resident, it should also be deductible when being paid to a non-resident. Paragraph 4 is, however, subordinate to the provisions of paragraph 1 of article 9, as considered in 3.1 above, paragraph 6 of article 11, or paragraph 4 of article 12, as stated in the extract of article 24(4) above.

Article 24 paragraph 4 of the OECD Model Tax Treaty (MTC), which deals with excessive interest together with the arm's length principle, is referred to as the 'deduction non-discrimination clause' and indicates that different rules between residents and non-residents with regard to expense deductions may be in contravention of article 24(4). Paragraph 4 does, however, not prohibit the country of the borrower from applying its domestic rules on thin capitalisation insofar as these are compatible with paragraph 1 of article 9 (OECD, 2010a:350). However, if such treatment results from rules that are not compatible with paragraph 1 of article 9 and that only apply to non-resident creditors, then such treatment is prohibited by paragraph 4 (Mandy, 2014). Accordingly, if the payment of interest by a tax resident enterprise of a contracting state to a resident of another contracting state is in excess of the amount of interest that would have been paid had the payment been at arm's length, that excess amount would be disallowed as a deduction. By making the operations of paragraph (4) of article 24 of the OECD model tax convention subject to the provisions of paragraph (1) of article 9, no resident enterprise of the host jurisdiction can take recourse to the argument of non-discrimination to seek immunity from disallowance of expenditure in excess of the arm's length principle, merely on the grounds that the domestic tax laws of the host country do not impose transfer pricing norms to disallow payments made to associated enterprises, which are tax residents of the host country (Mitra, 2007:2).

The discussion in 3.1 of this chapter on the concept of the arm's length principle and, thereafter, the discussion in 4.1 on the application of the arm's length concept to section 23M is therefore a critical aspect of determining whether section 23M complies with the arm's length principle, as article 24(4) would not prohibit the application of this section if the section applies an arm's length principle. However, if

section 23M does not comply with the arm's length principle, then article 24(4) may still regard the application of the section as discriminatory and therefore may prohibit the application thereof.

Although the language does not specify whether or not the creditor is or is not a related party, it most certainly does not exclude a related party (BIAC, 2005:3). It was noted that while it is true that the deduction non-discrimination provision is more specific in subject matter in dealing with interest deductions, it might be argued that the ownership provision is in fact more specific in relation to interest paid to a treaty partner resident shareholder, such as a parent company, since the deduction provision applies to interest paid to any non-resident (Avery Jones *et al.*, 1991).

3.2.2. Article 24(5) – “ownership non-discrimination clause”

Similar to article 24(4), article 24(5) is concerned with discrimination between two categories of residents. The subject of comparison is a resident company, the capital of which is held by a resident of the other contracting state. The objective of comparison is a ‘similar’ resident company (Bammens, 2012:377-378).

Article 24(5) of the OECD MTC states the following:

***Article 24(5):** Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected. (OECD, 2003).*

The commentary on the sub-articles in article 24 concerning non-discrimination in paragraph 76 explains that “this paragraph forbids a Contracting State to give less favourable treatment to an enterprise, the capital of which is owned or controlled, wholly or partly, directly or indirectly, by one or more residents of the other Contracting State” (OECD, 2010a:350). In short, article 24(5) regards as

discriminatory the disallowance of an interest deduction in circumstances in which a company is controlled by non-residents, if the interest deduction would be allowed if the company was controlled by residents (Elliffe, 2012:4). Article 24(5) seeks to ensure that taxpayers residing in the same state are not discriminated against on account of capital being foreign capital and therefore the emphasis is on foreign compared to domestic capital (Daimler Chrysler India (P.) Ltd., 2009). As per the OECD report on thin capitalisation, the reason for this paragraph is aimed broadly at preventing 'tax protectionism', which is the deterrence by tax measures of investment from outside the country and has not been designed to deal with measures introduced to prevent the transfer of profits in the guise of interest (OECD, 2000). The economic justification for section 23M, however, does not fall within the scope of the author's study.

The discrimination referred to in paragraph (5) of article 24 is solely based on who owns or controls the capital of the enterprise and therefore it would not be relevant with respect to rules that provide for a different treatment of an enterprise based on whether it transacts with residents or non-resident parties (Mitra, 2007:4). Assuming that the thin capitalisation rules apply only to interest paid to a non-resident controlling shareholder, such as a parent company, and not to a similar domestic shareholder, to the effect that the comparison to be made is with a company owned by a resident parent company, the ownership provision does, on the face of it, prevent the thin capitalisation rules from applying. However, it has been concluded by the OECD that the ownership provision was in such general terms that the deduction provision must take precedence over it in relation to the deduction of interest, so that adjustments permitted by the deduction provision cannot be prevented by the ownership provision (Avery Jones *et al.*, 1991). On the other hand, it has been noted that article 24(5) would generally not be relevant (i.e. outside the scope) for most thin capitalisation rules because the direct focus of such rules is not the relationship between an enterprise and the persons who own its capital (i.e. company-shareholder relationship) but, instead, the payments of interest from a resident enterprise to a non-resident creditor (debtor-creditor relationship) (TaxTalk, 2007).

Paragraph 76 of the commentary on article 24 explains that:

“this provision, and the discrimination which it puts an end to, relates to the taxation only of enterprise and not of the persons owning or controlling their capital. Its object therefore is to ensure equal treatment for taxpayers residing in the same State, and not to subject foreign capital, in the hands of the partners or shareholders, to identical treatment to that applied to domestic capital.”

The provision therefore relates to the avoidance of discrimination in view of the taxation of the company itself and does not relate to the person that owns or controls the capital. Although it is not specifically stated in the provisions of article 24(5), this article is also subject to the arm’s length principle as documented in article 24(4). This exception is noted in the commentary to the article 24(5), in paragraph 79, and states as follows:

This would also be important for purposes of paragraph 5 in the case of thin capitalisation rules that would apply only to enterprises of a Contracting State the capital of which is wholly or partly owned or controlled, directly or indirectly, by non-residents. Indeed, since the provisions of paragraph 1 of Article 9 or paragraph 6 of Article 11 form part of the context in which paragraph 5 must be read (as required by Article 31 of the Vienna Convention on the Law of Treaties), adjustments which are compatible with these provisions could not be considered to violate the provisions of paragraph 5.

With regard to the input of the limitation into article 24(5), Elliffe (2012:5) had the following to say: “The OECD Commentary has applied a teleological and systematic basis of interpretation to import the restriction included in paragraph 4 of Article 24 (namely an arm's-length transfer pricing type of exception) into paragraph 5. This is because the wording of paragraph 5 is too broad and would otherwise not prevent the transfer of profits in the form of interest. Without limitation in this way Article 24 (5) would render many countries’ domestic thin capitalisation rules ineffective” (Elliffe, 2012:5).

Bammens (2012:377-378) has indicated that

“the subject of comparison is a resident company, the capital of which is held by a resident of the other contracting state and the object of comparison is a “similar” resident company”.

In the 2007 public discussion draft, application and interpretation of article 24 (non-discrimination), the working group reached the conclusion that the right comparator for the purpose of paragraph 5 was a domestic enterprise owned by residents (OECD, 2007:27). Article 24(5) would therefore require a foreign controlled company, which is the subject of comparison to be compared to the domestically owned companies. Article 24(5) is concerned only with discrimination solely on the basis of foreign ownership. As a result, all other elements – that is to say, all relevant elements apart from foreign ownership – must be identical among the subject and the object of comparison (Bammens, 2012:408). It was noted that the term ‘similar’ in article 24(5) refers only to a resident company the capital of which is owned or controlled by another resident, and therefore, article 24(5) consequently applies if the foreign controlled company is taxed less favourably than a domestically owned enterprise, regardless of whether there are reasons for the different treatment other than the foreign control (Bammens, 2012:424).

In 2011, the functions set out in article 24(5) were considered in a United Kingdom tax case. This United Kingdom case, *FCE Bank plc v the Commissioner for Her Majesty’s Revenue & Customs* [2011] UKUT 420 (TCC), however, did not relate to thin capitalisation regimes, but rather involved the rules relating to group loss offset, between a US resident company (Ford Motor Company) and its subsidiary, which is a UK-resident company (FCE Bank Plc). Although the case does not specifically relate to thin capitalisation regimes, the basis of the argument is the same in any circumstance and that is whether the foreign ownership is the cause of the discrimination. As the First-tier Tribunal pointed out in its decision, the wording in the treaty applicable to this case is identical to article 24(5) of the OECD Model Tax Convention on Income and Capital. The Commissioners for Her Majesty’s Revenue & Customs (“HMRC”) held that there should be a two-stage approach when applying section 24(5):

1. Is there discrimination, in the sense that treatment would result in a greater tax burden, if the resident company (UK) has a non-resident holding company (US), than if the holding company had also been a UK resident? If this is true, then;
2. Is the difference in tax treatment (discrimination) solely due to the capital of the UK subsidiary being “wholly or partly owned or controlled, directly or indirectly” by the US holding company?

Is the tax treatment of section 23M therefore solely due to the capital of a South African subsidiary being held by a non-resident holding company? Chapter 4 of the study will determine the answer to this question.

Elliffe (2013:1) claimed that “thin capitalisation regimes are designed to prevent hidden capitalisation (the provision of debt financing, which is, in substance, equity capital) but on the other hand non-discrimination rules have a completely different focus and often result in adverse tax consequences for non-resident investors that do not apply to resident investors”. He added that, “It just so happens that often thin capitalisation rules apply to entities that are controlled by non-resident investors” (Elliffe, 2013:1).

The limitation of interest deductions and therefore the provisions of section 23M are implemented due to there being a deduction/exemption mismatch, this being due to the South African resident being able to claim a deduction for interest paid and the non-resident being exempt on interest received. In cases of excessive interest deductions, which trigger section 23M/thin capitalisation regimes, it usually comes across in related party transactions; therefore, as stipulated in article 24(5), the capital of a resident being owned or controlled by a non-resident. Thereby, the provisions of article 24(5) may be triggered as the provisions of section 23M may be seen as less favourable treatment to a resident company because its capital is foreign owned. The application of article 24(5) on the provisions of section 23M is explored in Chapter 4 in order to determine whether section 23M would be contrary to the OECD non-discrimination provisions.

3.3. INTERACTION BETWEEN DOMESTIC LAW AND DOUBLE TAX AGREEMENTS (DTA)

Within a domestic context, it is submitted that the DTAs to which South Africa is a party of, effectively form part of the ITA as a result of section 108 of the ITA incorporating such agreements and in fact override the provisions of the ITA. However, DTAs cannot impose tax; they merely allocate, in basic terms, taxing rights (Rood, 2014). This was confirmed in the Income Tax Practice Note 7 of 1999, paragraph 6.1, that tax treaties cannot impose tax liability, they merely allocate existing tax liabilities between countries (SARS, 1999).

Section 108 of the ITA contains the following provisions:

- (1) *“The National Executive may enter into an agreement with the government of any other country, whereby arrangements are made with such government with a view to the prevention, mitigation or discontinuance of the levying, under the laws of the Republic and of such other country, of tax in respect of the same income, profits or gains, or tax imposed in respect of the same donation, or to the rendering of reciprocal assistance in the administration of and the collection of taxes under the said laws of the Republic and of such other country.*

- (2) *As soon as may be after the approval by Parliament of any such agreement, as contemplated in section 231 of the Constitution, the arrangements thereby made shall be notified by publication in the Gazette and the arrangements so notified shall thereupon have effect as if enacted in this Act.”*

Section 108 of the ITA provides that when parliament has approved the international agreement as required by section 231 of the Constitution, the arrangements of the agreement shall be notified by the publication in the Government Gazette. Once published in the Government Gazette, the provisions of a tax treaty may acquire the force of law. Accordingly, once this procedure has been complied with, a treaty will have the same legal effects as any other section contained in the South African ITA (Olivier & Honiball, 2011:303). A DTA, once properly approved and adopted, has the

force of law and to that extent overrides the provisions of local South African fiscal legislation (Edward Nathan & Friedland, 2001).

Although it is clear that tax treaties are generally aimed at relieving double taxation, treaties, however, generally provide for more than merely the relief of double taxation such as providing for the sharing of information and prohibiting discrimination against non-nationals. For contracting states, the objectives of a tax treaty are, among others, to determine whether the particular state has the right to tax the income, while, from the perspective of a taxpayer, the objective is mainly to avoid double taxation with the resulting promotion of international trade as well as discrimination based on nationality (Olivier & Honiball, 2011:276). Although tax treaties are aimed at allocating the taxing rights on income, it is also aimed at prohibiting discrimination; therefore, despite the fact that section 23M relates to the deductibility of expenses and not necessarily the taxing of income, section 23M can still be in violation of discrimination, of which the tax treaty may prohibit.

3.4. CONCLUSION

In 3.1, it was identified that the OECD refers to two broad approaches when limiting the amount of debt on which deductible interest payments may be made. One being the 'ratio' approach, which was the approach used to calculate excessive interest in relation to the 'old' thin capitalisation. The other is the 'arm's length' approach, which is the approach used in the 'new' thin capitalisation provisions. Although it appears as if section 23M may be in line with thin capitalisation provisions, it is unsure whether the section represents an arm's length principle as it is based on a defined formula that may not include the necessary comparability factors in order for it to represent an arm's length transaction. Whether section 23M does in fact represent an arm's length transaction is an important aspect to consider, as this may influence the outcome of the study due to the arm's length exception included and incorporated into article 24(4) and article 24(5).

Article 24(4) applies when restrictions are placed on the deductibility of interest payments made to non-residents, in relation to the deductibility of the interest payments made to residents. This article, however, has an exception to the rule, i.e.

article 9(1), which refers to the arm's length principle. If thin capitalisation rules and therefore section 23M are compatible with the arm's length principle, article 24(4) will not apply to these rules. Article 24(5) applies if less favourable treatment is given due to the capital of an enterprise being owned by a non-resident, therefore disallowing an interest deduction based on the fact that the enterprise's capital is foreign owned and not domestically owned. Although article 24(5) does not specifically note that there is an exception to the rule, as above with article 24(4), Elliffe has argued that "it should be correct to import a restriction on paragraph 5, which means that the non-discrimination article cannot override an arm's length thin capitalisation regime as the OECD thin capitalisation report indicated that the objective of the paragraph is to prevent the deterrence by tax measures of inbound investments rather than the interference with the rules that prevent the transfer of arm's length profits in the guise of interest" (Elliffe, 2012:6).

Section 23M appears to have many of the same characteristics of thin capitalisation regimes and therefore there may also be the possibility of section 23M being in contravention of the OECD non-discrimination article. In order, however, to determine whether section 23M would indeed be in contravention of the OECD non-discrimination article, Chapter 4 will determine whether section 23M does in fact represent an arm's length transaction. Chapter 4 will continue to the analysis of the concept of the non-discrimination provisions as set out in articles 24(4) and 24(5) in relation to section 23M in order to determine whether section 23M may be affected by the non-discrimination provisions.

CHAPTER 4: ANALYSIS OF SECTION 23M COMPARED TO THE OECD MODEL ON NON-DISCRIMINATION

4. INTRODUCTION

The non-discrimination article, which is designed to prohibit discriminatory taxes levied against foreign nationals or their business, appears in almost every tax treaty (TaxTalk, 2007). In Chapter 3, it was identified that the non-discrimination article, in particular articles 24(4) and 24(5), may prevent the application of a thin capitalisation regime if the provisions of the regime only apply to non-residents and not to residents or if the provisions disallow a deduction on interest based on the fact that a company is controlled by a non-resident but allows the deduction if the company is controlled by a resident. If section 23M is found to fall within these non-discrimination provisions, the provisions could possibly prohibit the country of the borrower (in this case South Africa) from applying section 23M. It is therefore important to know whether there are provisions in the income tax legislation that may fall foul to these non-discrimination articles.

In Chapter 3 of the study, it was further identified that articles 24(4) and 24(5) of the non-discrimination provisions have an arm's length exception; therefore, if a transaction represents an arm's length transaction, then the non-discrimination provisions would not apply. The main objective of this study is to determine whether any aspect of section 23M would be contrary to the OECD guidelines relevant to thin capitalisation and in particular the non-discrimination provisions. In order to achieve this objective, Chapter 4 commences by considering whether the section 23M calculation, which determines the limitation on interest deductions, could be considered to be an arm's length calculation as this could be a determining factor as to whether the non-discrimination provisions would apply. Chapter 4 also considers whether the application of section 23M, read together with section 31, could have an impact as to whether section 23M could be considered an arm's length transaction. The chapter continues to explore why there may be a potential conflict between the section 23M provision and the non-discrimination provision and continues with an in-depth analysis of certain provisions contained in the non-discrimination article and how these provisions would apply to section 23M.

4.1. ANALYSIS OF SECTION 23M WITH REFERENCE TO THE ARM'S LENGTH PRINCIPLE

As discussed in Chapter 3, certain treaty non-discrimination provisions include an arm's length exception when applying the non-discrimination provisions. Article 24(4) specifically includes this exception in the OECD MTC provisions, while paragraph 79 of the commentary on article 24(5) imports a restriction that is imposed upon article 24(4) relating to certain arm's length transfer pricing requirements and applies it to article 24(5), even though paragraph 5 of the OECD model itself contains no such qualification (Elliffe, 2013:15). As the arm's length exception is an essential aspect to consider when determining whether provisions within the ITA would fall foul to the OECD non-discrimination provisions, it is necessary to determine whether the section 23M provision does actually represent the arm's length principle.

The review of section 23M in Chapter 2 indicated that the interest limitation provision is calculated based on +/-40 per cent of the debtor's 'adjustable taxable income'. The National Treasury has indicated that the formula represents a balanced reflection of market conditions in that it is flexible, recognising that the costs of debt funding fluctuate (National Treasury, 2014b:23). There has, however, been an indication that the interest deduction limitation of +/-40 per cent of the 'adjusted taxable income' may in fact be lenient (Lewis, 2014). The National Treasury has provided the following graphs to illustrate that the 40 per cent may be too high:

Figure 4.1 represents the average percentages for interest to EBIT and interest to EBITDA (based on gross interest) for five different company size categories for OECD countries. The figure illustrates that the global average in relation to EBITDA is below 20 per cent for all size categories (National Treasury, 2014b:13).

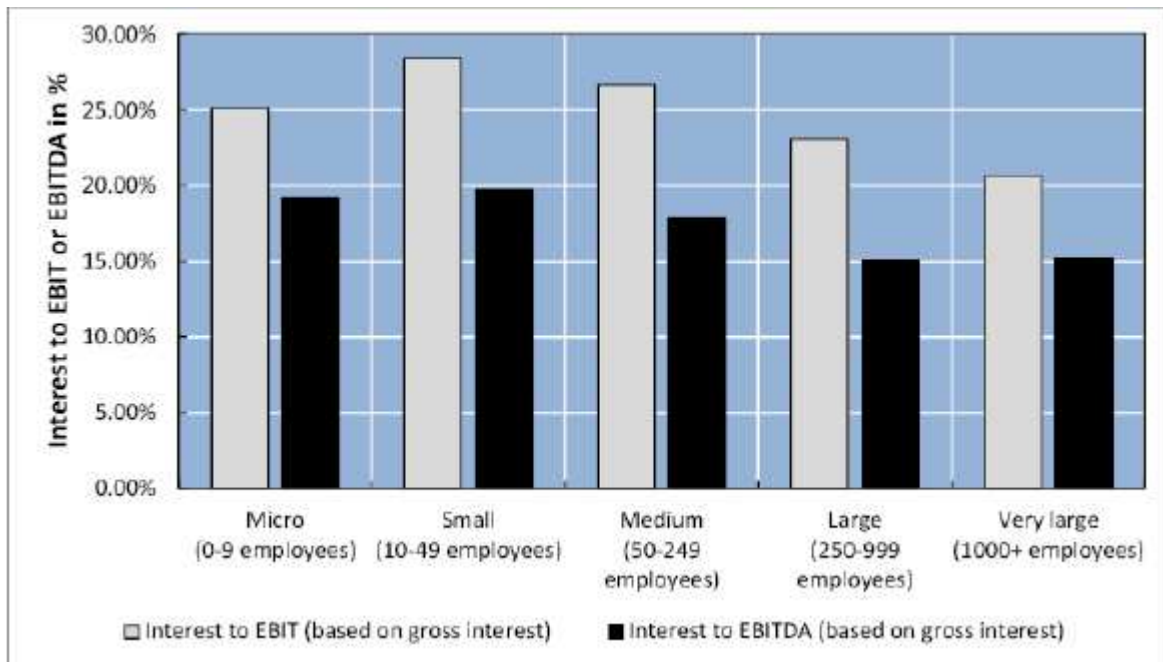


Figure 4.1: Ration of interest to EBIT and interest to EBITDA – by company size.

(Source: National Treasury: Draft response document from National Treasury and SARS, as presented to SCOF (2014b:14))

Figure 4.2, which represents South African data from Statistics South Africa, shows a very similar picture, with the exception of the electricity and business service sectors (National Treasury, 2014b:14).

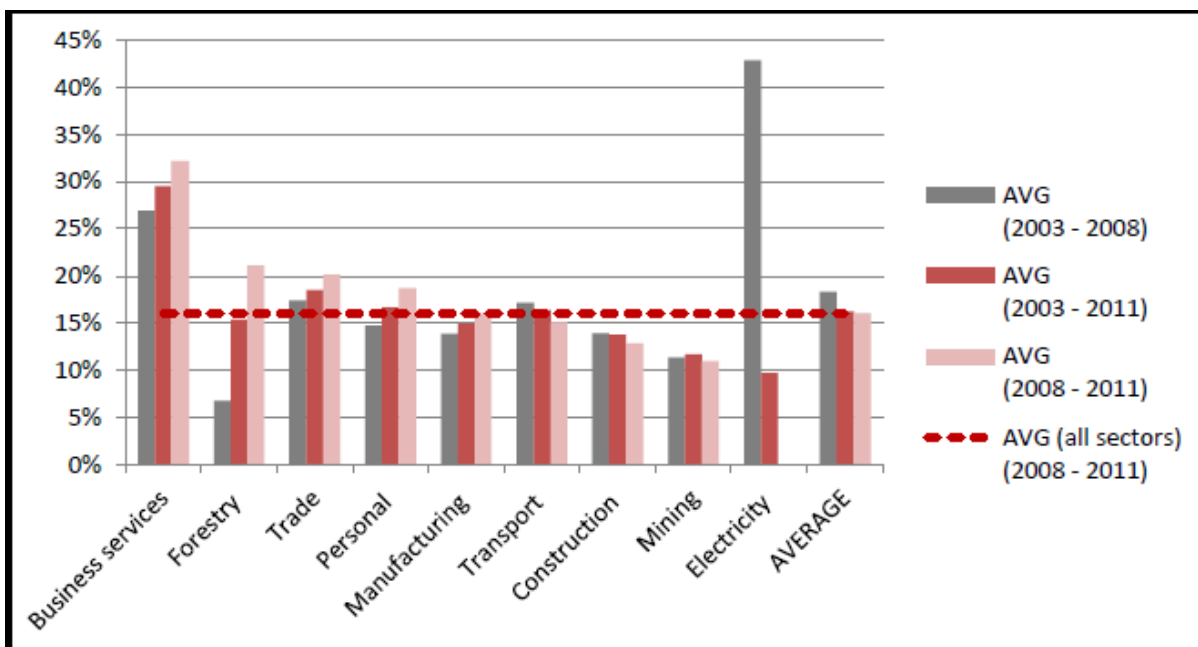


Figure 4.2: Interest expense to EBITDA ratio for South African companies – by sector.

(Source: National Treasury: Draft response document from National Treasury and SARS, as presented to SCOF (2014b:14))

As illustrated in the above figures, the interest to EBITDA differs when dealing with different company size categories as well as when dealing with different sectors within the corporate environment. The figures therefore confirm that each individual company is different with different characteristics and different financing needs. In Chapter 3, it was determined that the application of the arm's length principle should include certain 'comparability factors', such as the characteristics of the property or services transferred, the functions performed by the parties, the contractual terms, the economic circumstances of the parties, and the business strategies pursued by the parties. As the section 23M interest deductibility provision is based on a defined formula that is applied to every company that may fall within this provision, the section does not treat each individual transaction differently based on the specific contractual terms or the economic circumstances of the parties. The section merely allows an interest deduction that is equal to 40 per cent of adjusted taxable income of the debtor (with certain adjustments) regardless of any differentiating factors that may influence the amount of debt required within the company.

The OECD, however, considers that a fixed ratio may be compatible with the arm's length principle, but only when that ratio is employed merely as a kind of 'safe harbour' rule and allowing the relevant company the option of showing that the actual company's ratio is an arm's length ratio (OECD, 2012b). Section 23M, which may be considered to be a ratio approach, is, however, not employed as a kind of a safe harbour and also does not grant the taxpayer the opportunity to prove that their transaction is at arm's length. In addition, the fact that National Treasury already deems the 40 per cent to be too high could be another indication that section 23M may not be an arm's length provision. It appears as if section 23M does not consider any of the factors of the arm's length principle when determining the deductibility of interest together with the fact that section 23M does not allow the taxpayer to prove that the transaction is at arm's length, it would appear to be inconsistent with the arm's length principle, thereby being more of an arbitrary nature when applied without considering other sections within the ITA.

An important comment has been made with regard to the application of section 31, section 23M and section 23N, which all relate to the interest limitation provision and may target the same interest risk. The comment refers to the following: Would it

essentially be possible for an arrangement to be subject to the section 31 transfer pricing and thin capitalisation provisions, section 23N as well as section 23M? It is not at all clear which section should take precedence over the other. Which section would be applied first, section 23M or section 31, and if an adjustment is made to an interest deduction in terms of section 31, would section 23M still be applicable (Lewis, 2014)?

The question that therefore remains is which section is applied first between section 31 and section 23M, as this may affect whether section 23M, which appears to be arbitrary, could be considered as being at arm's length when applied with other provisions in the ITA that are said to be at arm's length, i.e. section 31. Section 23M serves a similar purpose to the thin capitalisation and transfer pricing rules contained in section 31; however, it is not clear whether SARS will agree not to apply section 31 when section 23M applies (Mazansky, 2013). The two sections target the same provisions, i.e. the limitation of interest deductions. It does, however, appear as if both sections could be applied on one transaction. The order of applying the sections is, however, not clear. The new thin capitalisation provisions require the terms and conditions of a transaction to be at arm's length, while section 23M alone appears to be of an arbitrary nature, as discussed above.

If section 31 is applied first, then the transaction would be at arm's length as this is the requirement in section 31; however, on the other hand, even though the transaction is at arm's length, it may still fall within the provisions of section 23M, as the interest allowed could still exceed 40 per cent of the adjusted taxable income, thereby decreasing the allowable interest deduction below the arm's length price. However, if section 23M was applied first, the allowable interest would be limited to 40 per cent of the adjusted taxable income, but because section 23M is based on a formula that appears to be arbitrary, it most likely does not represent an arm's length transaction and therefore section 31 could require a further adjustment on the limitation of interest. Based on this, it would appear as if either way, whether section 31 is applied first or vice versa, applying both of these sections could result in a transaction either being at arm's length or being decreased to a value below an arm's length amount. Taxpayers are therefore left uncertain in this regard as it is not

clear whether the South African Revenue Services will agree not to apply section 31 when section 23M applies (Mazansky, 2013).

On 15 October 2014, a draft response document from the National Treasury and SARS was published on the commentary received with regard to the draft Taxation Laws Amendments Bill, 2014 and Tax Administration Law Amendments Bill, 2014. It was noted within the draft response document that the purpose of section 31 is to ensure that if cross-border transactions, such as debt financing, are entered into by connected persons, they must be treated as if the amount lent and the interest rate charged between the parties are equivalent to that between two independent parties, i.e. the arm's length principle. Section 31 therefore in essence seeks to correct mispricing due to the terms and conditions of the transactions (National Treasury, 2014b:15). The National Treasury continued to note that the excessive interest limitation has a broader objective. By limiting the amount of interest deductible, it discourages companies from excessive leveraging, which is often done because the tax system inherently encourages debt over equity financing. The National Treasury added that interest limitation rules based on profitability and the inability to fund the finance charges are closer aligned with commercial practice and are more effective at protecting the South Africa economy than a simple debt-to-equity ratio (National Treasury, 2014b:15).

Because section 23M does not incorporate the necessary comparability factors in order to be an arm's length transaction and does not allow an opportunity for the taxpayer to prove that the transaction is at arm's length, it does appear to be inconsistent with the arms' length principle. Section 23M therefore appears to be of an arbitrary nature when applied on its own. As discussed above, when read together with section 31, if section 31 was applied first, which appears to be the view of the National Treasury and SARS, the application of section 23M thereafter could decrease the amount to below an arm's length amount, thereby still being an arbitrary calculation.

4.2. INTERACTION BETWEEN SECTION 23M AND ARTICLE 24 NON-DISCRIMINATION

The issue that South Africa may have is how to justify section 23M provisions that may discriminate against non-residents with treaty agreements that prohibit discrimination. It was noted that thin capitalisation rules can apply where there is a tax treaty that has a non-discrimination article, despite the clear language in the article to the contrary. In some cases, however, the non-discrimination article prevails, this being either when thin capitalisation rules go too far and are in breach of the arm's length principle or when a contextual interpretation importing the arm's length principle is inappropriate (Elliffe, 2013:3). In Chapter 3, it was identified that article 24(4) and article 24(5) of the non-discrimination provisions may prevent certain thin capitalisation regimes from applying. Before the non-discrimination provisions can apply, it has to be determined whether the transaction represents an arm's length transaction. In Chapter 3, it was identified that article 24(4) includes an exception, that if a transaction is at arm's length, then the provisions of article 24(4) would not be applicable, while the commentary on article 24(5) imports this same arm's length exception into article 24(5). In 4.1, the author considered whether the section 23M calculation that determines the limitation on interest deductions could be considered to be an arm's length calculation, as this is a critical aspect as to whether the non-discrimination provisions could be applicable or not. In 4.2.1 and 4.2.2 the author continues to explore the interaction of section 23M with article 24(4) and article 24(5).

4.2.1. Interaction of section 23M with article 24(4)

In Chapter 3, it was identified that, within the context of domestic rules, the OECD seems to indicate that different rules between residents and non-residents as to when expenses may be deducted may be in violation of article 24(4) (TaxTalk, 2007). Paragraph (4) examines the residency of the lender and ensures that, when interest paid to a resident is deductible, interest paid to a non-resident is also deductible. Paragraph (4) is, however, subject to an exception for any domestic regime that meets the arm's length requirement of article 9(1) (Elliffe, 2012:4). Section 23M does not specifically state that the section will apply only when there is

a resident-non-resident relationship, but that it is applicable when the interest payment has taken place between a debtor and a creditor in a controlling relationship. As discussed in Chapter 2, section 23M may be applicable to pension funds, charities and other organisations, but first needs to comply with certain requirements before they can be exempt from paying tax; therefore, it has been noted that it appears as if section 23M is primarily focused on cross-border transactions. Therefore, the limitation of the interest deduction, as detailed in section 23M, will in most cases be between a resident and a non-resident, thereby exposing section 23M to a potential violation of the article 24(4) non-discrimination provision.

As discussed in Chapter 3, article 24(4) has an exception, that if the transaction is at arm's length then article 24(4) will not deem the transaction as being discrimination. In 4.1 of the study, it has, however, been determined that the provisions of section 23M and the manner in which the non-deductible interest would be calculated do not appear to be on an arm's length basis, and therefore arbitrary in nature and consequently the exception found within article 24(4) would not be applicable to section 23M, thereby increasing the potential non-compliance with the non-discrimination provision. Article 24(4) specifically considers the residency of the lender, whereas section 23M is not applicable to the payment of interest to all non-residents, but only when a non-resident is not subject to tax on the income received from a South African source. If the non-resident is therefore subject to the new interest withholding tax, then the non-resident is 'subject to tax' and section 23M will not be applicable even though the payment of interest is being made to a non-resident.

The following analysis was performed by Bammens (2012:338) on the article 24(4) comparability requirement:

“The subject of comparison is a resident of contracting state A who pays interest, royalties or other disbursements to a resident of contracting state B. The object of comparison is a resident of contracting state A who makes such payments to a resident of contracting A. Accordingly, the protection offered by article 24(4) is protection against discrimination by the taxpayer's home state i.e. the state of residence of the person paying the disbursement/ or owing the debt”.

In accordance with section 23M, the comparability would be as follows: The subject of comparison would be a South African resident company that pays interest to a resident in another contracting state. The object of comparison would be a South African resident who makes such payments to another South African resident, thereby protecting the South African resident who makes the interest payments.

Bammens (2012:339) refers to an example with reference to his analysis of the comparability requirement, which could be referenced directly to section 23M and states as follow:

“Consider, for example a domestic thin capitalization rule in state A that applies exclusively to payments made by residents to tax-exempt entities, including non-residents that are not subject to taxation in that state but also resident entities that are tax-exempt for specific reasons such as charitable organizations”.

Section 23M is said to be the enactment of thin capitalisation and could therefore be seen as a thin capitalisation regime. Accordingly, the section 23M provisions in South Africa would apply to interest payments made by a South African resident to a tax exempt entity, as is specifically required within section 23M before the section will apply. As discussed in Chapter 2, section 23M may be applicable to non-residents as well as residents who are not subject to tax.

Bammens (2012:339) continues to say that:

“the subject of comparison is a state A resident making a payment to a non-resident, but what is the appropriate object of comparison in such a case? A resident making a payment to an exempt resident or a resident making a payment to a non-exempt resident? If article 24(4) were to include a same circumstances requirement, the only possible comparison would be with a resident making a payment to an exempt resident. Clearly, the fact that the subject of comparison makes a payment to a recipient that is not subject to tax in state A (i.e. a non-resident) is a relevant characteristic from the perspective of state A’s thin capitalisation rule. This characteristic is not inherently linked with the comparative attribute (the recipient’s residence), as there are also resident recipients who are exempt”.

To determine whether section 23M is discriminating, the object of comparison needs to be compared to the subject of comparison and therefore the subject of comparison is a South African resident making an interest payment to a non-resident and the comparative object is a South African resident making an interest payment to an exempt South African resident. As mentioned earlier, for section 23M to be applicable, the entity receiving the interest should not have been subject to tax. The requirements do not specify that section 23M is only applicable to non-residents, and therefore the object of comparison would also not be entitled to an interest deduction, and therefore there appears to be no discrimination.

Section 23M denies an interest deduction to resident entities for interest payments made to related tax exempt parties. The provisions of section 23M are not confined to payments made to non-residents, but would be applicable to all tax exempt related parties; therefore, to resident tax exempt parties as well as non-residents. Section 23M therefore does not solely target non-resident taxpayers, but will apply to all recipients, whether they are residents or not, who are not subject to South African income tax. It may therefore be concluded that the section 23M provisions appear to not constitute a violation of the non-discrimination provision constituted in article 24(4).

4.2.2. Interaction of section 23M with article 24(5)

With reference to Chapter 3, article 24(5) applies when less favourable tax treatment is given when the capital of an enterprise in a contracting state is owned by a resident of another contracting state. It was noted that, for article 24(5) to apply, the following three requirements should be present:

1. An enterprise in one state is owned by a resident of the other state, i.e. the capital of the domestic enterprise must be owned by a non-resident of the enterprise's state;
2. It does not matter that the capital is wholly or partly owned or controlled, nor does it matter whether the ownership is direct or indirect; and

3. The foreign-owned enterprise must be subjected, in the enterprise's state, to a more burdensome level of taxation than other similar enterprises owned by someone else (Elliffe, 2013:12).

The above three requirements can be applied to section 23M as follows:

1. As discussed in Chapter 2, section 23M could also apply to loans by retirement funds or by other associations that may be exempt from tax, such as public benefit organisations (BDO, 2014). It has, however, been identified that it appears as if section 23M's underlying focus would be on cross-border transactions, and therefore transactions with a non-resident. Chapter 2 also noted that section 23M has the requirement that a controlling relationship should exist between the parties, which, in essence, requires a connected person relationship. Section 23M is therefore more than likely to be applicable in a situation where an enterprise in one state is owned by a resident of the other state.
2. In Chapter 2, it has been identified that a controlling relationship includes a relationship where a person directly or indirectly holds at least 50 per cent of the equity shares or voting rights in a company. The second condition stating that it does not matter that the capital is wholly or partly owned or controlled, nor does it matter whether the ownership is direct or indirect, is therefore met, as section 23M only requires a direct or indirect 50 per cent holding, which is sufficient.
3. Section 23M limits the deduction of interest payments, which, in turn, results in an increased tax liability for the foreign-owned enterprise. The foreign-owned enterprise would therefore be subject to a more burdensome level of taxation than other similar enterprises owned by residents.

Article 24(5) could therefore apply to the provisions of section 23M; further discussion is, however, required to make a final conclusion.

The discussion in Chapter 3 also notes that the article 24(5) provisions refer to the avoidance of discrimination in view of the taxation of the company itself and not to the person who owns or controls the capital, and therefore, when seen in conjunction with the section 23M provisions, it would be with regard to the interest deduction limitation placed on the resident debtor of the republic and not the person who owns the capital in the resident company. Chapter 3 continued to establish that the commentary to article 24(5) imports the same arm's length exception as included in article 24(4) into article 24(5). However, as discussed in 4.2.1, it has been established that section 23M would not comply with the arm's length principle and therefore the arm's length exception would not be applicable when dealing with section 23M.

It was noted that the question in mind would need to be as to whether foreign ownership is the *cause* of the discrimination as this is when the non-discrimination article 24(5) would apply (Elliffe, 2012:8). Chapter 3 refers to a case that was released in the UK regarding the requirements as set out in article 24(5). When applying the ruling as found in *FCE Bank plc v the Commissioner for Her Majesty's Revenue & Customs* [2011] UKUT 420 (TCC) to section 23M, the following proposal may be applicable:

1. Is the discrimination with regard to the limitation of interest (section 23M) in circumstances where the amount of interest incurred exceeds the sum of the annual limitation pursuant to a defined formula, as a result of the capital of a South African resident being wholly or partly owned, directly or indirectly, by a resident of another contracting state?
2. If the capital of a South African company was owned by another South African company and the same amount of interest was incurred and as with a non-resident company also exceeded the sum of the annual limitation pursuant to a defined formula, would the limitation on the deduction of interest still be applicable?
3. Lastly, it should therefore be determined whether the rules stipulated within section 23M generate taxation that is more burdensome on the South African

company entirely because the South African company's capital is owned by a non-resident company.

As noted in *FCE Bank plc v the Commissioner for Her Majesty's Revenue & Customs* [2011] UKUT 420 (TCC), Lord Hoffmann in *Boake Allen* explained it as follows:

"In relation to article 24(1) of the OECD Model Convention, which prohibits discrimination between residents on grounds of nationality, the commentary says that the "underlying question" is whether two residents are being treated differently "solely by reason of having a different nationality". It does not repeat this observation in relation to article 24(5), but the principle must be the same."

Accordingly, one should ask whether the section 23M rules discriminate against a South African company based on the fact that the company's capital is "wholly or partly owned or controlled, directly or indirectly" by a non-resident. As noted in previous chapters, section 23M does not specifically state that the provisions will apply when the capital of the South African resident is "wholly or partly owned or controlled, directly or indirectly" by a non-resident; these are usually the circumstances in which the provisions do apply. There has, however, been a comment that South African tax exempt entities should be removed from the ambit of section 23M (National Treasury, 2014b:16). The National Treasury had the response that the limitation of excessive debt and the resulting high interest payments are necessary to protect the corporate tax base and that unintended adverse effects will be resolved through proposed changes (National Treasury, 2014b:16). This comment therefore further indicates that the section 23M provisions appear to target excessive interest payments to foreign companies. Accordingly, it would appear as if the provisions of section 23M would in most cases be applicable due to the capital of the resident company being held by a non-resident and therefore it could be possible that section 23M may be in breach of section 24(5), because foreign ownership is the cause of the application of section 23M provisions.

There are, however, two types of discrimination and because section 23M does not directly specify that the provisions will apply to a resident company whose capital is owned by a non-resident, it would appear as if the possible discrimination contained within section 23M may be more of a covert/indirect discrimination rather than a direct discrimination.

The OECD public discussion draft of the application and interpretation of article 24 (non-discrimination) distinguishes between overt/direct discrimination and covert/indirect discrimination as follows:

- Overt/direct discrimination: Where the relevant tax measure clearly distinguishes the two categories of taxpayers compared in the relevant provision, such as a tax measure that would treat nationals and non-nationals differently (OECD, 2007).
- Covert/indirect discrimination: Where the relevant tax measure does not directly distinguish between the two categories of taxpayers compared in the relevant provision, but may have that indirect effect, such as a measure that, in practice, applies almost exclusively to non-nationals (OECD, 2007:4).

The issue would be relevant, for example, where a thin capitalisation rule does not expressly deny the deduction of interest paid to non-residents, but does so with respect to interest paid to taxpayers who are not subject to the most comprehensive tax liability, which is typically the case of non-residents as opposed to residents (OECD, 2007:4). It was noted that the European Court of Justice (ECJ) has dealt with a number of cases on the subject of overt and covert discrimination and has also held that differing treatment of residents and non-residents does not *per se* constitute discrimination (PWC, 2008:5).

After scrutinising the application of article 24(5), Elliffe (2013:20-21) highlighted the need to consider three significant questions to determine how the non-discrimination article interacts with so-called thin capitalisation regimes, and these three questions are detailed below along with the application thereof with reference to section 23M.

1. How broadly has the non-discrimination article been interpreted? Have 'indirect or covert' forms of discrimination been included in a broad principle-based test? Has the discrimination been limited to a 'direct' type? Covert discrimination occurs when the relevant tax measure does not directly distinguish between two categories of taxpayers, but, in substance, has that effect by applying almost exclusively to non-residents. These may be cases where it is virtually impossible for a foreign taxpayer to meet the specific conditions of the tax provision, although the wording of the provision does not exclude foreign taxpayers (Elliffe, 2013:20).
 - Section 23M is being compared to the OECD model on non-discrimination and therefore, based on the first question, it would need to be determined whether the OECD non-discrimination article includes 'indirect or covert' forms of discrimination or has the discrimination been limited to a 'direct' type. In the 2007 public discussion draft, application and interpretation of article 24, the working group agreed that article 24 is not meant to cover 'indirect' or covert discrimination and that the non-discrimination provisions of article 24 are precisely drafted and do not introduce an all-encompassing non-discrimination rule (OECD, 2007). Section 23M does not directly distinguish between two categories of taxpayers, as it does not specify between residents and non-residents, but does, in substance, have the effect of almost exclusively applying to non-residents. Section 23M provisions therefore appear to be in the form of indirect discrimination and may therefore not be covered by article 24 of the OECD model.
2. What precisely is the relationship or connection required between the foreign ownership requirement of the non-discrimination article and the application of thin capitalisation rules? If foreign ownership is an aspect of the thin capitalisation rules, are these rules applicable solely because the enterprise is foreign owned? This will once again be based on the type of discrimination, i.e. whether it is indirect or direct discrimination. The greater the casual relationship between foreign ownership and the non-discrimination article, the

more likely the discrimination is directly related to foreign ownership (Elliffe, 2013:21).

- If foreign ownership is an aspect of the section 23M provisions, are these provisions applicable solely because the enterprise is foreign owned? Section 23M does not as such have a foreign ownership aspect contained within the provisions; it just so happens that the provisions almost exclusively apply when the domestic company is foreign owned. Although the provisions of section 23M are inclined to be applicable to resident companies that have foreign ownership, the foreign ownership may not be the sole reason for section 23M being applicable. Section 23M indicates that the provisions will be applicable when the interest received by the creditor is not subject to tax. If interest is therefore paid to a non-resident creditor (foreign owner of the resident company) and the interest is subject to interest withholding tax, then the interest payment will not be subject to section 23M, thereby indicating that there could be situations where interest is paid to a non-resident where section 23M would not be applicable, thereby confirming that foreign ownership is not the sole reason for the application of section 23M, but rather the fact that the creditor was not subject to tax on the interest received.
3. Lastly, what can the courts say concerning the relationship between an arm's length rule designed to prevent the transfer of profits and the foreign ownership non-discrimination article? Should the broad wording of article 25(5) be read down to be consistent with article 9(1) or 11(6)? Have the courts interpreted a tax treaty by reading into the meaning of article 24(5) the type of restriction contained in the wording of article 24(4) of the OECD model? Have they followed the guidance provided in the OECD commentary on article 24? (Elliffe, 2013:21).

- The OECD commentary has added a section indicating that article 24(5) should also contain the exception with regard to the compliance with the arm's length principle. It has, however, been concluded that section 23M does not comply with the arm's length principle and appears to be purely arbitrary.

When considered within the context of the above discussion, it does appear as if section 23M will not be in violation of the OECD non-discrimination article.

4.3. CONCLUSION

In 4.1 of the study, it was established that section 23M does not consider the factors that should be considered when an arm's length transaction is applicable, but merely applies the same formula to each company regardless of the size of the company or the industry sector. As a result of this, it appears as if section 23M is arbitrary in nature and regardless of whether section 31 is applied first, if the transaction still falls within the provisions of section 23M, the transaction may not be at arm's length.

Article 24(4) as well as the commentary on article 24(5) of the OECD Model contains the exception that the non-discrimination provisions would not be applicable provided that the thin capitalisation regimes are compatible with the arm's length principles of article 9. It was, however, established that section 23M would not be in line with the arm's length principle and that the provisions are purely arbitrary; therefore, this exception would not be applicable when determining whether section 23M would be in violation of the OECD non-discrimination article.

It was determined that if foreign ownership was an imperative condition within section 23M or that section 23M provisions were confined to payments made to non-residents, that section 23M would possibly be in breach of the non-discrimination article. It was, however, found that section 23M would be applicable to all tax exempt related parties, therefore residents as well as non-residents, and that the provisions of section 23M were not applicable solely due to foreign ownership, but rather due to the creditor not being subject to tax. Although section 23M does almost exclusively

apply to non-residents, the non-discrimination article in the OECD model appears to operate only in respect of overt and not covert discrimination. Section 23M does not directly discriminate against foreign-owned entities or payments specifically to non-residents and as a result of this would be referred to as covert/indirect discrimination and on that basis would also not be in violation of the OECD non-discrimination article. It was noted that section 23M could fall foul of the non-discrimination provisions of double tax treaties and was questioned whether any taxpayer would be prepared to challenge the section on the basis of treaty non-discrimination (Mandy, 2014). According to the findings within the research, it does, however, appear as if the taxpayer would not be successful when challenging section 23M on the basis of treaty non-discrimination, due to the reasons as stipulated above.

In 4.2.2, it was, however, noted that it has been proposed that South African tax exempt entities should be removed from the ambit of section 23M. If the proposal is accepted and South African tax exempt entities are removed from the ambit of section 23M, then it would be quite clear that section 23M targets non-residents as opposed to any creditor who is not subject to tax. The cause of the discrimination may then not be due to the creditor not being subject to tax. The cause may then be due to a non-resident creditor not being subject to tax. The fact of which could change the conclusion of this research as it would then appear as if section 23M is directly and not indirectly discriminating against non-residents.

CHAPTER 5: CONCLUSION

5.1. INTRODUCTION

The main objective (paragraph 1.3.1, page 3) of this study was to determine whether any aspect of section 23M would be contrary to the OECD guidelines relevant to thin capitalisation and in particular the non-discrimination provisions.

To achieve the main objective, which is also the problem statement of this study, the below secondary objectives (paragraph 1.3.2, page 4) were set:

- Determine what the provisions of section 23M entail, how these compare to the old section 31(3) and how thin capitalisation has developed over the years.
- Determine the provisions set out in the OECD guidelines relevant to thin capitalisation and in particular the non-discrimination provisions.
- Evaluate the provisions of section 23M against the OECD guidelines relevant to thin capitalisation and in particular the non-discrimination provisions.

5.2. CONCLUSION: DEVELOPMENT OF THIN CAPITALISATION AND SECTION 23M

The first secondary objective, which determined what the provisions of section 23M entail, how these compare to thin capitalisation and how thin capitalisation has developed over the years, was considered in Chapter 2.

The background and development of transfer pricing and thin capitalisation were discussed in 2.1. It was found that transfer pricing was introduced in the 1930s. Shortly thereafter, in 1963, the arm's length principle was brought into article 9 of the OECD model tax convention. Paragraph 2 of article 9, which eliminates the economic double taxation that can result from transfer pricing adjustments, was, however, only added in 1977. South African Income Tax Legislation was introduced to transfer pricing in 1995, followed by Practice Note No 2, which was released 14 May 1996 and was applicable to cross-border transactions entered into on or after

19 July 1995. In 2010, the National Treasury found that the thin capitalisation rules were not aligned with the views of the OECD because thin capitalisation rules at that point in time were based on a 3:1 debt-to-equity safe harbour ratio and did not incorporate an arm's length element to the calculation. A draft interpretation note was therefore released in 2012, which eliminates the use of the 3:1 debt-to-equity safe harbour ratio and provides that thin capitalisation would form part of transfer pricing as indicated in section 31 of the income tax legislation, therefore being calculated using the arm's length principle.

In 2.2, section 23M, the limitation of interest deduction was discussed. It was found that the National Treasury had indicated that the current methods to limit excessive interest owed to exempt persons were largely incomplete. In order to address the increasing concern with regard to excessive interest deduction, one of the key developments affecting South Africa has been the introduction of provisions targeting base erosion and profit shifting. Included in these provisions is section 23M, which limits deductions of interest paid to persons who are not subject to tax on the interest received. It was, however, found that section 23M provisions appear to target the same problem areas as thin capitalisation and are said to be an enactment of thin capitalisation rules.

A comparison between section 23M and thin capitalisation provisions is provided in 2.3. It was found that, apart from the manner in which the excessive interest deductions are calculated, the primary difference between section 23M and section 31 would be that section 31 specifically applies when there is a transaction between a resident and a non-resident who are connected persons, while section 23M does not strictly speaking discriminate on the basis of residence. Section 23M applies when the recipient of the interest is not subject to tax and the reason for the connection with thin capitalisation is that, in most cases, it would be a non-resident that is not liable for tax on interest received, thereby creating the same resident/non-resident relationship as with thin capitalisation.

5.3. CONCLUSION: OECD GUIDELINES RELEVANT TO THIN CAPITALISATION AND IN PARTICULAR THE NON-DISCRIMINATION PROVISIONS

The second secondary objective, which determines the provisions set out in the OECD guidelines relevant to thin capitalisation and in particular the non-discrimination provisions, was considered in Chapter 3.

In 3.1, it was identified that the OECD refers to two broad approaches when limiting the amount of debt on which deductible interest payments may be made. One being the 'ratio' approach, which was the approach used to calculate excessive interest in relation to the 'old' thin capitalisation. The other is the 'arm's length' approach, which is the approach used in the 'new' thin capitalisation provisions. Although it appears as if section 23M may be in line with thin capitalisation provisions, it is unsure whether the section represents an arm's length principle, as it is based on a defined formula that may not include the necessary comparability factors in order for it to represent an arm's length transaction. Whether section 23M does, in fact, represent an arm's length transaction, is an important aspect to consider as this may influence the outcome of the study due to the arm's length exception included and incorporated into article 24(4) & article 24(5).

The treaty non-discrimination provisions were discussed in 3.2 and identified that section 23M appears to be an issue when cross-border transactions are involved, in particular when a company is owned or controlled by a non-resident, thereby making section 23M susceptible to being in contravention of the article 24 non-discrimination provisions, in particular articles 24(4) and (5). Article 24(4) applies when restrictions are placed on the deductibility of interest payments made to non-residents, in relation to the deductibility of the interest payments made to residents. Article 24(4), however, has an exception to the rule, which refers to the arm's length principle. The aforementioned being the reasoning as to why it is important to determine whether section 23M could be considered to be at arm's length. Article 24(5) applies if less favourable treatment is given due to the capital of an enterprise being owned by a non-resident, thereby disallowing an interest deduction based on the fact that the enterprises' capital is foreign owned and not domestically owned. Although article 24(5) does not specifically note that there is an exception to the rule, as above

with article 24(4), Elliffe (2013:6) has argued that it should be correct to import a restriction on paragraph 5, which means that the non-discrimination article cannot override an arm's length thin capitalisation regime.

In 3.3, it was also noted that although tax treaties are generally aimed at relieving double taxation, tax treaties generally also provide for more than just the normal relief of double taxation and therefore also prohibit discrimination against non-nationals. It was therefore determined that although tax treaties are aimed at allocating the taxing rights on income, they are also aimed at prohibiting discrimination, and therefore, despite the fact that section 23M relates to the deductibility of expenses and not necessarily the taxing of income, section 23M can still be in violation of discrimination, which the tax treaty may prohibit.

5.4. CONCLUSION: ANALYSIS OF SECTION 23M COMPARED TO THE OECD MODEL ON NON-DISCRIMINATION

The third secondary objective, which evaluates the provisions of section 23M against the OECD guidelines relevant to thin capitalisation and in particular the non-discrimination provisions, was considered in Chapter 4.

An analysis of section 23M with reference to the arm's length principle was carried out in 4.1. In Chapter 2, it was found that the section 23M limitation of deductible interest is calculated using a defined formula, interest to EBITDA. It was thereafter established in Chapter 4 that a company's interest to EBITDA differs when dealing with different company size categories as well as when dealing with different sectors within the corporate environment. It can therefore be said that each individual company would be different due to the different characteristics and different financing needs. In Chapter 3, it was also identified that the application of the arm's length principle should include certain 'comparability factors' such as the characteristics of the property or services transferred, the functions performed by the parties, the contractual terms, the economic circumstances of the parties, and the business strategies pursued by the parties. It does not, however, appear as if section 23M takes any of these characteristics into account when determining the limitation of interest deduction, nor does the section allow a taxpayer the opportunity to prove

that the transaction is at arm's length and therefore, when considered without making reference to any other section within the Act, section 23M appears to be of an arbitrary nature. As there is more than one section that could apply to the same interest, it was considered whether applying section 23M in conjunction with section 31 would have an effect on whether section 23M could be at arm's length. It was found that when read together with section 31, if section 31 was applied first, the application of section 23M thereafter could decrease the amount to below an arm's length amount, thereby still being an arbitrary calculation even when being applied together with another section in the ITA.

In 4.2, it was found that article 24(4) as well as the commentary on article 24(5) of the OECD model contains the exception that the non-discrimination provisions would not be applicable provided that the thin capitalisation regimes are compatible with the arm's length principles of article 9. It was, however, determined that this exception would not be applicable to section 23M, as the section 23M provisions appear to be of an arbitrary nature and not at arm's length.

In addition to the above findings, it was found in 4.2 that if foreign ownership was an imperative condition within section 23M, or that section 23M provisions were confined to payments made to non-residents, that section 23M would possibly be in breach of the non-discrimination article. It was, however, found that section 23M would be applicable to all tax exempt related parties, therefore residents as well as non-residents, and that the provisions of section 23M were not applicable solely due to foreign ownership, but rather due to the creditor not being subject to tax. Although it was determined in Chapter 2 that the provisions of section 23M appear to primarily focus on cross-border transactions, it was found that the OECD non-discrimination provisions operate only in respect of overt/direct discrimination and not in respect of indirect discrimination. Section 23M does not directly discriminate against foreign-owned entities or payments specifically to non-residents and as a result of this would be referred to as covert/indirect discrimination and on that basis would also not be in violation of the OECD non-discrimination article.

5.5. SUGGESTIONS FOR FURTHER RESEARCH

As discussed in Chapter 3, the reason for article 24(5) is aimed broadly at preventing 'tax protectionism', which is the deterrence by tax measures of investment from outside the country. Section 23M could potentially be regarded as a tax measure that in essence deters investment from outside South Africa, which could be destructive to economic growth. If section 23M is guilty of tax protectionism, it could imply that South African policies tend to lean towards policies that drive out foreign investors rather than to lure them in. The economic justification for section 23M, however, does not fall within the scope of the author's study and therefore could be an issue for further research.

Chapter 4 noted that there are a few provisions that all relate to interest limitation and the question that is being asked is which provision is applied first and if one of the provisions is applied, could it be possible for another provision to apply to the same interest. Specifically noted was the application between section 31 and section 23M. What are the implications when section 31 is applied before section 23M or *vice versa*? Would the secondary adjustment still be applicable if section 23M was applied after applying section 31 to the same interest? Although the National Treasury and SARS have the view that section 31 should be applied first, this is still an uncertain matter that could require further research.

5.6. CONCLUSION

After achieving the secondary objectives and in light of the conclusions reached above, it appears as if the problem statements "to determine whether any aspect of section 23M would be contrary to the OECD guidelines relevant to thin capitalisation and in particular the non-discrimination provisions" should be answered in the negative. As a result of section 23M not directly discriminating against foreign-owned entities or payments that are specifically made to non-residents, section 23M does not directly discriminate against foreign nationals and therefore would not be in violation of the OECD non-discrimination provisions. It appears as if taxpayers would therefore not be able to justify the ineffectiveness of section 23M on the basis of treaty non-discrimination provision.

Chapter 4, however, notes that if South African tax exempt entities are removed from the ambit of section 23M as proposed, then it would be quite clear that section 23M targets non-residents as opposed to any creditor who is not subject to tax. The *cause* of the discrimination may then not be due to the creditor not being subject to tax. The *cause* may then be due to a non-resident creditor not being subject to tax. The fact of which could change the conclusion of this research as then it would appear as if section 23M is directly and not indirectly discriminating against non-residents. The acceptance of the proposal should therefore be considered carefully as the removal of South African tax exempt entities could result in section 23M being in violation of the article 24 non-discrimination provisions and could render section 23M as being ineffective.

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