

An analysis of Section 23M in light of the OECD best practice approach to interest limitation

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

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November 2016

ACKNOWLEDGEMENTS

Firstly, I would like to thank God for giving me strength and perseverance throughout this study. I am thankful for the guidance, encouragement and support of my supervisor, Mrs Corrie Meiring, during this study. My gratitude goes to Ms Lynne Southey for assisting with language editing.

I would also like to thank my family for their continued support, in particular my mother and cousin for taking care of my new-born so that I could concentrate on my studies, my husband for being my anchor and cheerleader, my sister for the prayers, as well as my friends, for the constant encouragement and support. I will forever be grateful. Lastly, to my son, thank you for constantly reminding me to stay strong and not give up.

APPROACH OF STUDY

The reader is reminded of the following:

According to the North-West University (General Academic Rule A4.1) a dissertation could be submitted in the “traditional book format” or in the more contemporary “article format”. As the author of the study is of the opinion that the study has practical value for tax practitioners and other researchers, the last mentioned format was selected.

Chapter 1 of the study is the introduction, Chapter 2 the article and Chapter 3 provides a summary and conclusion to the study. In order to present the article in a logical manner, it was necessary to repeat certain information that is also presented in Chapters 1 and 3.

This is a mini-dissertation in partial fulfilment of the requirements for this Masters’ Degree which means that the scope is limited. There is therefore only one main focus, which justifies a single article

ABSTRACT

The ability of multinational companies to reduce their tax burden on their worldwide profits has generated public interest in recent years. Excessive interest deductions can be used to shift profits from one country to another to avoid or reduce the tax burden of a group of companies. Base erosion through excessive interest deduction was identified as a risk in South Africa. To address this risk, the South African legislation introduced Section 23M to limit interest deductions for persons exempt from tax, effective from 1 January 2015. However, the Organisation for Economic Co-operation and Development (OECD) report with recommendations on limiting base erosion through interest deductions was only released in October 2015.

The objective of this study is to determine whether the provisions of Section 23M are in line with the OECD recommended best practice approach on interest limitation, as outlined in the OECD Action 4 report. The study found that Section 23M bears some similarities to the OECD best practice approach recommendation; but there are also differences. The OECD best practice recommendation and Section 23M both follow the general approach of basing the interest limitation on a fixed percentage of the profits of an entity. Section 23M, however, focuses on the interest deduction risk relating to intra-group debt utilised to fund exempt income whereas the OECD is concerned with interest deduction relating to both intra-group and third party debt. It was found that Section 23M seems to be a more lenient approach than recommended by the OECD.

KEYWORDS

- Arm's length principle
- Base erosion and profit shifting
- BEPS Action 4
- Excessive interest
- Fixed ratio rule
- Group ratio rule
- Limitation of interest deduction
- Limiting base erosion involving interest deductions
- Other financial payments
- Profit shifting;
- Section 23M
- Thin capitalisation

LIST OF ABBREVIATIONS

Abbreviation	Description
BEPS	Base erosion and profit shifting
DTA	Double Tax Agreement
EBITDA	Earnings before interest, tax, depreciation and amortisation
ICC	International Chamber of Commerce
IFRS	International financial reporting standards
OECD	Organisation for Economic Cooperation and Development
PWC	Price Waterhouse Coopers
SARS	South African Revenue Services
UNCTAD	United Nations Conference on Trade and Development

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CHAPTER 1: RESEARCH BACKGROUND

1.1 Introduction

1.1.1 Background

The increase in international integration has led to the ease of movement of capital, goods and services, which has been a tremendous boost to international trade. It has also led to entities operating in more than one country and a greater dependence on the global economy (BBC, 2016). The ability of entities to easily locate the production chain in different countries makes it possible for tax burdens to be avoided through international transactions (Hines & Summers, 2009).

The current international tax model lacks cohesion as countries maintain different tax rules. Multinational entities through aggressive tax planning exploit these differences to shift the location of their investments and operations to countries that impose relatively lower to a nil tax liability (Cockfield, 2010). According to the report released by the United Nations Conference on Trade and Development (UNCTAD, 2013), 80 percent of international trade consists of intra-company transactions. Multinationals are able to drastically reduce their tax burden on their worldwide profits, which has generated intense public debate in the last few years and brought the issue to the top of the international policy agenda (BBC, 2013).

1.1.2 Literature study on the research area

The employment of tax planning techniques that take advantage of the gaps in international and domestic tax laws, as well as mismatches between domestic tax systems to shift profits by some entities, is referred to as base erosion and profit shifting (BEPS) (OECD, 2013a). These have become buzzwords of this era in international tax circles. Profit shifting has resulted in the effective corporate tax rates for some multinational entities being unduly low and not reflecting the actual substance of the underlying economic activities (UN, 2016). These tax planning strategies and techniques, in most instances, are legal and within the confines of the law. Feinschreiber and Kent (2013) are of the opinion that instances of no taxation or of low taxation are not the cause for concern *per se*, they are, however, a cause for concern when they are associated with practices that artificially separate taxable profit from the activities that generate that profit.

A company is predominantly financed through a mixture of debt and equity. A situation in which a company is financed through a relatively high level of debt compared to equity is referred to as thin capitalisation (OECD, 2012). The *Income Tax Act* (58 of 1962) (the Act), subject to certain

conditions, allows a deduction of interest incurred when calculating taxable income, in the production of income by a person carrying on a trade (Section 24J of the Act). Distributions of profit are not an expenditure incurred in the production of income (Section 11 of the Act), and are therefore not deductible under that Section. There are no specific provisions for the deduction of a distribution in the Act (De Koker, 2010). Interest is therefore paid from pre-tax profits and distributions are paid from after-tax profits. Multinational companies may structure their financial arrangements to maximise the deductions available.

The Organisation for Economic Cooperation and Development (OECD) is an organisation that promotes policies intended to improve the economic and social well-being globally. The OECD, which has its headquarters in Paris, France, consists of 35 member countries of which 22 are situated in Europe. The OECD assists in the setting of international standards on a wide range of matters, including taxation (OECD, 2016b). The OECD has drafted guidelines on a range of tax matters, including guidelines for establishing tax agreements, transfer pricing and in response to the organisation's study on addressing BEPS, and formulated an action plan on BEPS, which was released in July 2013. The OECD (2013b) noted that crucial changes were needed to effectively tackle BEPS, in order to counter advantages unduly obtained from separating the activities and the resultant income that is taxed.

According to the National Treasury (2013b), in South Africa income shifting through excessive deductions was one of the most significant types of base erosion. The excessive deductions usually take the form of interest, royalties, service fees and insurance premiums. Excessive deductible interest being of the greatest concern in South Africa whereby entities shift large amounts of income through the creation of loans between identically owned group entities (National Treasury, 2013a). This research will focus on base erosion through the excessive deduction of interest.

Base erosion through excessive interest deduction can be addressed by application of thin capitalisation rules. These rules limit the amount of interest that can be deducted when determining an entity's taxable income. Olivier and Honiball (2011:657) submit that internationally it has been generally accepted that a thin capitalisation rate can be applied by utilising either an arm's length principle or a fixed debt to equity ratio. The arm's length principle assumes that an independent party would not be inclined to lend to a thinly capitalised borrower (Olivier & Honiball, 2011).

The arm's length principle is embodied in transfer pricing rules. The setting of prices of goods and services sold between entities is known as transfer pricing (SARS, 1999). The arm's length principle was originally developed by the League of Nations and is contained in the domestic

legislation of most countries and embodied in Article 7 and Article 9 of the OECD and UN Model Treaties, as well as in virtually all double taxation treaties (OECD, 2013c).

The first report on transfer pricing was issued in 1979. It was replaced in 1995 by a report that is continuously updated. The Committee on Fiscal Affairs' report on thin capitalisation was adopted by the OECD Council in 1986, and reproduced in Volume II of the loose-leaf version of the OECD Model Tax Convention. The committee established that Article 9 was relevant in determining whether the interest rate provided for in a funding arrangement was at an arm's length rate (OECD, 2014a:183-186).

1.1.3 Motivation for topic actuality

In instances where a South African resident is funded either directly or indirectly by a non-resident connected person, thin capitalisation usually becomes an issue. The South African tax base may be eroded by the funding of a South African resident with excessive intra-group or back-to-back debt due to possible excessive interest deductions (SARS, 2012).

Section 31 of the Act contains rules that limit excessive interest deductions by applying the arm's length principle. The National Treasury (2010:76) highlighted that the transfer pricing rules will be used to limit excessive interest deductions of entities thinly capitalised with excessive debt. The rules apply the arm's length principle to financial assistance, in the same way it would be applied to any other transaction, agreement or understanding (Edward Nathan Sonnenbergs, 2012). According to Linington (2010:510-520), if the state of the financial markets and the general unavailability of debt are taken into account, this could lead to a significantly lower level of acceptable shareholder loans. Mohokare (2013:49) also notes that since transfer pricing is inherently extremely subjective, the application of the arm's length principle to thin capitalisation transactions is a contentious issue.

The National Treasury (2013a) is of the view that with intra-group funding instruments, terms and conditions can be changed to serve the overall interest of the group and therefore are irrelevant. In most instances, the instrument is labelled as debt to benefit from tax and other regulatory factors. The loan capital frequently represents equity capital, which will be repaid only once the debtor is profitable. In line with the OECD BEPS pronouncements, South African legislation was amended to introduce Section 23M into the Act with the *Taxation Laws Amendment Act* (31 of 2013), which came into effect on 1 January 2015. The OECD final report on Action 4: Limiting base erosion involving interest deductions and other financial payments (BEPS report) with best practice approach recommendations was only released in October 2015.

The BEPS report recommends a fixed ratio rule approach that will permit entities to deduct a net interest expense up to a benchmark net interest/earnings before the interest, tax, depreciation and amortisation (EBITDA) ratio. Countries are urged to take into account relevant factors to assist in setting a benchmark ratio within a corridor of 10 percent to 30 percent (OECD, 2015a). In terms of Section 23M(3) of the Act, the ratio shall not exceed 60 percent, and the floor will be adjusted with reference to the repo rate using the formula as provided in this provision.

At the current repo rate of 7 percent (South African Reserve Bank, 2016) the percentage will be 43.95 percent, which is significantly above the maximum percentage recommended by the BEPS report. In the opinion of Ernst and Young (2015), the data cited by the OECD BEPS report indicated that 62 percent of the groups are in a position to deduct all their net third party interest expense if the benchmark is set at 10 percent. At the 30 percent benchmark, 87 percent of these groups could also deduct all their net third party interest expense. Despite a number of comments pointing out that a ratio set between the 10 percent and 30 percent benchmark corridor would be too low, the OECD BEPS report based its recommendation on the concerns that benchmark ratios set too high would not be effective in preventing BEPS (Ernst & Young, 2015). This sentiment is also echoed by the National Treasury (2014a:15), which states that a drawback in setting the level or ratio to try and suit all sectors is that the cap may end up being set too high, resulting in the rule being ineffective in countering BEPS.

Section 23M was enacted in 2013 as noted above and amended by the *Taxation Laws Amendment Act* (43 of 2014) before the OECD BEPS report was finalised. The Davis Tax Committee (2013) noted that there was a need to address concerns about the growth of small businesses as well as BEPS, in the context of corporate income tax, as identified by the OECD and the Group of Twenty (G20). The Minister of Finance is still reviewing the Davis Tax Committee's BEPS subcommittee final report, in, at the time of submission of this research. It is therefore relevant to analyse the provisions of section 23M of the Act in light of the OECD BEPS report.

1.2 Problem statement

Section 23M of the Act was enacted before the OECD BEPS final report on interest deductions limitations was released.

1.3 Research question

The research question that needs to be answered is whether the provisions of Section 23M of the Act are in line with the OECD recommended best practice approach as outlined in the OECD final

report on Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments.

1.4 Objectives

The following objectives assisted in addressing the problem statement and answering the research question.

1.4.1 Main objective

The main objective of this study is to determine whether the provisions of Section 23M are in line with the OECD recommended best practice approach on Interest Limitation, as outlined in the BEPS Action 4 report.

1.4.2 Secondary objectives

The main objective will be addressed by the following secondary objectives:

- i. To analyse the OECD recommendation of the best practice approach on limiting base erosion involving interest deductions, with particular emphasis on the group ratio rule. This objective will be addressed in Chapter 2.
- ii. To analyse the approach to limiting interest deductions introduced by Section 23M of the Act. This objective will be addressed in Chapter 2.
- iii. To evaluate the approach to limiting interest deductions introduced by Section 23M of the Act against the OECD recommended best practice approach. This objective will be addressed in Chapter 2.

1.5 Research method

A relativist view of the world assumes that reality is based on many circumstances and factors, and varies from person to person (Scotland, 2012)). Relativism can be described as the view that truth and falsity, right and wrong, standards of reasoning and procedures of justification are products of differing conventions and frameworks of assessment and that their authority is confined to the context giving rise to them (Baghramian & Carter, 2016).

An interpretivist paradigm posits that all interpretations are based in a particular moment, that is, they are located in a particular context or situation and time and are open to re-interpretation and negotiation through conversation (RWJF, 2016). Interpretivism provides an understanding of

social reality that is based on the subjective interpretation of the researcher (Levers, 2013:2). The varying judgements on the same aspect of tax law as evidenced in taxation case law indicates that the taxation legislation and landscape have multiple interpretations.

When a researcher's philosophical paradigm is positivist, the methodology adopted is most likely to be quantitative, whereas the interpretivist researcher would be more inclined to employ a qualitative methodology (McKerchar, 2008). A qualitative approach is concerned with subjective assessment of attitudes, opinions and behaviour (Hancock, 1998). A qualitative approach will be employed for this research.

According to the Pearce Committee (cited by McKerchar, 2008), 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. The research is theoretical in nature as the literature on the topic was reviewed.

Primary information was obtained from the Act, documents issued by National Treasury, South African Revenue Services (SARS), and reports issued by the OECD on limiting base erosion involving interest deductions. Secondary sources of information include journals, articles, theses, dissertations and electronic publications. The conclusion was based on the author's views and understanding of available literature.

1.6 Overview

1.6.1 Chapter 1 Research background

This chapter provides a background to the research, the research question and objectives that the research is attempting to achieve. The research method to be used throughout the research process is also established.

1.6.2 Chapter 2: (Article) Analysis of section 23M in light of the OECD best practice approach on interest limitation

This section addresses the secondary objectives stated in 1.4.2 above by analysing the best practice approach and its application, determining the objectives and relevance of Section 23M in the South African context and evaluating it against the OECD recommended approach. Factors that might have influenced a deviation from the guidelines are also considered.

1.6.3 Chapter 3: Conclusion

The chapter gives conclusions reached on the research findings, based on the stated objectives above and provides recommendations.

CHAPTER 2: RESEARCH ARTICLE

ABSTRACT

The ability of multinational companies to reduce their tax burden on their worldwide profits has generated public interest in recent years. Excessive interest deductions can be used to shift profits from one country to another to avoid or reduce the tax burden of a group of companies. Base erosion through excessive interest deduction was identified as a risk in South Africa. To address this risk, the South Africa legislation introduced Section 23M to limit interest deductions to persons exempt from tax effective from 1 January 2015. However, the Organisation for Economic Co-operation and Development (OECD) report with recommendations on limiting base erosion through interest deductions was only released in October 2015.

The objective of this study is to determine whether the provisions of Section 23M are in line with the OECD recommended best practice approach on interest limitation, as outlined in the OECD Action 4 report. The study found that Section 23M bears some similarities to the OECD best practice approach recommendation. However, there are also differences. The OECD best practice recommendation and Section 23M both follow the general approach of basing the interest limitation on a fixed percentage of the profits of an entity. Section 23M, however, focuses on the interest deduction risk relating to intra-group debt utilised to fund exempt income, whereas the OECD is concerned with interest deduction relating to both intra-group and third party debt. It was found that Section 23M seems to be a more lenient approach than recommended by the OECD.

KEYWORDS

- Arm's length principle
- Base erosion and profit shifting
- BEPS Action 4
- Excessive interest
- Fixed ratio rule
- Group ratio rule
- Limitation of interest deduction
- Limiting base erosion involving interest deductions
- Other financial payments
- Profit shifting
- Section 23M
- Thin capitalisation

2.1 Introduction

International trade has been on the rise due to increased international integration. The ability of entities to move capital, goods and services without effort has made it relatively easy for entities to operate in more than one country (BBC, 2016). International integration has allowed entities to easily locate the production chain in different countries making it possible for tax burdens to be avoided through international transactions (Hines & Summers, 2009).

Multinational entities take advantage of the current international tax model that enables countries to legislate different tax rules and shift the location of their investments and operations to countries that will enable them to reduce their total tax liability (Cockfield, 2010). According to the report released by the United Nations Conference on Trade and Development (UNCTAD, 2013), 80 percent of international trade consists of intra-company transactions. The ability of multinational companies to reduce the tax burden on their worldwide profits has generated public interest in recent years and brought the issue to the top of the international policy agenda (BBC, 2013).

Base erosion and profit shifting (BEPS) has become a buzzword of this era in international tax circles. It refers to the employment of tax planning techniques by companies to exploit mismatches between domestic tax legislation and the gaps in international and domestic tax laws, in order to shift profits (OECD, 2013a). Profit shifting has resulted in corporate tax rates for multinational entities being unduly low and not reflecting the substance of the underlying economic transactions (UN, 2016). These tax planning strategies and techniques in most instances are legal and within the confines of the law. Feinschreiber and Kent (2013) are of the opinion that instances of no taxation or of low taxation are a cause for concern only when they are associated with practices that artificially separate taxable profit from the activities that generate that profit.

A company is predominantly financed through a mixture of debt and equity. When a company is financed through a relatively higher level of debt compared to equity it is thinly capitalised (OECD, 2012). The *Income Tax Act* (58 of 1962) (the Act), subject to certain conditions, allows a deduction of interest incurred in the production of income by a person carrying on a trade when calculating taxable income (Section 24J of the Act). Distributions of profit are not an expenditure incurred in the production of income (Section 11 of the Act), and are therefore not deductible under that section; and there are no specific provisions for the deduction of a distribution in the Act (De Koker, 2010). Interest is therefore paid from pre-tax profits and distributions are paid from after tax profits. Multinational companies may structure their financial arrangements to maximise the deductions available.

The Organisation for Economic Cooperation and Development (OECD) is an organisation that promotes policies intended to improve the economic and social well-being globally. The OECD has its headquarters in Paris, France. It consists of 35 member countries of which 22 are situated in Europe. The OECD assists in the setting of international standards on a wide range of matters including taxation (OECD, 2016). The OECD has drafted guidelines on a range of tax matters, including guidelines for establishing tax agreements, transfer pricing and in response to the organisation's study on addressing BEPS, it has formulated an action plan on BEPS, which was released in July 2013. In order to effectively tackle BEPS, fundamental changes had to be made to address the segregation of the income that is taxable from the activities that resulted in the income (OECD, 2013b).

According to the National Treasury (2013b), making excessive deductions is one of the glaring ways the South African tax base is eroded by entities that shift income to no-tax or low-tax countries. These deductions are usually disguised as interest, royalties, service fees and insurance premiums, of which excessive interest deductions is of the greatest concern in South Africa. A large amount of income is shifted through the creation of loans between identically owned group entities (National Treasury, 2013a). This research will focus on base erosion through the excessive deduction of interest.

Base erosion through excessive interest deduction can be addressed by application of thin capitalisation rules. These rules limit the amount of interest that can be deducted when determining an entity's taxable income. Olivier and Honiball (2011:657) submit that internationally it has been generally accepted that a thin capitalisation rate can be applied by utilising either an arm's length principle or a fixed debt to equity ratio. The arm's length principle assumes that an independent party would not be willing to lend to a thinly capitalised borrower (Olivier & Honiball, 2011).

The arm's length principle was initially developed by the League of Nations and is utilised in the domestic legislation of most countries and incorporated in Article 7 and Article 9 of the OECD and UN Model treaties, as well as most double taxation treaties (OECD, 2013c). The arm's length principle is embodied in transfer pricing rules. Transfer pricing refers to the setting of prices by entities at which they will sell goods and services between each other (SARS, 1999).

The first report on transfer pricing was issued in 1979, which was replaced in 1995 by a report that is continuously updated. The Committee on Fiscal Affairs' report on thin capitalisation was adopted by the OECD Council in 1986. The committee established that Article 9 was relevant in determining whether the interest rate provided for in a funding arrangement was at an arm's length rate (OECD, 2014:183-186).

In a South African context, thin capitalisation normally becomes an issue in instances where a resident is funded either directly or indirectly by a non-resident connected person. Excessive interest deductions as a result of funding a South African resident with excessive intra-group or back-to-back debt will erode the South African tax base (SARS, 2012).

Section 31 of the Act contains rules that limit excessive interest deductions by applying the arm's length principle. The National Treasury (2010:76) highlighted that the transfer pricing rules will be used to limit excessive interest deductions of entities that are thinly capitalised with excessive debt. The rules apply the arm's length principle to financial assistance, in the same way it would be applied to any other transaction, agreement or understanding (Edward Nathan Sonnenbergs, 2012). According to Linington (2010:510-520), if the state of the financial markets and the general unavailability of debt are taken into account, this could lead to a significantly lower level of acceptable shareholder loans. Mohokare (2013:49) also notes that since transfer pricing is inherently extremely subjective, the application of the arm's length principle to thin capitalisation transactions is a contentious issue.

The National Treasury (2013a) is of the view that terms and conditions of an intra-group funding instrument may be changed to serve the overall interest of the group. The instrument is usually labelled as debt to benefit from tax and other regulatory factors. The loan amount frequently represents equity capital, which will be repaid only once the debtor is profitable. In line with the OECD BEPS pronouncements, South African legislation was amended to introduce section 23M into the Act with the *Taxation Laws Amendment Act* (31 of 2013), which came into effect on 1 January 2015. The OECD final report on Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments (BEPS report) with best practice approach recommendations was only released in October 2015.

The BEPS report recommends a fixed ratio rule approach, which will permit entities to deduct a net interest expense up to a benchmark net interest/earnings before an interest, tax, depreciation and amortisation (EBITDA) ratio. Countries are urged to take into account relevant factors to assist in setting a benchmark ratio within a corridor of 10 percent to 30 percent (OECD, 2015a). In terms of Section 23M(3) of the Act the ratio shall not exceed 60 percent, and the floor will be adjusted with reference to the repo rate using the formula in this provision.

At the prevailing repo rate of 7 percent (South African Reserve Bank, 2016) the percentage will be 43.95 percent, which is significantly higher than the maximum percentage recommended by the BEPS report. In the opinion of Ernst and Young (2015), the data cited by the OECD BEPS report indicated that 62 percent of such groups are in a position to deduct all their net third party interest expense if the benchmark is set at 10 percent. At the 30 percent benchmark, 87 percent

of the groups could also deduct all their third party interest expense. Despite receiving a number of comments pointing out that benchmark ratios within the 10 percent to 30 percent range would be too low, the OECD BEPS report based its recommendation on the concerns that benchmark ratios set too high would be ineffective in tackling BEPS (Ernst & Young, 2015). This sentiment is also echoed by the National Treasury (2014a:15), which stated that attempting to set a ratio to suit all sectors will result in a cap set too high to be effective in countering BEPS.

2.2 Problem statement, research question and objectives

The problem statement addressed by this paper is that Section 23M was enacted in 2013 and amended by the *Taxation Laws Amendment Act* (43 of 2014) before the OECD BEPS report was finalised.

The research question that will be answered is whether the provisions of Section 23M of the Act are in line with the OECD recommended best practice approach as outlined in the OECD final report on Action 4: Limiting base erosion involving interest deductions and other financial payments.

The following objectives will address the research question:

- i. To analyse the OECD recommendation of the best practice approach on limiting base erosion involving interest deductions with particular emphasis on the group ratio rule
- ii. To analyse the approach to limiting interest deductions introduced by Section 23M of the Act
- iii. To evaluate the approach to limiting interest deductions introduced by Section 23M of the Act against the OECD recommended best practice approach.

2.3 Analysis of the OECD recommendation of the best practice approach on limiting base erosion involving interest deductions with particular emphasis on the group ratio rule

2.3.1 Background to the BEPS Action 4 report

Shifting profit by using related party or third party interest may be one of the easiest existing profit-shifting techniques in international tax planning. The exercise of adjusting the debt and equity of a controlled entity is relatively easy due to the mobility of capital (Omri, 2016:7). Interest expenses on intra-group loans should not be considered actual interest cost to the extent that additional deductions are created (Vleggeert, 2015). The commission on taxation of the International

Chamber of Commerce (ICC) (2012), argues where tax is concerned there should be neutrality between equity and debt financing, and investment decisions should be based on the economic facts and circumstances not influenced by tax.

In most countries the tax regime have an impact on the cost of capital, and engender distortions between debt and equity financing (ICC, 2012). This argument is supported by the OECD (2015a:11), which identified the following three basic scenarios as posing a BEPS risk relating to excessive interest deductions:

- “Groups placing higher levels of third party debt in high tax countries
- Groups using intra-group loans to generate interest deductions in excess of the group’s actual third party interest expense
- Groups using third party or intra-group financing to fund the generation of tax-exempt income”

The ICC commission further noted that to the extent that there are limitations on deductions of interest payments, a well-targeted system in harmony with a well-functioning international tax environment should be formulated (ICC, 2012). The BEPS report makes recommendations for best practice in the design of rules to address base erosion and profit shifting using interest and payments economically equivalent to interest, by aligning interest deductions with taxable economic activity (OECD, 2015a). Yorke (2015) agrees that the best practice approach is intended to prevent excessive interest deductions, in relation to both outbound and inbound investments, that shift profits to low tax jurisdictions and give an unfair advantage to multinational entities over domestic groups .

Ruchelman and Shah (2015) note that the BEPS report approach attempts to encourage multinational groups to adopt funding structures that are closely aligned to the interest expense of individual entities with that of the overall group while allowing them a tax relief for actual third party interest expenses. The best practice approach will remove opportunities to place interest expenses into countries with high tax rates (Ruchelman & Shah, 2015).

2.3.2 Existing rules prior to the OECD final report

In attempting to find the best practice approach, the OECD considered a number of existing methods that attempt to limit interest deductions. Although some were dismissed entirely, some principles were incorporated in the final recommendation. It is important to note that some of these methods, either a combination or a variation thereof, are still used by some tax authorities. To obtain an understanding of the evolution of the approaches to limiting excessive interest deductions, some of the methods that have been developed are briefly discussed below.

2.3.2.1 Rules that disallow a specified percentage of the interest expense of an entity, irrespective of the nature of the payment or to whom it is made

According to Ruchelman and Shah (2015), this method does not address the risks that the BEPS report is attempting to address, but reduces the debt financing bias over equity. The OECD echoed this sentiment in the BEPS report (OECD, 2015a:20).

2.3.2.2 The arm's length approach

The arm's length approach was not considered during the consultation phase as some countries that applied the approach in practice conveyed concerns over its effectiveness in preventing BEPS. It was, however, noted that it could be a useful complement to other rules (OECD, 2014b). Oguttu (2016) notes that countries tend not to rely solely on the arm's length principle as there are no clear guidelines internationally for parameters within which the principle is applied in the context of thin capitalisation.

2.3.2.3 Fixed ratio rules, such as debt/equity, interest/earnings or interest/total assets

Fixed ratio rules include the interest to profit approach where the interest expense is tax deductible only to the extent that it does not exceed a prescribed percentage of EBITDA (Offermanns & Baldewsing, 2015:107). Offermanns and Baldewsing also note that some countries, such as Germany, provide that the interest expense in excess of 30 percent of EBITDA is not tax deductible. The BEPS report indicates that the way in which existing fixed ratio rules are designed in most cases is not the most effective way to address base erosion and profit shifting (OECD, 2015a:21). In formulating the OECD best practice approach, some principles of the fixed ratio rules were incorporated.

2.3.2.4 Rules that limit the level of interest expense or debt in an entity with reference to the group's overall position

The BEPS report contends that usually the amount of equity in an entity is an indirect measure of its level of activity, and equity levels of an entity are subject to manipulation, therefore rendering the method inadequate (OECD, 2015a:22). Webber (2010) contends that debt to equity limits are not always effective in preventing entities from shifting profits. If parent companies have sufficient capital, profit shifting can be achieved by ensuring the foreign subsidiary complies with debt to equity limits, by injecting debt and equity into the foreign subsidiary (Webber, 2010).

2.3.2.5 Targeted rules

These rules usually disallow the interest expense on specific transactions. The BEPS report OECD (2015a:22) notes that over time there is a tendency to introduce more rules as new BEPS

opportunities are identified. This might lead to a complex system, resulting in increased administration and compliance costs.

2.3.2.6 Conclusion

The introduction of numerous rules to combat excessive interest deductions suggests that there is still room for improvement in terms of combatting BEPS through interest deductions. Ruchelman and Shah (2015) note that the prevailing perception is that most multinational entities can still claim interest deductions in excess of the group's third party interest expense. A workable solution was therefore still needed, and the OECD embarked on an exercise to address this matter further.

2.3.3 The OECD solution

The OECD (2015a:25) based the best practice approach around a fixed ratio rule that aims to limit an entity's net interest deductions to a fixed percentage of its profit, which is measured using EBITDA to ensure that the deductible interest expense is linked to the economic activity (OECD, 2015a:25).

The BEPS report notes that setting a benchmark fixed ratio at a level appropriate to tackle BEPS might lead to unintended consequences such as double taxation for groups that are leveraged above this level. Countries are therefore encouraged to follow a combined approach augmenting the fixed ratio rule with a group ratio rule that allows an entity to deduct more interest expenses in certain circumstances (OECD, 2015a:26).

The highest risk of base erosion has been identified within entities that are part of a multinational group, hence the recommendation that the best approach should apply to such entities at the very least. It was recognised that some standalone entities might be held under the control of one investor through complex structures, thereby increasing the risk of profit shifting similar to multinationals. Interest paid to related and third parties under structured arrangements by domestic groups also places the fiscus at risk. The best approach may therefore also be applied to entities that are part of a domestic group as well as standalone entities that are not part of a group (OECD, 2015a:33-35).

As seen from the above, the best practice approach is based on a fixed ratio rule and therefore the following section will focus on the fixed ratio rule to obtain a better understanding of the approach taken by the OECD.

2.3.3.1 Fixed ratio rule

Fixed ratio rules assumes that an entity should be allowed to deduct interest up to a specified proportion of its earnings, assets or equity. This aims to ensure that an entity's profit are not shifted but a portion remains subject to tax in the country that the income is generated (OECD, 2014b:47). The fixed ratio rule is based on the rationale that an entity should be able to deduct its interest expense up to a specified proportion of EBITDA or earnings before interest and taxes (EBIT), and only in limited instances asset values instead of earnings (OECD, 2015a:25-26).

The OECD (2015a:37) notes that a fixed ratio based on the level of interest expense is preferable and not the level of debt in an entity due to the following reasons:

- “Base erosion and profit shifting is driven by the level of tax deductible expenses in the entity, not the level of debt.
- A fixed ratio based on debt/equity will need an additional mechanism to prevent base erosion by charging high interest rates.
- The level of debt can fluctuate in the period and averages can be manipulated.”

Johnson and Petzold (2016) are of the view that since the fixed ratio rule is based on similar tests applied in a number of countries, it should be familiar to many groups and its reliance on information that an entity should already have access to in preparing its tax return should result in minimal compliance costs.

As noted in 2.1 above, the BEPS report recommends that the benchmark ratio should be set within a 10 percent to 30 percent corridor. Yorke (2015) maintains that some industries and sectors, such as capital intensive manufacturing, real estate and infrastructure, are far more leveraged than others for purely commercial reasons. He contends that bank lending criteria take into account a multitude of other factors such as debt service coverage, asset coverage, cash flow volatility, industry specific factors, geopolitical factors, interest rates and currency, among others. There are also significant variations within an industry or sector, particularly between young growing businesses funded by bank debt, while mature, and stable businesses are usually funded by equity, retained earnings and the cheaper capital markets. He argues that the benchmark is too low and since it is based on publicly traded multinational companies it does not reflect the wider business community, particularly younger businesses in their organic growth phase reliant on bank funding (Yorke, 2015).

According to Hoor and O'Donnell (2015), basing the benchmark on the current interest rate is problematic given that the current interest rates are at their lowest, and future and historic trends should have been considered. The BEPS Monitoring Group (2015), however, is of the view that if the system is to be effective the cap should be fixed at the lowest limit of 10 percent. A firmer

rule is advocated that will ensure that in aggregate the interest deductions will not be greater than each group's consolidated interest expense to third parties, as far as possible, on a coordinated basis. Avi-Yonah (2016) is in agreement with this viewpoint and considers the benchmark corridor of the fixed rule approach not to be a strong tool in tackling BEPS.

The OECD (2015a:49), however, states that if the fixed benchmark ratio exceeds 30 percent it may incentivise groups to increase the level of intra-group debt in order to increase their interest deductions in excess of their net third party interest expense.

The group ratio rule will be analysed in the following section, since multinational groups have been identified to pose the highest base erosion and this method may address the risk more robustly if used in conjunction with the fixed ratio rule.

2.3.3.2 Group ratio approach

A number of responses to the Action 4 public discussion draft noted that if a fixed ratio approach is used as a recommended best practice, it would need to be accompanied by other rules to ensure that groups with external leverage higher than the fixed ratio would be able to deduct their third party interest expense (OECD, 2015b).

The BEPS report concluded that the fixed ratio approach in isolation offers a less than ideal approach to controlling interest based profit shifting. It concedes that groups in different sectors may be leveraged differently and some groups are just more highly leveraged. The fixed ratio rule would deny these groups a deduction of their third party net interest expense. It is therefore recommended that the fixed ratio rule be combined with a group ratio rule. It also argues that the benchmark fixed ratio should be kept low to ensure its effectiveness, with the group ratio rule compensating for the blanket approach of the fixed ratio rule (OECD, 2015a:57). In terms of the BEPS report, a group is made up of a parent company and all the entities that are consolidated in the parent's consolidated financial statements on a line-by-line basis (OECD, 2015a:59).

The group ratio rule enables an entity that exceeds the entity fixed ratio rule to deduct net interest expense up to the group's net third party net interest to EBITDA ratio. Countries may also apply an uplift of up to ten percent of the group's net third party interest expense to limit double taxation (OECD, 2015a). It is important to note that there is no upper limit placed on the group's net third party net interest to EBITDA ratio. When a country applies the fixed ratio rule alongside a group ratio rule, the benchmark fixed ratio is first applied to the entity's EBITDA to determine the maximum net interest expense that can be deducted. To apply the group rule, the group's net third party interest ratio to its EBITDA is calculated; if an uplift of ten percent is applied, the adjusted net third party interest figures are used; the group ratio will then be applied to the entity's

EBITDA. The deductible net interest expense of the entity will be limited to the higher of the two results (OECD, 2015a:101).

Webber (2010:706) argues that interest limitations that are consistent with the group's funding decisions tend to support market efficiency as the motivations of the parent company and its subsidiaries become aligned. The group's own financing decisions will establish the subsidiary's limit, therefore removing the incentive to incur excessive intercompany debt by subsidiaries in countries imposing high income taxes (Webber, 2010). According to Yorke (2015), the group ratio rule, however, assumes that all entities within the group have the same interest to EBITDA ratio, which seems commercially unrealistic and which might result in double taxation and denials of relief for actual interest costs.

The group ratio approach is guided by the principle that intra-group debt is disregarded and that interest deductions should be allocated within a group in a manner that matches the distribution of the group's economic transactions (Desai & Dharmapala, 2015). Conceptually, the group ratio treats interest paid to unrelated creditors as a business expense incurred for the benefit of all members of the group, not of the particular entity or entities that have formally contracted for the debt. The right to claim tax deductions for the interest cost is apportioned between the different group members according to an estimate of their relative benefits from the indebtedness, with these relative benefits measured by the members' incomes (Durst, 2015).

Ruchelman and Shah (2015) submit that group wide rules limit an entity's deductible interest based on factors applied to the entire group on a worldwide basis. This approach is more effective in tackling BEPS using interest, as it takes into account the centralisation of third party borrowings. The approach is based on the premise that the best measure for net interest deductions for a group is the difference between the interest paid and received from third parties and that the interest expense should be matched with the economic activity. Groups should therefore receive a tax relief where both premises match up (Ruchelman & Shah, 2015). Yorke (2015) also contends that the combination of the fixed ratio rule and the group ratio rule restricts the ability of a group to leverage its operating entities in high-tax countries whether through raising third party debt directly in that country or providing intra-group debt funding in excess of the higher of the fixed ratio and the group's overall ratio (Yorke, 2015).

According to Johnson and Petzold (2016), the fixed ratio rule and group ratio rule directly link an entity's net interest deduction to its level of taxable activity, thereby eliminating the risk that deductible interest can be used to fund income that is not subject to tax. The risks posed by excessive intra-group debt and the location of third-party debt in high tax countries are thereby significantly reduced. The BEPS report notes a higher benchmark ratio within the benchmark corridor should be considered by countries that do not adopt a group ratio rule (OECD, 2015a:50).

The group ratio rule requires an entity to be able to determine the net third party interest/EBITDA ratio of its worldwide group. It further recommends that the calculation should be based on the audited group's consolidated financial statements, prepared using International Financial Reporting Standards (IFRS) or relevant accounting standards as permitted by the relevant country (OECD, 2015a:62). Durst (2015) argues that this will leave open opportunities for tax avoidance by using entities that are not required to form part of the consolidation in terms of IFRS, but are financially related to group members.

Price Waterhouse Coopers (PWC) (2016b) notes that rules that require a subsidiary to calculate taxable profits based on detailed analysis of transactions undertaken by an overseas parent might be problematic. Parent entities may not share group information considered confidential with operating subsidiaries for business reasons, this then puts the subsidiaries in a position where they cannot access the information needed to complete their tax returns. It is recommended that rules that require detailed information regarding the affairs of an overseas parent should be minimised (PWC, 2016b). The BEPS report, however, states that if an entity cannot obtain the information required to apply the group ratio rule, the fixed ratio rule should be applied (OECD, 2015a:58).

From the discussion above, however, it is agreed that the combination of the fixed ratio rule and group ratio rule will be more effective in tackling BEPS while minimising double taxation. The entities or groups that are not highly leveraged may apply the fixed ratio rule, while highly leveraged groups would be able to apply the group ratio rule. It is, however, evident that there are some practical issues that need to be ironed out.

The OECD (2015a:57-66) identified a number of practical issues in relation to the operation of a group ratio rule that required further input. Some of it has been addressed in the Group Rule Public Discussion Draft issued by the OECD on the 11th of July 2016.

Addressing the practical issues is essential to the implementation of the group ratio rule therefore some of these practical issues are considered below.

- **Determining group net interest expense**

The BEPS report identifies a number of alternatives, but endorses an approach based on unadjusted financial reporting figures as the most practical. An uplift may be applied to these

figures to ensure that taxpayers are not negatively affected by volatility and the accounting treatment of certain items (OECD, 2015a:38-39);

The OECD (2015a:60-62) BEPS report suggests three ways of calculating a group's net third party interest:

- Approach 1 – Using interest income and expense figures taken from the consolidated income statement without adjustment
- Approach 2 – Using interest income and expense figures taken from the consolidated income statement, but adjusting these figures to reflect items included in the definition of interest and payments economically equivalent to interest in Chapter 2 of the BEPS Report
- Approach 3 – Identifying the group's items of income or expense, which fall within the definition of interest and payments economically equivalent to interest in Chapter 2 of the BEPS Report, and measuring these items based on how they are treated in the consolidated financial statements of the group.

The OECD received 23 responses to the Group Rule Public Discussion Draft and fourteen gave input on the three approaches above. The general view, being nine¹ out of the fourteen advocated for approach 1 citing that it provides the most simplified solution by taking the numbers from the group's financial statements. Approaches 2 and 3 are considered most likely to result in a very complex calculation that will be difficult and costly for large groups to prepare, and similarly difficult and costly for tax authorities to audit.

- **Determining EBITDA**

The OECD (2015a:63) notes that a group's consolidated income statement usually does not reflect EBITDA on the face of the financial statements therefore for purposes of applying a group ratio rule, figures used should be readily available from a group's consolidated financial statements. The OECD (2016a:11) suggests that tax authorities should consider simply excluding capitalised interest from the adjustment for interest income and expense instead of the ongoing adjustments to depreciation and amortisation described in the BEPS report. It also suggests that consideration should be given to the adjustment to include fair value gains and losses on a group's debt instruments and instruments directly connected to its debt funding, and interest on defined benefit pension liabilities and similar post-retirement benefits, in order to give an accurate calculation for group EBITDA and to reduce volatility in earnings.

¹ Federation of German Industries (BDI), Business and Industry Advisory Committee to the OECD (BIAC), Business Europe, Confederation of Swedish Enterprise, Grant Thornton UK LLP, International Chamber of Commerce (ICC), International Alliance for Principled Taxation (IAPT), Japan Foreign Trade Council Inc. (JFTC), Keidanren, PricewaterhouseCoopers International Limited (PwC)

Grant Thornton (2016) suggested that exchange gains and losses and fair value movements on derivatives should be removed from the EBITDA calculation. These lead to a possible volatile group EBITDA resulting in varying levels of interest deduction even though the underlying financing arrangements remain stable over the same period. The inclusion of these may therefore increase the volatility of group EBITDA, which might lead to a disconnect between the interest relief allowed and the underlying trading strength of the business.

KPMG (2016) recommended that as part of the best approach, an exhaustive list of items that would be included in interest income and expense for the purposes of adjusting EBITDA should be set out to minimise uncertainty and the risk of alternative interpretations.

- **Impact of loss-making entities on the EBITDA**

The BEPS report states that the presence of entities with a negative EBITDA within a group will affect the operation of the group ratio rule. Tax authorities are recommended to consider the treatment of groups with a positive group EBITDA, but include loss-making entities and those with a negative EBITDA where loss-making entities equal or exceed the positive EBITDA of profitable entities (OECD, 2015a). The responses to the Group Rule Discussion Draft indicated that excluding loss-making entities in the calculation of group EBITDA would result in significant additional burden on groups as well as being difficult for tax authorities to implement, therefore recommending that no adjustments should be made.².

2.3.4 Conclusion

The rapid increase in international trade and the growth in financial sophistication has led to a growing interest among policymakers and a need for a cohesive approach in the taxation of multinational entities.

The OECD recommends that countries adopting the fixed ratio rule should consider using the lower limit unless there are mitigating factors. This is a view that is shared by the BEPS Monitoring Group (2015) as well as Avi-Yonah (2016), who have argued that the flexibility of the corridor engenders aggressive interest deductions by multinationals, which might render the rule ineffective, therefore advocating for a 10 percent cap. Hoor and O'Donnell (2015) criticise the group ratio rule as in their opinion it lacks the flexibility of the existing arm's length principle and assumes that all entities within the group have the same interest to EBITDA ratio .

² The Confederation of Swedish Enterprise, International Alliance of Principled Taxation, Japan Foreign Trade, KPMG, Business Industry Advisory Committee to the OECD

Avi-Yonah (2016) argues that the success of the best approach in effectively addressing the risks that the best approach is targeting is dependent on the coordination among countries in enacting domestic laws in line with the recommendation. The recommendation might have a profound impact on the attractiveness and competitiveness of countries as investment destinations, which might affect the progress of its implementation (Avi-Yonah, 2016). PWC (2016a) notes that the EU seems to be more inclined to a minimum standard that is slightly different from the recommended approach where the limitation is based on the greater of 30 percent of EBITDA or a fixed monetary amount.

The fixed rule and group rule ensure that the best approach is robust and more effective in addressing the risks identified with respect to interest deductions. The combined approach restricts the ability of a group to leverage its operating entities in high-tax jurisdictions whether through raising third party debt directly in that jurisdiction, or providing intra-group debt funding in excess of the higher of the fixed ratio and the group's overall ratio. The operation of the group ratio rule is yet to be finalised, and it remains to be seen if the OECD will take into account the concerns and recommendations raised in response to the Group Rule Public Discussion Draft.

The interest deduction limitation rule is best practice and countries are encouraged to adopt it rather than being obligated to do so. The OECD best practice approach allows a degree of flexibility and offers alternatives. This will contribute towards its success, as countries will have leeway to balance the need to address BEPS and other policy matters in implementing the OECD best approach.

2.4 Analysis of the approach to limiting interest deductions introduced by section 23M of the Act

Excessive deductible interest has been noted by National Treasury (2013b:1) as one of the most significant types of base erosion in South Africa. In the opinion of De Koker, Clegg, Urquhart and Stretch (2016), in most cases, foreign shareholders of companies in South Africa fund these through interest bearing debt rather than share capital. This has resulted in an interest deduction in South Africa with no taxation in South Africa in the foreign shareholders' hands, this tax leakage was partly reduced through transfer pricing and thin capitalisation rules under Section 31 of the Act, and the interest withholding tax under section 50B of the Act (De Koker *et al.*, 2016). To counter the excessive interest deduction section, 23M of the Act was introduced with effect from 1 January 2015.

The following sections will therefore provide background to thin capitalisation rules in South Africa and an analysis of Section 23M of the Act including its interaction with other sections that limit interest deduction, notably Section 23N and Section 31 of the Act.

2.4.1 Rules limiting excessive interest deductions prior to Section 23M

The Katz Commission, due to the possible relaxation in exchange controls, recommended in its interim reports that transfer pricing provisions should be introduced into the Act, among other things, to counter thin capitalisation practices that may have had negative tax implications for the South African tax base (SARS, 1996).

Prior to the enactment of Section 23M of the Act, Section 31 of the Act, which was later amended, limited the interest that could be deducted, and was later amended. These provisions will be discussed in the next sections.

2.4.1.1 The old Section 31

The old Section 31 of the Act was in effect from 19 July 1995 to 30 September 2011, with Subsection 3 aimed at countering thin capitalisation schemes by connected persons in international transactions (De Koker & Williams, 2016). This section allowed the Commissioner to disallow a portion of the interest deduction if he was of the view that the financial assistance granted to the resident or the recipient was excessive in relation to the fixed capital of the resident or recipient (SARS, 1996).

The primary guidance to the thin capitalisation requirements of South African companies prior to 1 October 2012, was Section 31(3) of the Act, read with Practice Note 2. The practice note provided a safe harbour debt/equity ratio of 3:1, which applied to limit the deductibility of interest on excessive debt (Baum & Simoes, 2013). The safe harbour approach as explained by Offermanns and Baldewsing (2015) allows a company that has an equity of R100, a maximum amount of debt of R300. The interest deduction that accrues on the amount of debt in excess of R300 would be disallowed, while interest due on the amount of debt up to and including R300 will be allowed as a tax deduction (Offermanns & Baldewsing, 2015).

The purpose of section 31(3) of the Act was to enable the SARS to determine an acceptable debt-to-equity ratio in order to limit the tax deduction for interest paid to an amount of debt deemed reasonable and not excessive. The application of Section 31(3) was therefore in practice, limited to interest-bearing debt (PWC, 2012:181).

2.4.1.2 The new Section 31

The wording of the “old Section 31” did not focus on the overall economic substance and commercial objectives of an arrangement, which caused problems and uncertainties. It was therefore deleted to eliminate problems and uncertainties and replaced with the new Section 31 (National Treasury, 2010). Section 31 of the Act applies where any party derives a tax benefit in

any cross-border arrangement between connected persons and any term or condition of the arrangement is considered not to be at arm's length. The taxable income of each person that is a party to the arrangement will be calculated as if the arrangement was at arm's length (South Africa, 1962).

The new Section 31 of the Act deals with financial assistance as part of another transfer pricing transaction and therefore the relatively simple safe harbour check fell away for a more complex arm's length evaluation (Baum & Simoes, 2013:48-51). Section 31 of the Act limits the amount of interest that can be deducted to an amount that would have been incurred if the interest rate and quantum of debt had been at arm's length (Stiglingh, Koekemoer, Van Zyl, Wilcocks, & De Swardt, 2016).

The National Treasury (2010) stated that the OECD and UN Model Tax Conventions dealt with thin capitalisation as part of the associated enterprises article, therefore implying that thin capitalisation rules were an extension of the transfer pricing rules. They also argued that this approach minimised the interpretation difficulties under both domestic and mutual agreement procedures. The transfer pricing rules were therefore to be used to deny deductions for excessive interest (National Treasury, 2010). Webber (2010) agrees with arguments that this approach offers uncertainty and there are no assurances that entities' financing structures will not be challenged by tax authorities.

The interpretation note on Section 31 has not yet been finalised and thus the concerns and uncertainties surrounding the provisions are not yet addressed. The application of transfer pricing principles to limit excessive interest deductions, although more effective than its predecessor, proved not to be too effective, therefore Section 23M of the Act addressed in par 2.4.2 was introduced (National Treasury, 2013a).

2.4.2 Section 23M and its application

The National Treasury (2013a) noted that excessive interest deductions still posed an ongoing risk if the creditor and debtor form part of the same group. Section 23M of the Act was introduced as part of a comprehensive strategy to deal with tax arbitrage between related parties in relation to deductible interest (Ritchie, 2015). The methods that were in existence to limit excessive interest owed to exempt persons were incomplete and the withholding tax that was in the process of being legislated would in most cases be reduced to Rnil. This necessitated the need to augment the existing interest deduction measures with Section 23M (National Treasury, 2013a:38)

The application mechanism of Section 23M will be discussed in the following sections in order to obtain a good grasp of the interest limitation approach that was adopted by the National Treasury.

2.4.2.1 Section 23M(2)

Section 23M(2) of the Act limits the deductibility of interest amounts incurred by a debtor on debts:

- owed to a creditor that is in a controlling relationship with that debtor
- that are indirectly from a person who is in a controlling relationship with the debtor, who provides the funds to a third party and the third party then provides debt to the debtor. (Mandy (2014) notes that this is an anti-avoidance rule to prevent an unconnected person being interposed between a transaction involving connected parties)
- the creditor is not subject to tax in South Africa during the year of assessment the interest is incurred.

The requirements of Section 23M will be considered now to determine when the Section will apply.

The term creditor is not defined in the Act. A debtor and controlling relationship are defined in Section 23M(1) of the Act as follows:

“controlling relationship means a relationship where a person directly or indirectly holds at least 50 percent of the equity shares in a company or at least 50 percent of the voting rights in a company is exercisable by a person

debtor means a debtor who is

(a) a person that is a resident

(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.”

PWC (2014a) commented that in the context of a group relationship, a creditor would have the choice to finance the debtor in the form of debt or equity, hence the interest limitation is intended to target instances where the debtor and creditor are in a controlling relationship. The definition of controlling relationship does not prescribe which party, being a debtor or creditor, must be a company. The definition of debtor specifically refers to a person who is a resident or non-resident with a permanent establishment in the country. The debtor could therefore be a company or any other entity that falls within the definition of a person. Although the term creditor is not defined, it can be construed from the definition of controlling relationship to include any person, whether resident or non-resident. It is, however, according to Kruger (2015) and PWC (2014b) evident that either one or both creditor and debtor must be a company for a controlling relationship to exist and Section 23M of the Act to have any application.

It is important to note that the direction of ownership is irrelevant; all that is required is for a controlling relationship to exist between the debtor and creditor. This supports the National Treasury's (2013a) assertion that excessive interest is a major risk if a creditor and debtor form part of the same economic unit.

The tax residency of the lender is not of great importance, as to be triggered, Section 23M of the Act only requires the lender to be not subject to tax. The term subject to tax is not defined in the Act. Section 1 of the Act defines tax as any tax or penalty imposed by the Act. Section 10(1)(h) of the Act exempts interest that is accrued or is received by non-residents from normal tax. However, Sections 50A to 50H of the Act impose a withholding tax on South African sourced interest paid to non-residents. This could, however, be reduced to nil by a Double Taxation Agreement (DTA) and section 10(1)(h) of the Act.

The meaning of the term "subject to tax" has been considered by a number of researchers. Kruger (2015) concludes that where the recipient of the interest is subject to the withholding tax on interest, even if it is at a reduced rate due to the provisions of a DTA, the provisions of section 23M will not apply. If, however, the creditor is exempt from the withholding tax on interest under a DTA, there is no subjection to tax, and the debtor will in these circumstances be subject to the interest deduction limitation provided for in section 23M of the Act (Kruger, 2015).

This view is supported by Mandy (2014), who notes that an amount of interest will not be regarded as being subject to the withholding tax on interest if it is exempted from that tax, either in terms of the legislation or in terms of a DTA. An amount of interest that is reduced such that no actual tax liability arises is still regarded as being subject to tax (Mandy, 2014).

Rood (2014) explores the interpretation of the term internationally and concludes that Section 23M of the Act does not require the creditor to actually pay tax on the interest, but merely for it to be subject to tax in South Africa. If no South African tax is therefore paid or payable, it will not change the fact that the amount was initially subject to tax, and therefore Section 23M of the Act potentially cannot apply to limit the interest deduction. In the same breath, a counter-argument is offered that supports the view that, given that no withholding tax is paid or normal tax is paid in South Africa, the creditor is therefore not subject to tax (Rood, 2014). Stiglingh *et al.* (2016) pose the view that if the rate of the withholding tax is reduced to nil, the interest will not be considered to be subject to tax, therefore the interest deduction limitation will apply.

The limitation will apply in the year of assessment the interest is incurred³ unless the interest is subject to tax in the hands of the recipient during that year of assessment⁴. It has been submitted

³ Section 23M(2) of the *Income Tax Act* No 58 of 1962

⁴ Section 23M(2)(i)(aa) of the *Income Tax Act* No 58 of 1962

by Mandy (2014) and Kruger (2015) that possible timing mismatches may arise where withholding tax on interest is concerned due to the liability for withholding tax on interest only arising when the interest is paid or is due and payable. A debtor could find itself in the position where the interest is incurred but is only payable to the creditor in a different year of assessment and therefore subject to tax in the future in the hands of the creditor (Mandy, 2014; Kruger, 2015). KPMG South Africa (2015) concurs with this view.

2.4.2.2 Determination of the interest deduction limitation

Section 23M(3) of the Act provides guidance on the limitation to be applied. The interest deduction limitation will be calculated on the aggregate of the amount of interest received by or accrued to the debtor; and a percentage of the adjusted taxable income of the debtor will be determined in accordance with the stated formula. The adjusted taxable income as defined in Section 23M(1) is summarised as follows:

Starting point:	Taxable income
Less:	Interest received/accrued
	Controlled Foreign Company income
	Recoupments
Plus:	Interest incurred
	Depreciation and amortisation
	Assessed loss or balance allowed to be set off against income
Equals:	Adjusted taxable income

Source: Authors own compilation based on above sources

The percentage is determined as indicated in the following 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

(d) 'D' represents the number 10.”⁵

The formula links deductible interest expenditure to the average repo rate for the year and a ceiling of 60 percent is placed on the interest deduction limitation. The National Treasury (2014b) is of the view that this will provide a mechanism to protect the fiscus and tax base in periods of high interest rates. The limitation expressed as a percentage of the tax-EBITDA adjusts up and downwards based on the prevailing repo rate. The linking of the interest deduction limitation to the repo rate is to ensure that any change to the average repo rate for the year of assessment will be taken into account to allow for a true reflection of market conditions on the interest deduction limitation. The prevailing costs of obtaining debt will be taken into account by the addition of 400 basis points to the average repo rate (National Treasury, 2014b).

The average repo rate is calculated in terms of Section 23M(1) by averaging all the all the ruling daily repo rates within a year of assessment . At the current repo rate of 7 percent which have prevailed for 248 days⁶, being preceded by a repo rate of 6.75 from the commencement of year of the 2017 year of assessment (South African Reserve Bank, 2017). The average rep rate will be determined as follows:

$$(14 \times 6.75\% + 7\% \times 248) / 262 = 43.95\%$$

Debtors may therefore not deduct an aggregate of the amount of interest they received or that accrued to them, above 43.95 percent of the adjusted taxable income calculated as per the table above. Section 23M(5) of the Act allows the portion disallowed to be carried forward to the next year of assessment, and the interest carried forward will be deemed to be an amount incurred in that following year.

2.4.2.3 Conclusion

A controlling relationship must exist between the debtor and creditor for Section 23M of the Act to apply, and the creditor must also not be subject to tax. As noted in 2.4.2.1, a creditor may include residents and non-residents. As the section relates to debt owed to persons not subject to tax, it pools into its net those resident persons or bodies exempt in terms of Section 10 of the Act, which includes Traditional Communities and Public Benefit Organisations.

Although it can be concluded that if an amount of interest is subject to either the normal tax or to withholding tax on interest, no limitation on the interest deduction will be imposed for the interest incurred. Webber (2010) notes that generally tax obligations should be clearly stated and identified to avoid any ambiguity for the benefit of both the taxpayer and tax collector. The differing

⁵ Section 23M(3) of the *Income Tax Act* No.58 of 1962

⁶ Calculated as at 17 November 2016.

views on the term subject to tax with respect to DTA that reduces withholding tax to nil needs further clarity to remove ambiguity. The National Treasury noted that if financial intermediaries are not taken into account, apart from the electricity and business services sector, the interest expense/EBITDA ratios across South African sectors average 20 percent (National Treasury, 2014a). The effectiveness of the current interest expense/EBITDA ratios that are allowed by Section 23M of the Act is questionable.

2.4.3 Interaction between Sections 23M, 31 and 23N

The thin capitalisation rules contained in Section 31 of the Act address similar issues to Section 23M as they both attempt to limit base erosion and profit shifting through excessive interest deductions. The National Treasury (2013a), however, contends that the provisions of Section 31 will apply first to any cross border loans. SAICA (2014) and SAIT ((2014b)are of the view that there is still a degree of uncertainty concerning the interaction between Section 31 and Section 23M of the Act. There are instances where the interest is considered to be at arm's length but the quantum of the loan is not, and is therefore adjusted in terms of Section 31 of the Act. There is no guidance on whether the amount of interest that the Section 23M limits will be the actual interest incurred or the adjusted interest (SAIT, 2014c).

According to Ritchie (2015:72-74), a taxpayer who falls within the ambit of both sections is always limited to the smaller amount yielded by either section. Ritchie is of the view that the calculation of the carry forward in Section 23M(4) is materially affected by the order in which the sections are applied, as any limitation imposed by Section 31 will be negated if the carry forward is calculated based on the actual interest and not the repriced interest calculated in terms of Section 31.

Section 23N of the Act limits interest deductions in respect of debt applied to acquisitions of equity shares in an operating company as defined in Section 24O of the Act. It also applies to debt used to finance the acquisition of assets in terms of some of the provisions of Section 45 or 47 of the Act.⁷ Section 23M(5) states that if interest qualifies to be taken into account in terms of Section 23M as well as Section 23N, the latter section takes precedence and Section 23M will only be triggered if the interest has been disallowed under section 23N.

2.4.4 Conclusion

SAICA (2014) raised strong objections to Section 23M to the extent of calling for its withdrawal. SAICA submitted that Section 31 of the Act already addresses the abusive tax avoidance arrangement that Section 23M aims to target. SAIT (2014a) argues that having numerous anti-avoidance sections targeting interest is unnecessary and increases the compliance burden of

⁷ Section 23N(2) of the *Income Tax Act* No 58 of 1962

taxpayers and might deter investors. EY (2014), however, notes that Section 23M has a legitimate purpose as it aims to prevent base erosion when the creditor and debtor are economically indifferent to either debt or equity financing. The National Treasury (2014a) argues that Section 31 of the Act addresses the mispricing of the interest rate whereas Section 23M of the Act has a broader objective that includes discouraging companies from excessive leveraging. The discussion in 2.4.3 highlights the shortcoming of this view, especially in instances where Section 31 of the Act will adjust the debt amount but the interest rate is at arm's length.

Critics of Section 23M note that the definition of adjusted taxable income does not provide for the add back of exceptional allowances such as Section 11D of the Act, which may result in taxpayers afforded these allowances being treated more harshly by reducing their adjusted taxable income (KPMG, 2014; SAIT, 2014a). The interest expense/EBITDA ratios across South African sectors average 20 percent (National Treasury, 2014a). The repo rate will have to drop to 1 percent for interest deduction limitation to match the current averages. The effectiveness of Section 23M of the Act is therefore questionable. However, it is applied in combination with Section 31, which may act as another line of defence.

A timing mismatch occurs in instances where withholding tax is payable on the interest. For the interest deduction limitation not to apply, a non-resident creditor must incur the withholding tax in the same tax year that the debtor incurs the interest expense (PWC, 2014b). The interest will only be subject to tax in terms of Section 50B of the Act when it is paid and not when it accrues. As noted in 2.4.2.1 the term not subject to tax is unclear and open to interpretation, especially where a DTA is involved. Clarification is required to assist the taxpayer to know when Section 23M of the Act would apply. KPMG (2014) calls for an interpretation note to be issued to provide guidance or the impact of the application of DTAs to be clarified in the Act.

Deloitte (2015) and SAIT (2014b) have raised concerns on the lack of clarity on the application of thin capitalisation measures in Section 31 of the Act since their incorporation into Section 31 in 2012, as certainty is required by taxpayers to ensure compliance. Deloitte (2015) has expressed the need, where possible, for tax and exchange control rules relating to inbound debts to be aligned. BDO South Africa (2014) is of the view that Section 23M of the Act might deter foreign direct investment since it will raise the effective interest rates of local subsidiaries. This is a view shared by Naspers (2014:3), who, although appreciating the need for provisions of Section 23M, agrees that it may discourage investment.

Section 23M was enacted in response to the BEPS risk relating to interest deduction identified by the OECD. As evidenced by the above discussion there still seems to be some issues with the effectiveness of this section in addressing BEPS. The following section will analyse Section 23M

of the Act in comparison to the OECD recommended best approach in order to determine whether Section 23M is in line with the OECD recommended practice.

2.5 Critical analysis of Section 23M in comparison to the OECD recommended best practice approach

South Africa is not a member of the OECD, but was awarded an observer status, has a working relationship and actively participates in and provides input to OECD discussions and discussion papers (PWC, 2012:179).

The best approach to limiting BEPS through interest deduction limitation mainly focuses on entities that are part of a multinational group, but it can also be applied to entities that are part of a domestic group, as well as standalone entities that are not part of a group. This is captured by Section 23M(2)(a) of the Act, which limits interest paid to a creditor that is in a controlling relationship with the debtor. A controlling relationship exists when at least 50 percent of the equity shares or voting rights are directly or indirectly held by a person, or vice versa.⁸ The limitation under 23M therefore applies to companies, natural persons, and trusts that are in a controlling relationship with a creditor, if the interest income is not subject to tax in South Africa. The Section 23M limitation will apply regardless of the residence of the creditor if the controlling relationship and subject to tax requirements are met. The provisions of Section 23M therefore apply to entities forming part of a group, domestic or multinational, and standalone entities.

As discussed under 2.3.3, the fixed and group ratio rules are designed to ensure that profits are taxed where value is created and the underlying economic activity occurs. This approach attempts to address the use of third party, related party and intra-group debt to achieve excessive interest deductions or to finance the production of exempt or deferred income (OECD, 2015a:18). The Section 23M interest limitation focuses on interest paid where a controlling relationship exists that is not subject to tax in the hands of the recipient. It is therefore submitted that Section 23M only addresses the risk of groups using intra-group loans to fund tax exempt income, one of the risks identified in the BEPS report.

Section 23M of the Act does not address excessive interest paid to third parties and connected parties that have less than 50 percent ownership or voting rights. The National Treasury (2014a) took the approach of the concept of control requiring 50 percent ownership or control rather than connected person, which required a 20 percent ownership to trigger a limitation, to allay the concerns raised by institutional investors such as pension funds (National Treasury, 2014a).

⁸ Section 23M(1) of the *Income Tax Act* No 58 of 1962

Interest deductions by entities that are not in a controlling relationship are therefore not limited by Section 23M.

The OECD interest limitation rules are meant to apply to the net interest expense regardless of whether the corresponding debt arose from a third party, related party or intra-group. The rationale behind this is to ensure that the BEPS risks listed in 2.3.1 are addressed, which includes the placement of higher levels of third party debt in high tax countries (OECD, 2015a:38), whereas Section 23M of the Act is only applicable to interest paid to a creditor who is in a controlling relationship with the debtor. The National Treasury (2013a) is of the view that BEPS risk exists where a creditor and debtor form part of the same economic unit, as a financing arrangement could be structured to serve the overall interest of the group. The application of a group ratio rule would ensure that an entity's interest expense will not exceed the group's net third party interest to EBITDA ratio while also allocating interest expense within a group in a manner that corresponds to the distribution of the group's economic activity (Desai & Dharmapala, 2015).

The OECD's best approach targets interest payments to related parties as well as third parties through structured arrangements. Structured arrangements are defined in the BEPS report OECD (2015a:69) as "an arrangement where the entity, its group and its related parties, taken together, do not bear the entire cost of the interest payment". This is achieved through a back-to-back arrangement whereby a parent company lends funds to a third party, who in turn lends the funds to the subsidiary of the parent company. Section 23M(2)(b) of the Act addresses this risk by limiting interest deductions of back-to-back loan transactions.

The benchmark corridor provided by Section 23M of the Act has a fluctuating floor depending on the prevailing repo rate and has a ceiling of 60 percent. The corridor is much higher than the 10 percent to 30 percent recommended by the best approach. Concerns were, however, raised over the 60 percent upper limit, with KPMG (2014) calling for the limit to be lifted and arguing that taxpayers will suffer economically when interest rates increase, a view supported by SAIT (2014a).

The National Treasury (2014a:14) notes that the evidence indicates the average of interest to EBITDA for South African companies, excluding the banking and insurance sector, averaged 20 percent. The one drawback of the analysis, however, is that it focused on listed companies that are mostly fairly mature and would most likely have less debt to equity compared to unlisted companies. The companies that will be most affected by the Section 23M limitation are unlisted and are more likely to be highly leveraged (BDO South Africa, 2014). This is a notion which was refuted by National Treasury (2014a:15), which argued that no evidence to support this conclusion had been presented.

It was indicated that introducing more than one minimum for some subsectors was a possibility (National Treasury, 2014a:13). This is a deviation from the OECD best approach, which suggests applying different benchmark ratios depending on the size of an entity's group (OECD, 2015a:53). The OECD (2015a:76) acknowledges that the banking and insurance sector need specific best practice rules to deal with risks that a particular sector poses. Avi-Yonah (2016) argues that this might set a bad precedent as other industries might also claim the special treatments. It should be noted that the deviation with respect to the banking and insurance sector is due to the specific risk they pose. The fixed rule can still be applied but in combination with the best practice rules specifically designed for this sector (OECD, 2015a).

Deloitte (2015) and Oguttu (2016) note that the current legislative environment pertaining to interest limitation is complex and unclear. Introducing more than one minimum for different subsectors might just add to the administrative burden and as noted above might set a bad precedence if the deviation is not influenced by the BEPS risk peculiar to the subsector. National Treasury, (2014a), however, notes that a ratio that attempts to cover all sectors will result in a cap being set too high, resulting in Section 23M being ineffective in countering BEPS risks. Where a fixed ratio rule is used, the OECD (2015a:26) recommends a benchmark ratio that is sufficiently low to address BEPS to be augmented by a group ratio rule. It is therefore submitted that the current benchmark ratio of 43.95 percent as per the formula is too high given that the average interest to EBITDA for South African companies, excluding the banking and insurance sector, is 20 percent. The OECD (2015a) further recommends a *de minimis* threshold for entities that pose the lowest risk.

The OECD (2015a:50) stipulates a few scenarios in which a higher benchmark fixed ratio within the 10 percent to 30 percent corridor may be set. These include where the fixed ratio rule is used in isolation, and no carry forward of disallowed interest is permitted, among others. The group ratio rule in conjunction with a fixed ratio rule is recommended to reduce the impact on groups that are highly leveraged, to ensure net third party interest is deducted (OECD, 2015a:57). Group ratio does not have a ceiling as it is based on net third party interest ratio to group EBITDA. The current provisions of Section 23M are more akin to a fixed ratio rule than a group ratio rule. Introduction of a group ratio rule might address some of the concerns raised by BDO South Africa with respect to highly leveraged unlisted companies. Section 23M(4) of the Act allows for a carry forward of any disallowed interest, therefore the higher benchmark ratio set by Section 23M of the Act is contrary to the OECD best practice approach.

In accordance with Section 23M(4) of the Act any interest that is in excess of the limitation may be carried forward to the next year and deemed to be interest incurred in that year. The non-deductible interest may be carried forward into perpetuity or until the carried forward interest is fully utilised against taxable income. Section 23M therefore defers the deduction of a portion of a

company's interest expense but does not permanently disallow it (KPMG South Africa, 2015). The OECD best approach recommends putting a limit on the interest to be carried forward, either on the number of years or value to be carried forward. This will ensure that the timing mismatches discussed in 2.4.2.1 above are catered for (OECD, 2015a:68).

The OECD (2015a:82) notes that other existing interest restrictions in individual jurisdictions such as arm's length requirements could have a role in supplementing the best practice approach. The National Treasury (2014a:15) is of the view that transfer pricing always applies first by determining the correct pricing, before Section 23M is applied. The OECD (2015a:38) endorses this approach, which states that the interest expense should first be tested to be in line with the arm's length principle before it is subjected to the best practice interest limitation. There is, however, no guidance from the OECD or National Treasury with respect to the issues highlighted in 2.4.3 above. Questions still remain as to the amount of interest that will be subject to the limitation and the amount that the carry forward will be based on, when an arm's length principle is applied (SAIT, 2014c; Ritchie, 2015). The OECD (2015a:37) acknowledges that applying an arm's length test first would increase complexity.

2.5.1 Conclusion

Section 23M of the Act was introduced prior to the finalisation of the OECD's recommendation despite a call by the Davis Tax Committee (2014) warning against responding to the OECD's BEPS plan until clear guidance is issued. Section 23M follows the general approach of utilising a ratio that is based on the ratio of interest expense to EBITDA. There are, however, some similarities and differences between its provisions and the OECD recommended best approach.

Section 23M of the Act limits the interest deduction of interest paid to persons not subject to tax that are in a controlling relationship with the debtor. This is a slight deviation from the OECD recommendations that state that the interest limitation should apply to all forms of interest regardless of whether it arose from a debt provided by an intra-group, related or third party. The OECD recommended benchmark fixed ratio in line with the best practice approach should be set within the 10 percent to 30 percent corridor. The current benchmark fixed ratio set by Section 23M is at 43.95 percent, which is way above the recommended benchmark.

Although it is not specifically included in the provisions of Section 23M of the Act, the National Treasury (2014a) is of the view that transfer pricing always applies first by determining the correct pricing, before section 23M is applied. This is also the approach applied by the OECD. In line with the BEPS report recommendations, the disallowed interest under Section 23M may be carried forward to the following year. However, there are no limitations with respect to the amounts or years that the interest should be carried forward, which is a deviation from the OECD

recommendations. Table 2-1 below illustrates the most important differences and similarities between the OECD best approach and the provisions of Section 23M.

Table 2-1: BEPS Action 4 comparison to Section 23M

OECD recommendation	Section 23M
Fixed ratio rule	
Applies to multinational groups at a minimum as well as to domestic groups and standalone entities	Applies to any creditor in a controlling relationship with any person not subject to tax
Utilises the interest to EBITDA ratio	Utilises the interest to EBITDA ratio
EBITDA calculation Earnings before • interest • depreciation • taxation • amortisation	Adjustable taxable income Earnings before • interest received/accrued • controlled foreign company income recoupments • interest incurred • depreciation • amortisation • assessed loss • taxation
Limits net interest expense paid to • third parties • related parties • intra-group	Limits interest paid to • persons in a controlling relationship (forming part of the same economic unit) • back to back transactions involving a person in a controlling relationship and a third party that is not subject to tax or included in the net income of a controlled foreign company
Benchmark corridor Fixed at a rate between 10%-30% of entity.	Benchmark corridor Varies depending on the prevailing repo rate but limited to 60%. At the current repo rate it is 43.95%.

OECD recommendation	Section 23M
Fixed ratio rule	
Carry forward to be limited	Carry forward unlimited
Arm's length principle to be applied first to the interest expense	Arm's length principle to be applied first to the interest expense

OECD Recommendation	Section 23M
Group ratio rule	
Group ratio Allows an entity to deduct net interest up to the group ratio (net third part interest/EBITDA) An uplift of up to 10% can be applied to the net third party interest of the group in calculating the group ratio.	No group ratio rule is in existence
Group defined as per IFRS	Controlling relationship as 50% ownership and control

Source: Author's own compilation based on above sources

The Davis Tax Committee (2014) recommends that in addressing the BEPS, South Africa needs to balance its needs and adopt measures that are in line with its other policies and should also not address the BEPS in isolation, but take heed of the response of the international community. Oguttu (2016:143) shares this view and urges African countries to balance the need to attract foreign investment against the necessity of protecting their tax bases.

The National Treasury (2013a) recognises that debt is an important tool for investment and stated that "a balance is required between attracting debt capital and the protection of the tax base against base erosion". It is submitted that in an attempt to obtain the stated balance, the benchmark ratio might have been set too high to render it effective.

2.6 Overall conclusion

The research set out to determine whether the provisions of Section 23M of the Act are in line with the OECD recommended best practice approach as outlined in the OECD final report on Action 4: Limiting base erosion involving interest deductions and other financial payments.

Section 23M of the Act was introduced prior to the finalisation of the OECD's recommendation. The general approach of basing the interest limitation on a fixed percentage of the profits of an entity is in line with the OECD approach. Whereas the OECD is concerned with three types of BEPS risk, it seems the National Treasury is more concerned with risk relating to intra-group debt utilised to fund exempt income.

The main difference between the OECD best practice approach and Section 23M provisions is the fixed benchmark ratio. Section 23M seems to be a more lenient approach than recommended by the OECD, despite evidence that the average interest expense to EBITDA is 20 percent. The minimum benchmark ratio is currently at 43.95 percent, whereas the OECD recommends placing the benchmark within a 10 percent to 30 percent corridor. The OECD recommends utilising the fixed ratio rule in conjunction with the group rule, but currently the South African legislation does not utilise the group ratio rule.

Section 23M of the Act therefore adheres to some of the principles of the OECD best practice recommendation; it is however not entirely in line with the recommendations, as was found in the analysis performed.

In applying the recommendations of the OECD, South Africa was urged to strike a balance between limiting interest deductibility to a reasonable level and remaining attractive for foreign direct investments. Although excessive interest deduction is a BEPS risk in South Africa, given the concerns that were raised about the impact of Section 23M on foreign direct investments, it remains to be seen if the National Treasury will adjust the benchmark ratio or if other national policy issues will take priority. The National Treasury will also need to consider the capacity of SARS to administer any further changes such as the implementation of the more complex group ratio rule.

CHAPTER 3: CONCLUSION

3.1 Introduction

The main objective of this study was to determine whether the provisions of Section 23M are in line with the OECD recommended best practice approach on interest limitation, as outlined in the BEPS Action 4 report. The sections below will provide a summary of key findings of the study and how these findings address the research question formulated in Chapter 1.

3.2 Research findings

3.2.1 Objective 1: OECD best practice approach

The OECD based the best approach on a limitation of interest based on a fixed benchmark percentage of EBITDA. It is recommended that the fixed benchmark fall within the 10 percent to 30 percent corridor. A guideline is provided on determining the benchmark ratio. Countries adopting the fixed ratio rule should consider using the lower limit unless there are mitigating factors. Critics of the approach are of the view that it is too lenient, rendering the rule ineffective. However, some have argued that it is too blunt and might result in legitimate interest expense being denied.

It is recommended that the fixed ratio rule be applied in conjunction with a group rule, to ensure a robust approach to addressing BEPS. The group ratio rule also assumes that all entities within the group have the same interest to EBITDA ratio, which seems commercially unrealistic and might result in double taxation and denials of relief for actual interest costs. The success of the best approach in effectively addressing the risks that the best approach is targeting is dependent on the coordination among countries in enacting domestic laws in line with the recommendation. The recommendation might have a negative impact on the attractiveness and competitiveness of countries as investment destinations due to possible increases that might affect the progress of its implementation.

3.2.2 Objective 2: Section 23M

Section 23M of the Act limits the deduction of interest paid to a creditor in a controlling relationship with the debtor that is not subject to tax in South Africa. The term subject to tax is not defined, and there is uncertainty to Section 23M when a DTA is applicable to certain interest payments. The interaction between Section 31 and Section 23M of the Act is also unclear, and an interpretation note would provide clear guidance.

The interest expense/EBITDA ratios across South African sectors average 20 percent. The repo rate will have to go down to 1 percent for the interest deduction limitation to match the current averages. The effectiveness of Section 23M of the Act is therefore questionable, as the current benchmark ratio is calculated to be 43.95 percent based on the formula. There are concerns that Section 23M of the Act might deter foreign direct investment since it will raise the effective interest rates of local subsidiaries.

3.2.3 Objective 3: Comparison of the OECD best practice and Section 23M of the Act

Section 23M follows the general approach of utilising a ratio that is based on the ratio of interest expense to EBITDA, which is also followed by the OECD's best practice approach. There are, however, some similarities and differences between its provisions and the OECD recommended best approach.

Section 23M of the Act does not apply to all forms of interest regardless of whether it arose from a debt provided intra-group, by a related or third party as recommended by the OECD. The recommended benchmark fixed ratio in line with the best practice approach should be set within the 10 percent to 30 percent corridor, and yet the Section 23M current benchmark fixed ratio is based on a formula that results in the current fixed benchmark being 43.95 percent, which is way above the recommended benchmark. The OECD recommends utilising the fixed ratio rule in conjunction with the group rule. Currently the South African legislation does not utilise the group ratio rule.

3.3 Conclusion

Section 23M of the Act was introduced prior to the finalisation of the OECD's recommendation. The general approach of basing the interest limitation on a fixed percentage of the profits of an entity is in line with the OECD approach. Whereas the OECD is concerned about three types of BEPS risk, it seems the National Treasury is more concerned with risk relating to intra-group debt utilised to fund exempt income.

The main difference between the OECD best practice approach and Section 23M provisions is the fixed benchmark ratio. Section 23M seems to be a more lenient approach than recommended by the OECD, despite evidence that the average interest expense to EBITDA is 20 percent. The minimum benchmark ratio is currently at 43.95 percent, whereas the OECD recommends placing the benchmark within a 10 percent to 30 percent corridor. The OECD recommends utilising the fixed ratio rule in conjunction with the group rule, but currently the South African legislation does not utilise the group ratio rule.

It was therefore found in the analysis performed in this study that Section 23M of the Act adheres to some of the principles of the OECD best practice recommendation but it is however not entirely in line with the recommendations, as illustrated above.

In applying the recommendations of the OECD, South Africa was urged to strike a balance between limiting interest deductibility to a reasonable level and remaining attractive for foreign direct investments. Although excessive interest deduction is a BEPS risk in South Africa, given the concerns that were raised about the impact on Section 23M on foreign direct investments, it remains to be seen if the National Treasury will adjust the benchmark ratio or if other national policy issues will take priority. The National Treasury will also need to consider the capacity of SARS to administer any further changes such as the implementation of the more complex group ratio rule.

3.4 Suggestions for Further Research

As concluded in 3.2.1 the success of the best approach in effectively addressing the risks that the best approach is targeting is dependent on the coordination among countries in enacting domestic laws in line with the recommendation. A proposed area of study will be determining the extent different countries have applied the best practice approach and the impact thereof on its effectiveness in addressing the intended risks.

It was noted in 2.4.3 that there is a degree of uncertainty concerning the interaction between Section 31 and Section 23M of the Act. There are instances where the interest is considered to be at arm's length but the quantum of the loan is not, and is therefore adjusted in terms of Section 31 of the Act. There is no guidance on whether the amount of interest that the Section 23M limits will be the actual interest incurred or the adjusted interest. For this reason future study to explore the implications of the different interactions of Section 31 and Section 23M of the Act is recommended.

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