Executive summary

Understanding and closely managing the potential tax risks and uncertainties associated with traditional South African inbound financing is becoming increasingly critical. In the Budget speech delivered on 25 February 2016, the South African National Treasury raised concerns about the excessive use of leverage by South African companies in order to reduce their tax burden through interest deductions. Specifically, the Minister of Finance stated “…of particular concern are …highly geared financing structures that reduce companies’ tax liabilities with excessive interest-expense deductions.” Further concerns were raised about the use of hybrid instruments and measures were proposed to address the issue of double non-taxation.

Overall, there is continuing revision of the tax rules on inbound financing, tightening of the administrative enforcement machinery (including improved audit capacity and global information sharing) and calls for aggressive audit from Government.

Detailed discussion

A South African entity wishing to raise loan capital from its foreign parent or connected entity will have to comply with a number of tax and regulatory rules. This Alert highlights the impact of some of these rules.
Exchange control regulations
Exchange controls regulations are generally applicable to residents to prevent the erosion of foreign exchange and improve the balance of payments. South African residents may borrow funds from abroad, subject to prior approval by an authorized dealer (commercial banks) or central bank approval, depending on the terms of the funding. The regulations place restrictions on interest payable to ensure that repayments do not disrupt the balance of payments. Payment of interest without the relevant approval is subject to regulatory sanctions.

General interest deduction and timing rules
The deduction of interest in the issuer's hands is mainly spread on a mark to market basis using the internal rate of return. Interest is only deductible if incurred in the production of income. There are special rules applicable to the deduction of interest on loans used for the acquisition of shares.

Thin capitalization rules
South Africa's thin capitalization rules are based on the arms-length principle. The rules measure the arm's length nature of the terms of financing, debt burden and interest charge. There is limited guidance on the practical application of the rules and no safe harbors. Non arms-length interest is not deductible and is subject to secondary tax treatment as deemed dividends. Arguably, the tax on the secondary adjustment falls outside the treaty protection and thus liable to tax at a domestic tax rate.

Although not legislatively prescribed, the revenue authority expects taxpayers to maintain a certain level of documentation (including benchmarking of the funding arrangement).

General interest deduction limitation rules
The deduction of interest incurred on certain connected party loans is limited to an inflation linked formulary determined ceiling (roughly 40% of taxable earnings before interest, tax, depreciation and amortization/EBITDA); this came into effect from 1 January 2015. The computation is complex as several adjustments need to be made to the normal tax numbers. The interest limitation rules target interest paid to entities that are “not subject to tax” and apply in addition to the thin capitalization restrictions. There is no clear guidance on when a foreign entity will be regarded as not “subject to tax” and thus trigger the interest deduction limitation rules.

Hybrid debt limitation rules
The hybrid debt rules reclassify interest on specified debt or interest with equity or dividend like features as deemed dividends. Affected instruments include certain subordinated loans, instruments with longer maturity dates, and convertible features. As a result, even what is generally perceived as an ordinary loan may be covered if it has the prescribed features.

The impact is that the interest is not deductible and is taxable in the hands of the issuer. Special rules apply if the debt is used in an acquisition context.

A proposal was announced in the 2016 budget to address double non-taxation that arises in respect of hybrid debt instruments between a resident and a nonresident. Details are not yet available, but it was announced that the proposed changes will come into effect on 24 February 2016.

Hybrid equity rules
The hybrid equity rules target equity funding with specific debt-like features such as redemptions within prescribed periods, prescribed coupon rate and equities backed by financial instruments, among others. Dividends on hybrid equity instruments are deemed to be income, and thus subject to normal tax rules.

Withholding tax on interest
South Africa introduced a withholding tax on interest at a rate of 15% as of 1 March 2015. The tax applies on the “payment” of interest (i.e., when interest is paid or is due and payable). As a result, it is not uncommon to find interest accrued prior to the introduction of the tax but paid thereafter falling subject to the tax. Applicable tax treaties where the beneficial owner of the interest is located in a treaty country may impact the tax treatment.

Currency slide exposure
The South African currency is relatively volatile. This often raises concerns to investors about the impact on profitability and return on investment. A slight tax benefit is provided in the form of the deduction of foreign exchange losses on an annual basis. However, the deduction of losses on certain connected party loans is deferred until realization of the loan. There are specific anti-avoidance rules to curb the realization of foreign exchange items solely for the purpose of using the exchange losses.
Reportable arrangement
South Africa has a prescribed list of arrangements that are reportable to the revenue authority. Reportable arrangements are generally arrangements perceived by the revenue authority to have characteristics that may lead to undue tax benefits. Reportable arrangements include hybrid instruments, certain equity financed share-buy backs, finance costs linked to the tax treatment in the issuers’ hands, tax v. accounting revenue or expense recognition mismatches, financing arrangements that do not result in reasonable expectation of pre-tax profits or the pre-tax profit is less than the tax benefit, and transactions that lack commercial substance.

Filing a tax return
Nonresidents receiving interest that is “not exempt from income tax” are required to file a return. This will generally be the case where the interest is effectively connected to a local permanent establishment of that nonresident.

Renegotiation of zero rate treaties
South Africa is in the process of renegotiating a significant number of its treaties with most of the preferred funding jurisdictions. The renegotiation is meant to secure taxing rights on interest subject to certain exceptions for publicly traded debt and government backed funding.

Davis Tax Committee review
South Africa has appointed a special committee (Davis Tax Committee) to advise Treasury on various issues, including base erosion and profit shifting (BEPS) in relation to the use of leverage. The committee is expected to make recommendations that may have an impact on the deductibility of interest. These recommendations are mainly influenced by the proposals of the OECD Base Erosion and Profit Shifting reports.

Voluntary disclosure program
The 2016 Budget speech announced additional benefits for voluntary disclosure program (VDP) in order to give non-compliant taxpayers the opportunity to correct their tax and exchange control affairs. The revised VDP will apply from 1 October 2016. The program is meant to facilitate a clean start, as South Africa adopts global standards on automatic information exchange with foreign revenue authorities.

Reviewing inter-company financing
The mushrooming of inbound funding rules and improved enforcement continues to influence the use of traditional funding locations, techniques and instruments, some of which may no longer be suitable. Each instrument and the entire debt position of the local entity should be assessed against the tax and regulatory complexities.

An assessment can be performed on selected financial instruments or widely, taking into account the whole debt book. A comprehensive assessment of inter-company financing arrangements may include:
- Assessing regulatory compliance of the intercompany financing arrangement
- Assessing the loan book for existence of prescribed hybrid features, potential operational tax exposure, and the need for possible rationalization
- Comparing the tax impact of the withholding tax and possible grossing-up to the application of the interest deduction limitation rules
- Changing terms, rates, location of intercompany financing arrangements and possible debt push down strategies
- Substituting hybrid instruments for “straight” debt or equity or other efficient profit participation models
- Using contractual or derivative arrangements to synthetically leverage high-tax instruments
- Mitigating debt-equity audit exposures resulting from refinancing or lack of documentation
- Compliance and regulatory disclosure
Endnotes

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