CONCEPTUAL OUTLINE FOR TAX REFORM

INTRODUCTION

It has long been recognized that South Africa is out of line with its international trade partners in so far as it relates to:

(1) Tax deductions in respect of funding costs incurred, particularly equity investments
(2) Holding company status
(3) Finance company status

SAICA has formed a task team to assist National Treasury with research (that is, international precedent for proposed reform) into the technical aspects of the above. This document is intended to be an initial ‘Conceptual Outline’ by this task team, for purposes of pre-empting an extensive process of consultation between representatives of the SAICA National Taxation Committee and National Treasury.

INTERNATIONAL TRENDS

No doubt National Treasury is acutely aware of the fact that countries such as the United Kingdom, the United States of America, the Netherlands and Australia (to name a few) allow some tax concession, for example, for interest costs associated with equity investments. As such, South African investors are at a distinct disadvantage when competing with non-resident investors for target investments as our cost of investment is higher solely due to the tax regime. In addition, the economic shift and the offshore investor interest in Africa as a whole, makes the timing of any tax reform opportune, if South Africa is to claim its position as the ‘gateway into Africa’.
In this regard, should South Africa wish to pursue reform in the aforementioned areas, it is imperative that South Africa:

- refrain from adopting any proposals unique to South Africa that deviate from international best practice; and
- learn critical administrative, legislative and practical lessons from the experiences of other countries.

The task team accepts that any proposals based on international precedent would have to be adapted to the exigencies of the South African taxation system.

Extensive research into the international experience in these areas would, however, help to ensure the quality of the legislation required to allow both the transition to and subsequent application of any reformation.

In summary, the task team has sought to outline options available to National Treasury below and has noted issues, at first glance, that require further input and research:

(1) **TAX DEDUCTIONS IN RESPECT OF FUNDING COSTS INCURRED, PARTICULARLY IN RELATION TO EQUITY INVESTMENTS**

**Proposal**

Interest on money borrowed to acquire equity shares should be inherently tax-deductible.

**Rationale**

The status quo, which denies interest deductibility for equity purchases, creates distortions. Firstly, where borrowings are from financiers who are South African taxpayers, this creates negative arbitrage, with interest payments not being deductible, and the corresponding interest receipts being taxable.

This distortion makes such interest extremely costly. A consequence is that such borrowings are undertaken only as a last resort. Alternative forms of financing (such as preference share financing) are generally favoured and/or transactions are structured in more complex ways (for example, with equity acquisitions followed by immediate divisionalisation) to ensure that tax deductions are secured. These variations add complexity and cost and have the potential to unduly distort business structures.

Whilst some may contend that this is not an unusual state of affairs and where, for example, shares are acquired as a passive investment, denying the interest deduction could perhaps be justified, clearly the issue is different where one is in effect acquiring a business. Logic dictates that just because the form of the purchase differs (shares vs the underlying assets and goodwill) this should not, in itself, be sufficient to deny the interest deduction.
Possible limitations

Should this deduction be limited to borrowings from entities that are South African taxpayers?

This is clearly a policy matter which National Treasury must evaluate. On the one hand, having such a restriction ensures that there is tax base neutrality, in that every consequent tax deduction would be matched by a taxable income inclusion. On the other, this would result in discrimination against foreign lenders, and would consequently act as a barrier to raising foreign debt.

It is understandable that such a limitation is attractive to the fiscus, because of this tax neutrality. From a practical point of view it would not be too difficult to get around the restriction on the deduction applying to foreign borrowings, by routing the offshore borrowing via a South African lender. This will, therefore, necessitate some fairly complex anti-avoidance rules. But the more important question is whether from a philosophical and policy point of view, it is desirable, and even necessary, to impose this restriction.

We believe that, on balance, there is no need for a limitation of this nature. Currently the problem of not obtaining a tax deduction for interest when shares are acquired is solved, with the "blessing" of Treasury and the SARS, by post-acquisition restructuring involving a vanilla debt push-down. In such case, the interest on the loan incurred to acquire the business will be allowed as a deduction, regardless of whether the lender is on-shore or off-shore. Why, then, should it make a difference if the law is changed to allow the interest as a deduction when the shares are purchased (obviating the need for the debt push-down) so as to deny deductibility when the lender is foreign?

Moreover, to emphasise a point already made above, disallowing the interest paid to a foreign lender can be discriminatory and prejudicial to encouraging foreign investment. For example, if, say, a foreign investor owns a South African subsidiary which is to acquire a new subsidiary from a third party seller, and the foreign parent capitalises its South African subsidiary with interest-bearing shareholder debt to enable it to pay for the purchase, the interest would be disallowed in circumstances where the same interest on a loan from a South African bank would not be (or interest on a loan from a South African parent company would not be).

Should some form of limitation indeed be deemed necessary, then it need not take the form of an absolute prohibition, but could be more targeted. For example, South Africa could consider following the Danish tax regime by implementing the following targeted limitations on deductions in respect of interest:

- Thin Capitalisation rules: based on debt/equity ratio: thin capitalisation limitations with a debt/equity ratio of, for example, 4:1;
- Asset Limitation rules: based on value of assets: net financing expenses limited to an amount corresponding to, say, 6.5% of certain assets. The rate of 6.5% to be adjusted
annually;

- EBIT limitation rules: based on annual profits: net financing expenses not to exceed, say, 80% of EBIT.

**Should this deduction be limited to acquisitions of ordinary equity, with other forms (for example, preference equity) being excluded?**

In principle, there is no logical reason why preference equity should be excluded, if such shares are indeed a part of the capital structure of a company, and are acquired together with the ordinary shares of that company, and in the same ratio. Thus, for example, where 60% of the ordinary shares are acquired together with 60% of the preference shares, there is no restriction on the interest deduction. However, in this example, should 100% of the preference shares be purchased, interest on the debt associated with the additional 40% would be disallowed.

**Should this deduction be limited to acquisitions of substantial holdings in the target, say, holdings of 10% or more of the ordinary equity?**

A threshold of at least 10% seems appropriate. Such a limit signifies a structural change and which, incidentally, corresponds to what Excon permits for a foreign direct investment by a South African corporate, and is more in line with international norms.

**Should this deduction be limited to borrowings to acquire holdings in South African entities, with holdings in foreign entities being excluded?**

In principle, it should not necessary to limit this deduction to this degree. South African taxpayers should be allowed to diversify internationally on an equal footing to counterparts in the United Kingdom, Europe, etc (subject to thin capitalisation rules, asset limitation rules and EBIT limitation rules).

**Discussion**

Should the principle of interest deductibility for equity acquisitions be accepted, the most conservative approach from a fiscal perspective would be to make the deduction subject to all four restrictions highlighted above. This may be termed the “closed circuit” approach, where the interest flows are wholly contained within the South African tax base (thus ensuring that no ‘tax leakage’ occurs), whilst capital flows are contained within South Africa, other than where the acquisition is of a foreign shareholding in a South African company. Further, the interest concession is limited to substantial shareholdings, and is thus not an incentive to speculative portfolio transactions.

Should NT and SARS wish to be conservative, this “closed circuit” approach would still be a major improvement on the *status quo* and would be widely welcomed.
Notwithstanding, a case for deviating from each of these restrictions can be made as follows:

**Pro:** Allowing the incentive to apply to foreign borrowings will encourage capital inflows into South Africa and especially in the case of a major acquisition, will widen the range of lenders.
**Con:** Tax leakage will occur.
**Discussion:** The policy here should be driven by National Treasury policy on foreign borrowing in general, rather than purely tax considerations.

**Pro:** Allowing the incentive to apply to portfolio investing will allow for greater consistency between debt and equity assets.
**Con:** There does not seem to be a major need to encourage portfolio investments.
**Discussion:** There do not seem to be any strong reasons for extending this concession to portfolio investments, given that if the portfolio investment constitutes ‘trading stock’ the deductions should be allowed (subject to section 9C).

**Pro:** Allowing the incentive to apply to the purchase of foreign holdings would enable South African multi-nationals to compete more equally in the international M&A arena.
**Con:** To the extent that the borrowing is from local lenders, this incentivises the export of capital, although it is tax neutral. If the lender is foreign, this is capital-neutral, but assuming the first limitation noted above is waived, there is tax leakage.
**Discussion:** This is perhaps the most difficult of these four qualifications to resolve.

**Pro:** South Africa could be seen to be a more attractive location for setting up holding company or regional headquarters.

(2) **HOLDING COMPANY STATUS**

**Proposal**

As a policy, holding companies that hold non-South African investment holdings should be tax-neutral and Exchange Control neutral in South Africa.

**Rationale**

South Africa is, in many respects, an ideal location for offshore holding companies that invest into the rest of Africa. An environment that encourages this will not only directly create economic activity (such as encouraging the sourcing of goods and services from South Africa to be exported to foreign subsidiaries) and employment opportunities in South Africa, but will lead to an increased use of professional and financial services, thus creating further economic activity. Creation of a status that supports such structures is thus to be encouraged.

**Possible limitations**
Should this status be limited to substantial holdings in the target, say holdings of 10% or more of the ordinary equity?

Should this status be limited to companies wholly-owned by offshore shareholders, or should South African shareholdings be allowed, to an approved degree?

In principle, there must be South African participation allowed, firstly, because it's common to do international joint ventures with local partners and, secondly, in South Africa there is the further variation on this theme where ‘black economic empowerment’ may be required.

Discussion

From a tax perspective, neutrality is largely in place if investments are in substantial shareholdings and there are thus no major tax barriers to success in creating this status. Amongst other things, dividends and capital gains can be received without a tax liability. Further, if interest is incurred on foreign borrowings, this interest may be remitted without withholding tax. The remittance of dividends to non-resident shareholders, however, will attract STC if not matched by dividend income. This may occur, for example, where a foreign subsidiary has been sold, yielding a capital gain, and this gain is ‘passing through’ the South African holding company, for onward distribution to foreign shareholders.

A similar (but more extreme) mismatch may occur in the proposed new Dividends Tax, projected to replace STC towards the latter half of this year. For example, as currently drafted, with limited exceptions, all foreign dividends flowing through a South African holding company will be subject to the new dividends tax when declared to foreign shareholders. Furthermore, double taxation will occur when these foreign dividends have already been subjected to foreign withholding taxes.

If is accepted that South Africa should encourage the establishment of holding companies of this nature, and it is accepted that foreign dividend income should in these circumstances be outside the CFC/worldwide tax arena (hence the participation exemption) it must be accepted that these are no good grounds to tax a dividend passing through such a company.

Accordingly, we suggest that a ‘deemed credit system’ along the following lines should cater for this problem: For qualifying holding companies, where there is foreign source income (including dividends, fees or capital gains) there should be a deemed credit amounting to such foreign income, net of foreign withholding tax. This deemed credit is claimable against dividends paid to non-resident shareholders, in the determination of STC, and, in future, the new Dividend Tax. Any unutilised credit is carried forward for similar offset in future years.

From an Exchange Control perspective, the status quo involves major negatives from a foreign shareholder point of view. These considerations effectively negated the previous attempt to introduce a benign holding company regime. This proposal will only succeed if the Exchange Control authorities can give advance binding clearances to structures of this nature,
effectively allowing free remittance from South Africa of any offshore equity or loan capital introduced, plus any offshore income earned, attributed to offshore capital.

As regards the two possible limitations noted above, it is suggested that:

(2.1) This status be limited to substantial holdings (of at least 10%) in the target.
(2.2) This status should be granted whether or not there are South African shareholders provided that there are substantial offshore shareholders (holding, say, at least 40% of the ordinary equity share capital). The benefits will naturally (and automatically) be limited to remissions to such offshore shareholders.

(3) FINANCE COMPANY STATUS

Proposal

Finance Companies that raise equity or loan capital internationally, to lend internationally, should be tax-neutral and Exchange Control neutral in South Africa.

Rationale

As noted above, South Africa is in many respects an ideal location for financing companies that provide debt finance into the rest of Africa. An environment that encourages this will not only directly create economic activity and jobs in South Africa, but will lead to an increased use of professional and financial services, thus creating further economic activity. In principle, creation of a status that supports such structures is thus to be encouraged.

Possible limitation

Should this status be limited to companies wholly-owned by offshore shareholders, or should South African shareholdings be allowed, to an approved degree?

Discussion

From a tax perspective, neutrality is largely in place if only loan capital is raised, and there are thus no major tax barriers to success in creating this status. Amongst other things, where a financing company is funded with foreign capital, and invests into the rest of Africa, interest can flow through South Africa without fiscal cost. There are, however, some qualifications that must be made.

Firstly, there is the extent to which the tax authorities may require a ‘mark-up’ or interest spread in terms of transfer pricing rules. In principle, if a South African company is borrowing, for example, from its foreign parent, to lend to its foreign subsidiary, the thin capitalisation rules should be relaxed, otherwise an unnecessary tax burden will be created in South Africa for what is essentially a conduit-type arrangement.
Secondly, if the structure is financed (in whole or in part) by foreign equity capital, then a substantial tax liability accrues in South Africa, as there is no cost to offset interest income.

Thirdly, there is the fact that South Africa’s network of double tax treaties is hardly optimal, sometimes resulting in African withholding taxes on interest in excess of rates that apply for other treaty countries.

Fourthly, the existence of Exchange Control Regulations results in negative attitudes by potential providers of foreign finance. On this last point, as noted above, this proposal will only succeed if the Exchange Control authorities can give advance binding clearances to structures of this nature, effectively allowing free remittance from South Africa of any offshore equity or loan capital introduced, plus any offshore income earned, attributed to offshore capital.

As to the possible limitation listed above, there seems to be no inherent reason why the existence of South African shareholders should affect the status of the finance company.

As explored above, one of the downsides of allowing interest paid as a deduction to a greater extent is that there might have to be introduced anti avoidance rules such as thin capitalisation-type rules into our domestic dealings. Alternatively, ‘interest cover’ rules, where the interest deduction is limited to a percentage of EBIT or assets, both of which have been introduced into various countries' tax laws.

A similar principle could apply to South African companies holding intellectual property, allowing international royalties to flow through without additional South African tax.

CONCLUSION

In the interest of transparency and collaboration, SAICA looks forward to a consultative process in the course of exploring reformation in the areas noted above.

Yours faithfully

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