

Tax Planning Using Interest – An Organised Chaos for Those Interested

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Abstract

Taxation of interest is one of the most complex areas of tax in South Africa. Various provisions apply to interest, with some regulating the inclusion of interest in gross income, others allowing for the deductibility of interest incurred, others limiting the amount of interest that is deductible and yet others providing for anti-avoidance tax measures using interest. This makes tax planning using interest to be a technically intense exercise, time consuming and often costly. This article critically analyses the provisions applicable to interest and highlights the circumstances in which they apply as well as the results of their application. It also illustrates instances of the overlaps in the application of these provisions.

Keywords

Transfer pricing; controlling relationship; interest deductibility; withholding tax; limitation of deductions; reorganisation transaction; arm's length; incurral and accrual of interest.

1 Introduction

The tax treatment of interest is one of the most complex areas of taxation. Due to the unique nature of interest; the mobility of capital; the tax residence of the recipient and payor of the interest; and the difficulty in determining the accrual and incurral of interest, the potential for the avoidance and evasion of tax using financial instruments giving rise to interest is high. This has resulted in various specific provisions being included in legislation worldwide, including South African laws, to curb such avoidance.

This article analyses the general provisions relating to the accrual and incurral of interest, provisions enabling the deductibility of interest where the general provisions would otherwise not allow, the limitation of interest rules and the anti-avoidance provisions in respect of interest. The aim is to explicate the tax challenges faced by taxpayers when entering into transactions involving debt instruments and the powers bestowed to the tax authority to challenge such transactions.

2 Different tax treatment of debt v equity – the basics

As a general matter, interest earned forms part of the gross income of the recipient. It is fully taxable in the hands of a person other than a natural person and taxable subject to minimum amounts exemptions for natural persons. Interest incurred in the production of income, which does not fall within the section 24J interest definition, is deductible under the general deductions formula contained in section 11(a) read with section 23(g) of the *Income Tax Act* (hereafter the Act).¹ Interest arises from debt instruments and should be distinguished from earnings from equity instruments, as the tax implications of the two are vastly different. Equity instruments give rise to dividends. Dividends received or accrued form part of gross income in terms of specific inclusion in paragraph (k) of the definition of gross income in section 1 of the Act. Local dividends are then exempt from normal tax in terms of section 10(1)(k)(ii) of the Act. Dividends that are exempt from normal tax are taxable in terms of the withholding tax on dividends in terms of section 64D-64N of the Act. Dividend payments are not deductible, and expenditure incurred in the production of dividend income is not deductible.

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¹ *Income Tax Act* 58 of 1962. Note that all references to sections in this article refer to sections of the *Income Tax Act*, unless stated otherwise.

This favourable tax treatment of interest over dividends makes investment using debt instruments lucrative from the tax point of view of the issuer.

3 Jurisdiction to tax interest

South Africa taxes residents on a worldwide basis.² Thus income earned by a resident is taxable in South Africa regardless of the source of the income. Natural persons are resident in South Africa if those natural persons are ordinarily resident in South Africa, i.e. the persons consider South Africa to be their home,³ or they pass the physical presence test, i.e. they are physically in South Africa for periods stated in the Act as sufficient for a person to be taxable in South Africa.⁴ Persons other than natural persons are tax resident in South Africa if they are incorporated, established or formed in South Africa; or they are effectively managed in South Africa.⁵ If a person is not a South African tax resident, such a person would be taxable in South Africa only on income sourced in South Africa. The source of income is established by first determining the originating cause of the income (i.e., what the taxpayer does to produce the income) and then locating that originating cause.⁶ The source of the income is therefore the location at which the taxpayer performed acts that produced that income.⁷

The challenge with interest is that the originating cause may not be definitively determined, as it could exist in multiple locations. For example, it could be the location where the contract giving rise to interest was concluded or initiated; or where the debt instrument originated; where the money was obtained; where the money was used; or where the creditor or debtor is resident; and many other locations. On the other hand, it could be argued that none of any one of the above locations could, on its own, be the

² The section 1 definition of "gross income". See Legwaila *et al Tax Law* 28; Olivier and Honiball *International Tax* 9-10.

³ *Cohen v CIR* 1946 AD 174; *CIR v Kuttel* 1992 3 SA 242 (AD); *Thompson v Minister of National Revenue* 2 DTC 812 (SCC).

⁴ The section 1 definition of "resident" provides the mechanical calculation of the days that a person is required to be physically present in South Africa to pass the physical presence test.

⁵ The section 1 definition of "resident"; *SIR v Downing* 1975 4 SA 518 (A); *Commissioner for the South African Revenue Service v Tradehold Ltd* 2012 3 All SA 15 (SCA).

⁶ *CIR v Lever Brothers* 1946 AD 441. Also see Oguttu 2008 *CILSA* 80.

⁷ *CIR v Lever Brothers* 1946 AD 441; *Rhodesia Metals Ltd (In Liquidation) v COT* 1938 AD 282; *Essential Sterolin Products (Pty) Ltd v CIR* 1993 4 SA 859 (A).

source of interest.⁸ As a result, the Act contains a deeming provision in respect of interest to provide clarity as to the source of interest.

3.1 Source in respect of interest

Interest is from a South African source if it is attributable to an amount incurred by a resident, unless the interest is attributable to a permanent establishment which is situated outside South Africa; or it is in respect of the utilisation or application in South Africa by any person of any funds or credit obtained in terms of any form of interest-bearing arrangement.⁹ Thus, interest incurred by a resident in favour of a person that is not resident in South Africa has its source in South Africa and is therefore subject to tax in South Africa.

Thus, interest earned by a resident is taxable in South Africa because residents are subject to tax on their worldwide income. An exception to this is where such interest is attributable to a permanent establishment situated outside the Republic.¹⁰ The Act does not necessarily link the permanent establishment to a resident. While that would provide clarity as to the exception of the interest of that person, the debate would end up being academic since any interest attributable to a permanent establishment outside South Africa should not be taxable in South Africa, whether that permanent establishment is of a resident or otherwise. Furthermore, the facts that with regard to the resident the Act requires that the interest be incurred by the resident, and with regard to the permanent establishment the wording refers to attributable make the exception wider. It is wider in that the interest could be incurred by the resident, but in respect of the activities of the permanent establishment outside South Africa. In that case, the exception would still apply.

4 What is interest?

The Act does not contain a general definition of interest in its definitions section. As a result, for the general purposes of the Act the ordinary meaning of the word interest is applied. Ordinarily, interest is payment for

⁸ See *CIR v Lever Brothers* 1946 AD 441; *COT v William Dunn & Co Ltd* 1918 AD 607, where the argument was whether the source of interest was the place where the capital was employed as opposed to the place where the debt was located or the debtor resided; and *First National Bank of Southern Africa Ltd v Commissioner for the South African Revenue Service* 2002 3 SA 375 (SCA), where it was argued that the source of interest is where the credit is made available, but the court held that it was where the bank's business activities were carried on.

⁹ Section 9(2) of the Act.

¹⁰ Section 9(2) of the Act.

the use of money.¹¹ In general, it is understood to be an amount charged by a lender for the use or detention of money.¹²

The source provision on interest refers to interest as defined in section 24J, thus importing the specific definition of interest into the deeming provision.¹³ Because section 24J widens the definition of interest from what is ordinary, various anti-avoidance provisions incorporate the definition of interest in section 24J. Section 24J defines interest for the purposes of the timing rules determining the accrual and incurral of interest.

Section 24J defines the salient aspects of interest to include the following:

- the "gross amount of any interest".¹⁴ Because interest is not defined in the Act other than in this definitional provision, the common law meaning of interest is adopted in this regard. In terms of the common law, interest is compensation payable by the borrower to the lender for the supply of credit by the lender to the borrower.¹⁵ "The reason for the payment should be closely linked to the use of another person's funds."¹⁶ It also includes finance charges similar to interest, discount or premium payable or receivable in terms of or in respect of a financial arrangement. Finance charges would typically include fees related to an instrument;¹⁷
- the amount, or portion thereof, payable by a borrower to the lender in terms of any lending arrangement as represents compensation for any amount to which the lender would, but for such lending arrangement, have been entitled.¹⁸ A lending arrangement is basically an arrangement in terms of which a lender lends an instrument to a borrower, and the borrower undertakes to return any instrument of the

¹¹ See *Linton v Corser* 1952 3 SA 685 (AD); *Cactus Investments (Pty) Ltd v CIR* 1999 1 All SA 435 (A); *CIR v Genn & Co Ltd* 1955 3 SA 293 (A); *ITC 1496 53 SATC 229*; *ITC 1588 57 SATC 148*; *ITC 1485 52 SATC 337*; *Riches v Westminster Bank Limited* 1957 All ER 469 HL.

¹² *CIR v Lever Brothers* 1946 AD 441 442; *Cactus Investments (Pty) Ltd v CIR* 1999 1 All SA 435 (A).

¹³ Section 9(2)(b) of the Act.

¹⁴ Paragraph (a) of the definition of "interest" in s 24J(1) of the Act.

¹⁵ See *CIR v Lever Brothers* 1946 AD 441.

¹⁶ *Stiglingh et al Silke* 544.

¹⁷ See *Commissioner for the South African Revenue Service v South African Custodial Services (Pty) Ltd* [2012] JOL 28496 (SCA).

¹⁸ Paragraph (b) of the definition of "interest" in s 24J(1) of the Act.

same kind and of the same or equivalent quantity and quality to the lender.¹⁹

These amounts constitute interest irrespective of whether such an amount is calculated with reference to a fixed rate of interest or a variable rate of interest; or payable or receivable as a lump sum or in unequal instalments during the term of the financial arrangement.²⁰

5 Accrual and incurral of interest

Section 24J is a timing provision in relation to the accrual and incurral of interest. The section determines when a debtor incurs interest and can thus deduct such interest in the determination of its taxable income.²¹ It also regulates the timing of the accrual of interest in respect of the creditor, as to when the creditor should include the interest in its gross income. In its very nature, section 24J is an anti-avoidance provision intended to curb the early reporting of the incurral to deduct the interest prematurely by the debtor. It also curbs the avoidance of tax by creditors artificially delaying the accrual of interest for the purposes of inclusion in gross income for a particular year. The basic principle of 24J is that an amount of interest expenditure is incurred by, or accrues to, a taxpayer by applying a constant compound rate of interest over the term of an instrument. Interest is incurred or accrues on a debt instrument (as a general matter) and section 24J applies to qualifying instruments as defined.²²

5.1 Accrual of interest

Section 24J(3) is a charging provision that also determines the timing of the accrual of interest. It determines the amount of interest that accrues to a person who is a holder of an income instrument²³ in a tax year that must be

¹⁹ See the definition of "lending arrangement" in s 24J(1) of the Act.

²⁰ The definition also includes the absolute value of the difference between all amounts receivable and payable by a person in terms of a sale and leaseback arrangement as contemplated in s 23G throughout the full term of such an arrangement, to which such a person is a party, irrespective of whether such an amount is calculated with reference to a fixed rate of interest or a variable rate of interest; or payable or receivable as a lump sum or in unequal instalments during the term of the financial arrangement.

²¹ See Stiglingh *et al Silke* 543; also see Brincker *Taxation Principles of Interest Transactions* V9.

²² Sections 24J(2) and (3). Also see Stiglingh *et al Silke* 528-530.

²³ An "income instrument" is defined in s 24J(1) as "(a) in the case of any person other than a company, any instrument (i) the term of which will, or is reasonably likely to, exceed one year; and (ii) which is issued or acquired at a discount or premium or bears deferred interest; and (b) in the case of any company, any instrument".

included in the gross income of that person in that tax year.²⁴ The amount of interest accrues to a taxpayer by applying a constant compound rate of interest over the term of an instrument. In this regard the amount of interest that is included in gross income in the year of assessment is equal to the sum of all accrual amounts²⁵ in relation to all accrual periods²⁶ falling, whether in part or in whole, within such a year of assessment in respect of such an income instrument. Alternatively, the amount included in the gross income for the year of assessment could be the amount determined in terms of an alternative method. An alternative method is one which (a) accords with the generally Accepted Accounting Principles; (b) is applied consistently in respect of all such instruments for all financial reporting purposes; and (c) does not result in a significantly different outcome.²⁷ Section 24J(3) includes in the gross income of a holder in relation to an income instrument income which accrues to that person, whether or not that amount constitutes a receipt or accrual of a capital nature.

5.2 Incurral of interest

Section 24J(2) is the inverse of section 24J(3) in that it allows for the deductibility of interest and determines the amount of interest incurred by a person in a year of assessment. Section 24J(2) determines that if a person is an issuer in relation to an instrument, such a person shall be deemed to have incurred an amount of interest during that year of assessment.²⁸ The amount of deemed interest is equal to the sum of all accrual amounts²⁹ in relation to all accrual periods³⁰ falling, whether in part or in whole, in that year of assessment in respect of such an instrument. Alternatively, the

²⁴ Section 24J(3); also see Haupt *Notes on South African Income Tax* 455.

²⁵ See the definition of "accrual amount" in s 24J(1).

²⁶ "Accrual period" in relation to an instrument is defined in s 24J(1) to mean "(a) where in terms of such instrument regular payments at intervals of equal length and not exceeding 12 months per interval are to be made throughout the term of such instrument, the period between such regular payments; or (b) any period not exceeding 12 months elected by the holder or issuer, as the case may be, which period shall be applied consistently throughout the term of such instrument".

²⁷ See the definition of "alternative method" in s 24J(1) of the Act.

²⁸ Also see Haupt *Notes on South African Income Tax* 455.

²⁹ See the definition of "accrual amount" in s 24J(1).

³⁰ "Accrual period" in relation to an instrument is defined in s 24J(1) to mean "(a) where in terms of such instrument regular payments at intervals of equal length and not exceeding 12 months per interval are to be made throughout the term of such instrument, the period between such regular payments; or (b) any period not exceeding 12 months elected by the holder or issuer, as the case may be, which period shall be applied consistently throughout the term of such instrument".

amount included in the gross income for the year of assessment could be the amount determined in terms of an alternative method.³¹

Section 24J(2) allows an amount of interest incurred to be deducted if that amount is incurred by that person's carrying on any trade and in the production of income. Thus, interest that is not deductible in terms of the general deduction formula³² because it does not meet the "capital nature" requirement contained therein may still be deductible in terms of section 24J.³³

6 Enabling provision: Deduction of interest not incurred in the production of income

As stated above, interest is deductible in terms of section 24J only if it is incurred in the production of income. However, the Act makes special provision for interest to be deducted even when the production of income requirement is not met.³⁴

Section 24O applies to debts issued by a company for the purpose of financing certain acquisitions of equity shares in an "operating company". Section 24O allows for a deduction of interest incurred by a company in respect of a debt issued, assumed or used by that company for the purposes of financing the acquisition of an equity share in an operating company. It

³¹ See the definition of "alternative method" in s 24J(1) of the Act.

³² Contained in s 11(a) read with s 23(g) of the Act.

³³ Previously, interest could be deducted only if it was not capital in nature. According to the National Treasury *Explanatory Memorandum on the Revenue Laws Amendment Bill* of 2004 (National Treasury 2004 <https://www.sars.gov.za/wp-content/uploads/Legal/ExplMemo/LAPD-LPrep-EM-2004-02-Explanatory-Memorandum-Revenue-Laws-Amendment-Bill-2004.pdf> 22) the removal of the capital requirement for both the accrual and incurral of interest was "[i]n order to provide certainty as to the tax treatment of interest and to introduce the principle that interest should always be treated on revenue account ... This would bring the tax treatment of interest in line with the treatment of exchange differences, which is not subject of the capital nature test. However, the deduction of interest should still be subject to the trade and production of income tests".

³⁴ According to the National Treasury, the rationale behind the introduction of s 24O was as follows: "[u]nder the [previous] paradigm, a practical dichotomy exists. Interest deductions associated with debt-financing of direct share acquisitions are not deductible while indirect debt-financing via sections 45 and 47 are allowed if the financing meets the requirements of section 23K. Therefore, these indirect share acquisitions have been formally accepted in the tax system under certain limited circumstances. No reason exists to deny interest-deductions associated with direct share acquisitions occurring under similar limited circumstances. To force an indirect share acquisition in all instances is to effectively add unnecessary transaction costs". See National Treasury 2012 <https://www.sars.gov.za/wp-content/uploads/Legal/ExplMemo/LAPD-LPrep-EM-2012-01-Explanatory-Memorandum-Taxation-Laws-Amendment-Bill-2012.pdf>.

also allows a deduction of interest where the interest is incurred as a result of a substitution of a debt issued, assumed or used to acquire equity shares in an operating company.

An "operating company" is a company of which at least 80 per cent of the aggregate amount received by or that accrued to that company during a year of assessment constitutes income in the hands of that company. In addition, that income must derive from a business carried on continuously by that company; and in the course or the furtherance of which goods or services are provided or rendered by that company for consideration.³⁵

The acquisition of the cooperating company must be in terms of an acquisition transaction, which basically means that the transaction should result in a group relationship.³⁶

If the requirements of section 24O are met, then the production of income restriction contained in section 24J will not apply. Section 24O allows for the deductibility of the expenditure by deeming the interest expenditure to have been incurred in the production of the income of that company and laid out or expended by that company for the purposes of trade.³⁷ The full amount of qualifying interest expenditure is then deductible.

Interest on the purchase of assets in a business as a going concern has historically been allowed as a deduction in terms of the reorganisation rules contained in sections 41 to 47 of the Act. However, interest on the purchase of shares has not been allowed as a deduction, resulting in a plethora of aggressive tax structuring schemes that either succeeded or failed to reduce the tax liability.³⁸ In effect, therefore, section 24O levels the playing

³⁵ Section 24O definition of "operating company".

³⁶ The definition of an "acquisition transaction" is twofold. It is defined in relation to an operating company and a controlling group company: (a) in respect of an operating company an acquisition transaction is any transaction in terms of which a company acquires an equity share in another company from a person that does not form part of the same group of companies as that company, as a result of which, at the end of the day of that transaction, that company is a controlling group company in relation to that other company; and that company and that other company form part of the same group of companies as defined in section 41(1); (b) in respect of a controlling group company it is any transaction in terms of which a company acquires an equity share in another company from a person that does not form part of the same group of companies as that company, as a result of which, at the end of the day of that transaction, that company is a controlling group company in relation to that other controlling group company; and that company and that other controlling group company form part of the same group of companies as defined in s 41(1).

³⁷ Section 24O(2).

³⁸ Beilings 2018 <https://www.webberwentzel.com/News/Pages/refining-rules-for-debt-financed-acquisitions-of-controlling-interest-in-an-operating-company.aspx>.

field between the purchase of a business as a going concern and the purchase of the shares in a business.

Timing also plays a role in the deductibility of the interest. The operating company in which the equity share is acquired should have qualified as an operating company in its preceding tax year for the debtor to qualify for the deduction in the debtor's current tax.³⁹

In Binding Private Ruling 260 a company that incurred debt to fund the acquisition of shares in two South African resident operating companies was able to rely on section 24O of the Act to claim the deduction for the interest arising in respect of the debts incurred. The company was the holding company of one of the companies, which was in turn a holding company of the other company.⁴⁰ In this ruling section 24O would apply to the effect that the interest on the debt would continue to be deductible even if the operating companies were to be eliminated, and thus, the production of income (and potentially trade) requirement would not be met.

7 Limitation of interest deductions

Interest received by, or that accrues to, a person that is not tax resident in South Africa is exempt from normal tax in South Africa in terms of section 10(1)(h) of the Act. At the same time, interest incurred by a resident is deductible in terms of section 24J of the Act (provided all requirements are met) in the hands of the resident.

A common tax avoidance mechanism at an international level involves the relocation of income from a high tax jurisdiction to a low tax jurisdiction, and the relocation of deductible expenses from a low tax jurisdiction to a high tax jurisdiction. These avoidance mechanisms are generally entered into between persons that are related, or associated, in such a way that the shifting of the profits or deductions does not economically disadvantage the parties to the transaction or shareholders of such parties. The South African law contains provisions that are aimed at curbing this form of tax avoidance by limiting the amount of interest that could be allowed as a deduction by a South African tax resident.

³⁹ Section 40O(3)(a). See Haupt *Notes on South African Income Tax* 544.

⁴⁰ See SARS 2017 <https://www.sars.gov.za/wp-content/uploads/Legal/Rulings/BPR/LAPD-IntR-R-BPR-2017-04-BPR-260-Interest-on-loans-used-to-acquire-shares.pdf>.

7.1 Thin capitalisation

7.1.1 Introduction

Thin capitalisation refers to the practice of funding a related party with excessive debt to obtain the tax benefit of the deductibility of a higher amount.⁴¹ Up until 2012, South Africa applied a 3:1 debt to equity safe harbour, which meant that taxpayers could deduct interest on debt up to three times their capital investment. In April 2012 these rules were amended and broadened by incorporation into the transfer pricing rules.⁴² The current rule focusses on cross-border transactions, operations, schemes, arrangements or understandings effected between or undertaken for the benefit of connected persons.

7.1.2 Application

Transfer pricing rules allow the SARS to adjust the tax consequences of affected transactions between connected persons. Essentially, an affected transaction is a transaction that, when entered into would effectively shift income from South Africa to another country or increase the deductions in South Africa.⁴³ It applies to transactions between residents and persons that are not resident, and transactions involving persons that are not resident but who have permanent establishments in South Africa, and residents who have permanent establishments outside South Africa. It also applies to transactions between residents and controlled foreign companies outside South Africa.⁴⁴ Section 31(2) provides that if an affected transaction is entered into which results in a tax benefit, the taxable income or tax payable by any person must be calculated as if that transaction had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm's length.

7.1.3 Arm's length principle

The arm's length principle is applied to adjust transfer prices so that they reflect the prices that would have been set between unrelated parties acting independently.⁴⁵ The main transfer pricing methods used to implement the arm's length standard are the following: the comparable uncontrolled

⁴¹ Oguttu *International Tax Law* 213-215.

⁴² The amendment was introduced by the *Taxation Laws Amendment Act 24 of 2011*.

⁴³ See the definition of "affected person" in s 31(1) of the Act.

⁴⁴ Section 1 definition of "connected person".

⁴⁵ OECD *Transfer Pricing Guidelines* 29-39; Arnold and McIntyre *International Tax Primer* 57.

price;⁴⁶ the cost-plus method;⁴⁷ the resale price method;⁴⁸ the profit split method;⁴⁹ and the transactional net margin method.⁵⁰

7.1.4 Connected person

As with the other anti-avoidance measures discussed herein, the transfer pricing rules require there to be some relationship between the parties entering into a transaction. This makes the definition of connected person central to the application of the thin capitalisation provisions contained in section 31 of the Act. It determines the persons whose transactions fall within the ambit of the transfer pricing rules.

A connected person in relation to a natural person is any relative⁵¹ of that person and any trust (other than a portfolio of a collective investment scheme) of which such a natural person or such a relative is a beneficiary.⁵² In relation to a trust (other than a portfolio of a collective investment scheme) this is any beneficiary of such a trust; and any connected person in relation to such a beneficiary.⁵³ In addition, the beneficiaries of a trust are connected persons in relation to one another.⁵⁴ In relation to a member of any partnership or foreign partnership a connected person is any other member; and any connected person in relation to any member of such a partnership or foreign partnership;⁵⁵

⁴⁶ OECD *Transfer Pricing Guidelines* 97-101; Arnold and McIntyre *International Tax Primer* 61.

⁴⁷ OECD *Transfer Pricing Guidelines* 106-113; Arnold and McIntyre *International Tax Primer* 63.

⁴⁸ OECD *Transfer Pricing Guidelines* 101-106; Arnold and McIntyre *International Tax Primer* 62.

⁴⁹ OECD *Transfer Pricing Guidelines* 128-147; Arnold and McIntyre *International Tax Primer* 64-65.

⁵⁰ OECD *Transfer Pricing Guidelines* 113-128; Arnold and McIntyre *International Tax Primer* 66.

⁵¹ Section 1 defines "relative" in relation to any person to mean "the spouse of that person or anybody related to that person or that person's spouse within the third degree of consanguinity, or any spouse of anybody so related, and for the purpose of determining the relationship between any child referred to in the definition of 'child' in this section and any other person, that child shall be deemed to be related to the adoptive parent of that child within the first degree of consanguinity".

⁵² Section 1(a) of the definition of "connected person".

⁵³ Section 1(b) of the definition of "connected person".

⁵⁴ Section 1(bA) of the definition of "connected person" states that a connected person in relation to a trust (other than a portfolio of a collective investment scheme) means any other person who is a connected person in relation to such a trust.

⁵⁵ Section 1(c) of the definition of "connected person".

In relation to a company,⁵⁶ a connected person is

- any other company that would be part of the same group of companies as that company if the expression "at least 70 per cent of the equity shares in" in paragraphs (a) and (b) of the definition of "group of companies" in this section were replaced by the expression "more than 50 per cent of the equity shares or voting rights in";
- any person, other than a company as defined in section 1 of the *Companies Act* that individually or jointly with any connected person in relation to that person holds, directly or indirectly, at least 20 per cent of the equity shares in the company; or the voting rights in the company;
- any other company if at least 20 per cent of the equity shares or voting rights in the company are held by that other company, and no holder of shares holds the majority voting rights in the company.⁵⁷ With regard to the granting of financial assistance, section 31(4) provides that the 20% holding is sufficient to create a connected person relationship regardless of whether any holder holds the majority voting rights in the company or not;
- any other company if such other company is managed or controlled by any person who or which is a connected person in relation to such a company; or any person who or which is a connected person in relation to a person contemplated in item (aa);⁵⁸ and
- where such a company is a close corporation (i) any member; (b) any relative of such a member or any trust (other than a portfolio of a collective investment scheme) which is a connected person in relation to such a member; and (c) any other close corporation or company which is a connected person in relation to the aforementioned member or relative or trust.

A person is a connected person in respect of any other person who is a connected person in relation to that person.⁵⁹ Thus, if I am a connected person to you, then you are a connected person to me.

⁵⁶ The section provides that for the purposes of the definition, a company includes a portfolio of a collective investment scheme.

⁵⁷ Section 1(v) of the definition of "connected person".

⁵⁸ Section 1(vA) of the definition of "connected person".

⁵⁹ Section 1(e) of the definition of "connected person".

The ambit of the transfer pricing rules is widened by the broad definition of a connected person, which applies to a low threshold of holding, and to natural persons that are relatives, as defined. For example, a spouse to a person that is a connected person to a company is a connected person to that company. This casts the net wide as to the application of the transfer pricing rules. The inclusion of the "tax benefit" requirement could potentially limit the application of the rules. If this is not proven, the transfer pricing rules would not apply, similarly to the General Anti-Avoidance Rule. However, considering the wide definition of "tax benefit" to include any tax avoidance, postponement or reduction of any liability for tax, any tax planning product would fall into the definition.

While section 31 is broad in its application, proving that a consideration is not at arm's length is an economic determination, applying the arm's length methods mentioned above. A failure to prove that the transaction does not conform to any of the methods applied could be the demise of the probe into the arm's length characteristics of the consideration. The application of the methods depends largely on the availability of comparisons, more on some than on others.

7.2 Limitation of interest deductions – controlling relationship purchases

Section 23M of the Act limits the amount of interest that can be deducted by a taxpayer (debtor). Section 23M applies to an amount of interest (as defined in section 24J) incurred by a debtor in respect of a debt owed to a creditor that is in a controlling relationship with that debtor; or a creditor that is not in a controlling relationship with that debtor, if that creditor obtained the funding for the debt advanced to the debtor from a person that is in a controlling relationship with that debtor.⁶⁰

A trigger for the limitation in section 23M is that the amount of interest incurred is not during that year of assessment subject to tax in the hands of the person to which the interest accrues; or included in the net income of a controlled foreign company as contemplated in section 9D in the foreign tax year of the controlled foreign company commencing or ending in that year of assessment. In addition, the amount of interest incurred should not be disallowed under section 23N of the Act.⁶¹

⁶⁰ Section 23M(2) of the Act.

⁶¹ Section 23M(2) of the Act.

The gist of section 23M is that it applies to debts directly or indirectly owed to a creditor that is in a "controlling relationship" with that debtor. A "controlling relationship" is defined as "a relationship where a person directly or indirectly holds at least 50 per cent of the equity shares in a company or at least 50 per cent of the voting rights in a company is exercisable by a person".⁶²

Section 23M applies only in respect of interest owed by a category of debtors whose interest payments and deductibility could undermine the South African fiscus. For the purposes of section 23M a debtor is a debtor who is a person that is a resident or 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.⁶³ This definition is aimed at effectively focussing the attention of the limitation of deductibility on payments made by South African tax residents or out of income that could be taxable in South Africa. It is the provision that ensures the protection of the South African tax base.

The amount of deductible interest is limited by way of the application of a formula contained in section 23M(3). In terms of the formula, the maximum amount of interest deductible cannot exceed 60 per cent of the adjusted taxable income of the debtor. The amount of interest allowed to be deducted in respect of all debts owed in respect of any year of assessment must not exceed the sum of (a) the amount of interest received by or accrued to the debtor; and (b) an amount determined by multiplying the adjusted taxable income of that debtor for that year of assessment by a percentage to be determined in accordance with the following formula:

$$A = B \times \frac{C}{D}$$

In this formula:

- (a) "A" represents the percentage to be determined;
- (b) "B" represents the number 40;
- (c) "C" represents the average repo rate plus 400 basis points; and

⁶² The section 23M(1) definition of "controlling relationship".

⁶³ The section 23M(1) definition of "debtor".

(d) "D" represents the number 10.

The only variable numbers in the formula are the amount of interest received or accrued to the debtor and the repo rate. Thus, the amount deductible depends largely on the interest received or accrued, and if no interest is so accrued or received, the maximum amount of interest deductible would be 40% of the adjusted taxable income of the debtor. The more the interest received by or accrued to the taxpayer, the higher the percentage of interest deductible. However, the interest deductible may not exceed 60% of the adjusted taxable income of the taxpayer.

The definition of adjusted taxable income is crucial in the determination of what amount would be allowed as a deduction. Adjusted taxable income is composed of two elements. Firstly, it is taxable income reduced by the interest received or accrued that forms part of taxable income; controlled foreign company income; and any amount recovered or recouped in respect of a capital. Secondly, taxable income is increased by the interest that has been allowed as a deduction, any amount allowed as a deduction in respect of a capital asset and any assessed loss or balance of assessed loss allowed to be set off.⁶⁴

Because section 23M applies to amounts that have not been disallowed in section 23N, if 23N applies to the same amount, section 23N should be considered first before determining whether 23M applies to an amount of interest. This also means that where the amount of interest is considered in terms of a reorganisation and acquisition transaction under section 23N, the provisions of section 23M must be applied to any amount not already disallowed under section 23N.

7.1.1 When does section 23M ever apply?

Section 23M applies where the interest income recipient is not subject to tax on that income. The question is: what does "subject to tax" mean? As a starting point section 1 of the Act defines "tax" as "tax or a penalty imposed in terms of this Act". Thus, "subject to tax" means subject to tax in South Africa.

Withholding tax on interest is a tax levied in terms of the Act.⁶⁵ "Subject to tax" means that the relevant income has to be actually taxable, and the

⁶⁴ Definition of "adjusted taxable income" in s 23M(1) of the Act.

⁶⁵ Section 50A-50H.

customer cannot be exempt from tax on that income.⁶⁶ Thus, interest is subject to tax in the form of withholding tax on interest. In instances where interest is paid to a resident of a country with which South Africa does not have a double taxation agreement, it is clear that the interest will be subject to tax in South Africa (because there is no relief from tax in South Africa) and therefore section 23M would not apply. In instances where the interest is paid to a resident of a treaty partner, a treaty may reduce the tax rate on the interest. For example, the OECD Model Convention reduces the withholding tax rate in the source country to 10%.⁶⁷ In this case, the interest is still subject to tax in South Africa, albeit at a lower rate. Section 23M would apply where the treaty exempts interest from tax in South Africa. Such treaties generally provide as follows:

Interest arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State if such resident is the beneficial owner of the interest and if such interest is subject to tax in that other State.

This is provided for in treaties between South Africa and the following countries: Croatia, Cyprus, Czech Republic, Denmark, Finland, France, Hungary, Ireland, Kuwait, Luxembourg, Netherlands, Norway, Oman, Seychelles, Slovak Republic, Sweden, United Kingdom and United States. Thus, section 23M applies only in very limited circumstances to curb the avoidance of taxation in South Africa by residents of some South African treaty partners. In effect, therefore, through the application of section 23M South Africa limits the elimination of the double taxation benefit afforded by the treaties that it has entered into.

7.1.2 *The amended section 23M*

Section 23M is amended with effect to the year of assessment ending on or after 31 March 2023. The amendment changes the determination of the amount of interest that is disallowed. The salient provision of the amended section 23M is *inter alia* that where an amount of interest is incurred by a debtor during a year of assessment in respect of a debt owed to a creditor

⁶⁶ See *S v Marwane* 1982 3 All SA 405 (AD) on the interpretation of "subject to". Also see Horak 2002 *Acta Juridica* 78; Leshomo *Proposed Interpretation of the Phrase "Subject to Tax"*.

⁶⁷ Article 11 of the OECD *Model Tax Convention* provides as follows: "1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State. 2. However, interest arising in a Contracting State may also be taxed in that State according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest ...".

that is in a controlling relationship with that debtor;⁶⁸ and the amount of interest so incurred or the related interest is not during that year of assessment subject to tax in the hands of the creditor,⁶⁹ the amount of interest allowed to be deducted may not exceed the amount determined in accordance with subsection (3). In terms of the new section 23M(3) the amount of interest allowed to be deducted in respect of controlling relationship debts⁷⁰ must not exceed a sum determined in terms of section 23M(2). The amount determined in section 23M(3) is the sum of the amount of interest received by or accrued to the debtor and an amount determined by multiplying the adjusted taxable income of that debtor by 0.3 must be determined. The sum of these amounts must then be reduced by the excess of the amount of the interest incurred by the debtor in respect of debts (other than controlling relationship debts), as exceeds any amount not allowed to be deducted in terms of section 23N.

If any amount is not included in income, the amount that is not subject to tax will be the amount that would not have been subject to the withholding tax at the rate of 15 per cent.⁷¹ Thus, if the amount of interest is payable to a non-resident who is exempt from the withholding tax on interest in terms of a DTA, the full amount of interest will be deemed to not be subject to tax. Where a resident debtor makes an interest payment and the payment attracts withholding tax on interest at a rate higher than zero but less than the standard rate, a portion of the deduction for interest expense will be subject to section 23M.⁷² This amendment therefore corrects the anomaly outlined in 7.1.1 as to the application of section 23M.

7.3 Limitation of interest deductions – Limitation of interest deductions in respect of reorganisation and acquisition transactions

Section 23N imposes a limit in the case of leveraged asset acquisitions.⁷³ It regulates the amount of interest allowed to be deducted in terms of all debts owed in respect of any year of assessment in which the acquisition

⁶⁸ Section 23M(2)(a).

⁶⁹ Section 23M(2)(i)(aa).

⁷⁰ All debts owed as contemplated in s 23M(2).

⁷¹ Proviso to s 23M(2).

⁷² National Treasury 2022 <https://www.sars.gov.za/wp-content/uploads/Legal/ExplMemo/LPrep-EM-2021-01-Explanatory-Memorandum-to-2021-Taxation-Laws-Amendment-Bill-25-January-2022.pdf> 20.

⁷³ See National Treasury 2020 <http://www.treasury.gov.za/public%20comments/Reviewing%20the%20Tax%20Treatment%20of%20Excessive%20Debt%20Financing,%20Interest%20Deductions%20and%20Other%20Financial%20Payments.pdf> 3.

transaction⁷⁴ or reorganisation transaction is entered into and in respect of five years of assessment immediately following that year of assessment.⁷⁵ It applies to transactions in which an acquiring company⁷⁶ acquires the equity shares of an operating company (referred to as an acquired company)⁷⁷ as a result of which, at the end of the day of that transaction, the acquiring company is a controlling group company in respect of that operating company.

Section 23N applies when an amount of interest is incurred by an acquiring company in terms of a debt—

- directly or indirectly assumed or applied for the purpose of procuring, enabling, facilitating or funding the acquisition by that acquiring company of any asset in terms of a reorganisation transaction;⁷⁸
- used directly or indirectly for the purpose of redeeming, refinancing or settling the debt directly or indirectly assumed or applied for the purpose of procuring, enabling, facilitating or funding the acquisition by that acquiring company of any asset in terms of a reorganisation transaction;⁷⁹
- issued, assumed or used in terms of an acquisition transaction;⁸⁰ or

⁷⁴ "Acquisition transaction" is defined as any transaction (a) in terms of which an acquiring company acquires an equity share in an acquired company that is a company as contemplated in paragraph (a) or (b) of the definition of "acquisition transaction" in s 24O (1); and (b) as a result of which that company, as at the end of the day of that transaction, becomes a controlling group company in relation to that acquired company.

⁷⁵ Interest in excess of the ceiling can be carried forward for deduction in the tax year in which the transaction is entered into and the five tax years thereafter. This is intended to prevent the use of excessive debt mainly to achieve tax savings so that the tax savings become a core element of making the deal viable. See Keep and Makola "South Africa".

⁷⁶ "Acquiring company" is defined in s 23N(1) to mean (a) a transferee company contemplated in the definition of "intra-group transaction" in s 45(1); (b) a holding company contemplated in the definition of "liquidation distribution" in s 47(1); or (c) a company that acquires an equity share in another company in terms of an acquisition transaction.

⁷⁷ "Acquired company" is defined in s 23N(1) as (a) a transferor company or a liquidating company that disposes of assets pursuant to a reorganisation transaction; or (b) a company in which equity shares are acquired by another company in terms of an acquisition transaction.

⁷⁸ Section 23N(2)(a).

⁷⁹ Section 23N(2)(b).

⁸⁰ Section 23N(2)(c).

- used directly or indirectly for the purpose of redeeming, refinancing or settling the debt issued, assumed or used in terms of an acquisition transaction⁸¹

Section 23N(2) provides that the amount of interest allowed to be deducted must not exceed the amount determined in terms of section 23N(3). The amount of interest deducted may not exceed the sum of the amount of interest received by or accrued to the acquiring company and an amount determined in terms of the following formula:

$$A = B \times \frac{C}{D}$$

In this formula—

- "A" represents the percentage to be determined;
- "B" represents the number 40;
- "C" represents the average repo rate plus 400 basis points; and
- "D" represents the number 10.

The amount of the interest deductible may not exceed 60 per cent of the adjusted taxable income of that acquiring company. Adjusted taxable income is specifically defined for the purposes of section 23N and the definition is similar to that in section 23M above, with an addition in the taxable income of 75 per cent of the receipts or accruals derived from the letting of any immovable property.

For example, section 23N applies in the assumed hypothetical facts as follows: Company A is tax resident in South Africa and acquires 75% equity shares in Company B which is an operating company and obtains a loan for the purposes of this acquisition. Company A's taxable income for the year of assessment is R100 million, which consists partly of R20 million of interest. Company A also has a balance of assessed loss of R30 million. Company A's adjusted taxable income will be calculated as R100 million minus R20 million plus R30 million. Thus, the adjusted taxable income will

⁸¹ Section 23N(2)(d).

be R110 million. Company A will then be able to deduct interest amounting only to a maximum of 60 per cent of R110 million, which is R66 million.

8 Withholding tax on interest

Section 10(1)(h) of the Act exempts interest from income tax if the interest is earned by a person that is not resident. However, the exemption does not apply if that person is a natural person who has been physically present in South Africa for a period of 183 days or more in that year of assessment, or if the interest is earned by a person other than a natural person and the interest is attributable to a permanent establishment that such a person has in South Africa. Interest that is exempt as aforesaid is subject to a withholding tax (WHT) on interest in terms of Part IVB of the Act.

The WHT is levied on interest paid to a foreign person to the extent that the interest is regarded as having been received by or accrued to that person from a source in the Republic.⁸² The WHT imposes a tax liability on a payee of interest and a liability to collect that tax on the payor of the interest. It is an administrative mechanism to collect the tax from the person who receives interest, or to whom interest accrues if that interest is from a South African source. Thus, the liability for, and incidence of, the tax on interest rests upon the recipient or payee of the interest. In this regard, section 50C(1) provides that:

[a] foreign person to which an amount of interest is paid is liable for the withholding tax on interest to the extent that the interest is regarded as having been received by or accrued to that foreign person from a source within the Republic in terms of section 9(2)(b).

The WHT is leviable on any interest paid to a foreign person at the rate of 15 per cent.⁸³ The liability to withhold is on the part of the payer of the interest. Any person who makes payment of any amount of interest to or for the benefit of a foreign person is required to withhold an amount of withholding tax on the interest.⁸⁴

Section 50D exempts interest paid by (a) the government of the Republic in the national, provincial or local sphere;⁸⁵ (b) any bank, the South African Reserve Bank, the Development Bank of Southern Africa or the Industrial Development Corporation;⁸⁶ and (c) a headquarter company in respect of

⁸² Section 50C(1).

⁸³ Section 50B(1)(a)(i).

⁸⁴ Section 50E.

⁸⁵ Section 50D(1)(a)(i)(aa).

⁸⁶ Section 50D(1)(a)(i)(bb).

the granting of financial assistance.⁸⁷ Section 50D also exempts the interest paid to specified international bodies and certain specific foreign persons, as will be explained below. Because the interest is paid by the entity giving rise to the exemption, no further requirements are to be met to qualify for the exemption.⁸⁸

8.1 Bank back-to-back anti-avoidance exception

Section 50D(2) provides an anti-avoidance measure for instances where a bank can be used as an intermediary or pass-through entity for interest paid by an entity that does not qualify for an exemption. This could be achieved where a foreign person extends a loan to a resident entity which is not a bank. Under section 50B such interest is subject to the WHT. There is no exemption for that interest in section 50D. The WHT could be avoided by the foreign person's lending the capital to a local bank, and the local bank's on-lending that amount to a local entity (commonly referred to as a back-to-back loan). On payment of the interest the WHT does not apply, as the interest is paid to a resident. When the bank pays the foreign person the interest, such interest would be exempt from WHT as it is paid by a bank. For income tax purposes, the local entity paying the interest could claim a deduction for the full amount of the interest (in terms of section 11(a)) and the bank would also deduct the full amount of the interest on-paid to the foreign person (in terms of section 11(a)). The bank may be taxed on any commission (albeit minimal) earned in terms of the back-to-back loan. In order to curb this form of avoidance, section 50D(2) provides as follows:

Interest paid to a foreign person in respect of any amount advanced by the foreign person to a bank is not exempt from the withholding tax on interest if the amount is advanced in the course of any arrangement, transaction, operation or scheme to which the foreign person and any other person are parties and in terms of which the bank advances any amount to that other person on the strength of the amount advanced by the foreign person to the bank.

Thus, with the application of the exception, the interest paid by a local bank to a foreign person will be subject to the WHT. The local subsidiary will be able to deduct the interest paid to the local bank.⁸⁹ The amount of interest

⁸⁷ The headquarter-company exemption is provided for in s 50D(1)(a)(i)(cc) for "a headquarter company in respect of the granting of financial assistance as defined in section 31(1) to which section 31 does not apply as a result of the exclusions contained in section 31(5)(a)".

⁸⁸ In this regard s 50E(2)(a) merely provides that "[a] person must not withhold any amount from any payment contemplated in subsection (1) to the extent that the interest is exempt from the withholding tax on interest in terms of section 50D (1)".

⁸⁹ Section 24J(2).

received by the local bank will form part of the local bank's gross income but the local bank will be able to deduct the interest paid to the foreign person.⁹⁰ As Stiglingh *et al* state: "[l]ocal banks can therefore not be used as intermediaries for foreign funding to avoid the withholding tax on interest".⁹¹

8.2 Double taxation relief

Relief from withholding tax can be provided by the application of a double taxation agreement (DTA) between South Africa and a foreign country. Section 50E(3) provides for a reduction of the withholding tax. The payee can access treaty relief by providing the payer with a declaration that the interest is subject to a reduced rate as per a double taxation agreement between South Africa and the country of residence of the payee.⁹²

The OECD Model Tax Convention provides for the taxation of interest in the country of residence of the payee of the interest.⁹³ It also gives the country from which the interest is paid a right to tax the interest. However, if the beneficial owner of the interest is a resident of the payee country, then the right of the payor country to tax the interest is limited to 10 per cent of the gross amount of interest.⁹⁴ Other treaties provide for the taxation of interest only in the payee country, thus fully exempting the interest from tax in the payor country. For example, the treaty between South Africa and the United Kingdom provides that "[i]nterest arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State, if such resident is the beneficial owner of the interest".⁹⁵ Thus in this case the United Kingdom has the sole right to tax the interest if the beneficial owner of the interest is resident in the United Kingdom.

In effect, the DTA may reduce the rate to as low as zero per cent. While the Act does not provide for an exemption provided by the DTA, the practical effect is the same. Technically, however, the interest is taxable at the rate of zero per cent. For treaty purposes this means that the payee country

⁹⁰ Section 24J(2).

⁹¹ Stiglingh *et al Silke* 829.

⁹² Section 50E(3)(a).

⁹³ Article 11 of the OECD *Model Tax Convention* provides that "Interest arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable in the other Contracting State".

⁹⁴ Article 11(2) of the OECD *Model Tax Convention*.

⁹⁵ *Double Taxation Agreement between South Africa and the United Kingdom* (2002) Art 11(1).

would treat the interest as subject to tax in South Africa and not exempt from tax. This will affect the relief measures provided in the payee country.

9 Anti-avoidance measures

9.1 *Substance over form*

In a bid to avoid tax taxpayers often disguise their transactions in order to present them as attracting the least amount of tax. "Substance over form" is a common law doctrine (the doctrine) that allows the courts to ignore the form of a disguised transaction, to examine its true nature of the transaction and to attach adequate legal implications to it.⁹⁶ While the doctrine is of general application, the uniqueness of the complexities of transactions involving interest raises the question as to whether this principle could be applied in cases where interest is involved, and if so, how? The Supreme Court of Appeal had an opportunity to decide on a contrived case specifically involving the deductibility of interest - that of *Commissioner for the South African Revenue Service v NWK Ltd (NWK)*.⁹⁷

The facts in *NWK* are quite complex and based on contrived actions and agreements. The salient facts are that FNB lent NWK an amount of about R50 million which was disguised as R96 million by including a series of interlinked and self-cancelling transactions resulting in FNB being in a liquid position to pay the full loan amount to NWK. It was expressly planned and understood that this series of transactions would enable NWK to deduct interest paid on the capital amount (R96 million) in the year it was payable under section 11(a) of the Act. The capital amount would be repaid by NWK in cash and by delivering maize to FNB at the end of the five-year period. The parties agreed that the interest would be payable on the capital sum at a fixed rate per annum, payable every six months.

The Commissioner for the South African Revenue Service (the Commissioner) argued before the Tax Court that the agreements did not reflect the substance of the real transaction. The Commissioner's basis was that the actual transaction was for a loan of R50 million and that the R96 million was a simulation that was intended to increase the amount of interest

⁹⁶ *WT Ramsay Ltd v Inland Revenue Commissioners* [1982] AC 300; 11 ATR 752; *Dadoo Ltd v Krugersdorp Municipal Council* 1920 AD 530. The maxim *plus valet quod agitur quam quod simulate concipitur* loosely translates to "what is actually done is more important than that which seems to have been done" or "the substance of a transaction is more important than its form".

⁹⁷ *Commissioner for the South African Revenue Service v NWK Ltd* 2011 2 SA 67 (SCA) (hereafter *NWK*).

that NWK would be able to deduct.⁹⁸ The Tax Court found that NWK should be able to deduct the interest because it found in favour of NWK that NWK and FNB intended to fulfil all the obligations in terms of the agreements in the matter.⁹⁹

The Supreme Court of Appeal (SCA) held that in order to determine whether the loan and other transactions were simulated, a question had to be asked whether there was a real and sensible commercial purpose in the transaction other than the opportunity to claim deductions of interest from income tax on a capital amount greater than the actual amount that NWK needed, namely R50 million.¹⁰⁰ The court could not find any sensible commercial purpose in the transaction and concluded that what NWK really wished to achieve was a tax advantage.¹⁰¹

In deciding in favour of the Commissioner, thereby upholding the appeal against the order of the Tax Court, the SCA stated as follows:¹⁰²

In my view the test to determine simulation cannot simply be whether there is an intention to give effect to a contract in accordance with its terms. Invariably where parties structure a transaction to achieve an objective other than the one ostensibly achieved they will intend to give effect to the transaction on the terms agreed. The test should thus go further, and require an examination of the commercial sense of the transaction: of its real substance and purpose. If the purpose of the transaction is only to achieve an object that allows the evasion of tax, or of a peremptory law, then it will be regarded as simulated. And the mere fact that parties do perform in terms of the contract does not show that it is not simulated: the charade of performance is generally meant to give credence to their simulation.

In its decision the SCA paid attention to and put emphasis on the circumstances before and during the conclusion of the contracts as these had shed an important light on what the parties intended at the relevant times. In this regard the SCA concluded that the contract had been dressed up in order to create an obligation to pay higher interest, and thus an opportunity for NWK to claim a tax deduction to which NWK was not entitled. It held that NWK deliberately disguised the true nature of the loan for this purpose. It did not intend, genuinely, to borrow a sum approximating the one it purported to borrow.¹⁰³

⁹⁸ *NWK* para 26.

⁹⁹ *NWK* para 37.

¹⁰⁰ *NWK* para 86.

¹⁰¹ *NWK* para 82.

¹⁰² *NWK* para 55.

¹⁰³ *NWK* para 87.

Finally, the court expressed its observation that despite the agreements in relation to the maize, there was never an intention to deliver the maize and, therefore, the agreements in respect of the maize were illusory and merely designed to create a tax benefit in the form of an interest deduction.¹⁰⁴ Thus, in transactions where interest is concerned the SCA has been sufficiently prudent to analyse the transactions with full acknowledgement of the complexity of transactions involving interest and to apply the doctrine accordingly. It is noted that in subsequent cases of *Bosch v Commissioner for the South African Revenue Service*¹⁰⁵ and *Roshcon (Pty) Ltd v Anchor Auto Body Builders CC*¹⁰⁶ the courts acknowledged the complexities involved in *NWK* and distinguished it. In this regard Vorster notes that "the facts considered by the court in *NWK* are most unusual and the reasoning and the remarks of the court in that case must be confined to cases in which its facts are substantially duplicated".¹⁰⁷

9.2 Legislative general anti-avoidance rules applicable to interest

9.2.1 General anti-avoidance provision (GAAR)

The South African tax laws include legislated general anti-avoidance provisions. These provisions allow the South African Revenue Services (SARS) to adjust the tax consequences of a transaction if the transaction falls foul of the provisions.¹⁰⁸ As a general matter the provisions target impermissible avoidance agreements that contain abnormal features and that provide a tax benefit¹⁰⁹ to the parties. An impermissible avoidance arrangement is an arrangement whose main or sole purpose is to obtain a tax benefit. In this regard a transaction that involves interest which is entered into for the sole or main purpose of obtaining a tax benefit and that contains abnormal features could be adjusted for the correct tax consequences to be applied thereto.¹¹⁰ This goes to illustrate the myriad of general and specific provisions that taxpayers need to consider when planning for tax using interest as a tool.

¹⁰⁴ Moosa 2012 *Insurance and Tax Journal* 3-8.

¹⁰⁵ *Bosch v Commissioner for the South African Revenue Service* 2013 5 SA 130 (WCC).

¹⁰⁶ *Roshcon (Pty) Ltd v Anchor Auto Body Builders CC* 2014 4 SA 319 (SCA).

¹⁰⁷ Vorster 2011 *The Taxpayer* 84.

¹⁰⁸ Section 80B(1). Also see Legwaila *et al Tax Law* 513.

¹⁰⁹ As stated in the definition of an "avoidance arrangement" in s 80L.

¹¹⁰ See Legwaila *et al Tax Law* 497-522; Stiglingh *et al Silke* 1115-1135.

9.2.2 *Specific anti-avoidance provisions*

9.2.2.1 Hybrid equity instruments

Section 8E deems dividends received from hybrid equity instruments to be interest in the hands of the recipient of the dividend. The anti-avoidance measure classifies the hybrid equity instruments into four categories, namely (1) redeemable shares that are not equity shares; (2) equity shares with redemption features; (3) preference shares secured by interest-bearing instruments; and (4) equity instruments that derive their value from hybrid equity instruments. The salient characteristics of these instruments are mainly that (1) the borrower is or may be obliged to make repayments in respect of a debt; (2) the debt has some preferential ranking upon liquidation of the issuer; and (3) the return for the investor is based on the interest rate or the time value of money applied to the investment made.

The effect of section 8E is that the recipient of the dividend is deemed to have received interest which is taxed at the corporate tax rate of 28 per cent, noting that if the recipient is a resident company and receives a dividend, the dividend would be exempt from normal tax¹¹¹ and from the dividends tax.¹¹² However, there might be a mitigating factor for the recipient of the interest. While expenditure incurred in the production of dividends is not deductible because dividends are exempt from tax, expenditure incurred in the production of interest might be deductible in terms of section 11(a) provided all the requirements are met.

9.2.2.2 Third party-backed shares

Third party-backed share anti-avoidance provisions aim to curb the avoidance of tax by the recharacterisation of interest as a dividend in the hands of the recipient where a third party directly or indirectly guarantees a dividend to be paid to the holder of the share. The salient provisions of this anti-avoidance provision exclude instances where the guarantee is in terms of an enforcement right against an operating company or an issuer of a preference share if that preference share was issued for a qualifying purpose.

Thus, in a simplified example, section 8EA applies if a Company A issues shares to Company B for R1 million in order to use the R1 million to purchase shares in Company C. Company B then requires Company C to

¹¹¹ In terms of s 10(1)(k)(i) of the Act.

¹¹² In terms of s 64F(1)(a) of the Act.

provide surety that Company A will pay a dividend to Company B, and section 8EA will apply to a dividend paid by Company A to the effect that such a dividend will be deemed to be interest. However, the anti-avoidance provision would not apply if Company C were an operating company.

9.2.2.3 Hybrid debt instruments and hybrid interest instruments

Section 8F and 8FA provisions re-characterise interest income and expenditure where taxpayers attempt to disguise equity instruments as debt instruments in order to benefit from an interest deduction. These hybrid debt and hybrid interest provisions re-characterise any amount of interest accrued by a company in relation to a "hybrid debt instrument" and "hybrid interest" as a dividend *in specie*. As a result of this application, the payor is not allowed to deduct the expenditure on the payment.¹¹³ This neutralises the tax benefit of the restructuring of equity as debt.¹¹⁴ The interest recharacterised as a dividend could be included in the gross income of the payee or be subject to 20 per cent dividend withholding tax in terms of sections 64D to 64N of the Act.

10 Interconnectivity analysis

In the consideration of transactions involving interest the application of the appropriate provision is absolutely essential by both the taxpayer in planning and the tax authority in assessing the taxpayer. In seeking to minimise tax liability, a taxpayer should consider the deductibility of interest in terms of section 24J and, if it fails, consider whether it qualifies for section 24O. The benefit of section 24O is considerable. The next step is to look at the existence or lack of existence of the relationship required to bring the application of the anti-avoidance provisions.

Section 23N applies to instances where there is no relationship, but the tested transaction results in the acquiring company's becoming a controlling group company in relation to the acquired company. This means that the transaction should result in the acquiring company's holding more than 70 per cent of the shares in the acquired company. Section 23N does not depend on the residence or lack thereof of the parties to the transaction.

Section 23M requires that there be a controlling relationship between the debtor and the creditor and that the amount of interest not be subject to tax in South Africa. A controlling relationship requires a 50 per cent equity

¹¹³ Stiglingh *et al Silke* 565.

¹¹⁴ Stiglingh *et al Silke* 565.

holding between the debtor and the creditor. The priority level between sections 23N and 23M is clarified in legislation that 23M applies only to those transactions to which 23N does not apply.

There are also commonalities in respect of the nature of the transactions to which these provisions apply. Transfer applies generally, regardless of the nature of the transaction. Section 23N applies to interest in respect of reorganisation and acquisition transactions which are not excluded from the application of 23M. This is part of the reason why 23N takes preference based on the specificity of the transactions to which it applies. The fact that if the amount of interest is considered in terms of a reorganisation and acquisition transaction under section 23N, the provisions of section 23M must be applied to any amount not already disallowed under section 23N, is of little importance because the formula for the two sections is almost identical (subject to the 2022 amendment to section 23M). Therefore, the amount subject to section 23M will be insignificant if any at all.

Transfer pricing provisions have general application and apply a low equity holding threshold of 20 per cent for financial assistance transactions.¹¹⁵ The National Treasury's Discussion paper proposes that legislation be clarified that companies should first apply the transfer pricing rules before section 23M, i.e. that the interest limitation rules should be applied to the net interest expense that has already passed the arm's-length test.¹¹⁶ I am of the view, however, that such a clarification is not necessary as section 23M(2)(ii) requires that for an amount to be disallowed in terms of section 23M(2) it should not be disallowed under section 23N.

Can section 23M or section 23N apply to the same transaction as section 31? If an equity holder holds 51 per cent of the equity in a company and effects a reorganisation transaction that results in that acquirer's being a controlling group company in respect of the acquired company, both sections 23N and 31 apply. Thus, the interest that could be paid by the acquired company to an acquiring company that is not a resident would be subject to both the fixed ratio rule in section 23N and adjustment in section 31. Similarly, section 23M could apply (because of the 50% holding), if the "subject to tax" requirement is met, together with section 31.

¹¹⁵ The definition of "connected person" in s 1 of the Act in this regard refers to 20% of the equity share or voting rights.

¹¹⁶ National Treasury 2020 <http://www.treasury.gov.za/public%20comments/Reviewing%20the%20Tax%20Treatment%20of%20Excessive%20Debt%20Financing,%20Interest%20Deductions%20and%20Other%20Financial%20Payments.pdf>.

Needless to say, in all this, if the form of the transaction differs from the substance of the transaction, the substance over form doctrine could be applied to ignore the form. Also, the GAAR could apply to the same transaction if it satisfies the specific requirements of the GAAR.

The bank back-to-back exception turns off the exemption for banks. The fact that the exemption no longer applies means that the interest that is subject to the withholding tax on interest payable by a bank would also be "subject to tax" and thus 23M would not apply to it, at least with the tax years before the effective date of the 2021 amendment to section 23M.

11 Conclusion

The ambit of the nature of the provisions applicable to interest is wide. There are accrual provisions, incurral provisions, special provisions that allow interest to be deductible when it otherwise would not be, provisions that limit the deductibility of interest and provisions that curb the avoidance of tax using interest instruments. All these provisions could potentially apply to interest incurred and received in terms of a single transaction. The flexible nature of interest makes it a likely tax avoidance tool. And it is understandable that the legislature would seek extensive measures to curb that potential risk. Inevitably this imposes a tedious and often costly activity on the part of taxpayers to understand how the provisions work and ensure that their transactions are not foul of the law, even when there is no tax evasion or tax avoidance intent.

In tax planning, the parties more than ever need to ensure that the form of the transaction entered into achieves its purpose, without being negatively affected by the anti-avoidance and deductibility limitation provisions. This is especially so if the viability of the transaction depends on the deductibility of the interest. In the end of it all, taxpayers planning transactions could be sufficiently prudent only if they test their transactions against all the potentially applicable provisions. SARS has an arsenal of all these provisions to choose from, and where multiple of them apply, chooses the most drastic of them in the particular circumstances of the taxpayer's transaction.

Having explored the various complex provisions relating to interest, it goes without saying that the correct treatment of interest requires a proper and detailed analysis of the applicable provisions. In the case of uncertainty, taxpayers have available to them the avenue of applying for a private

binding ruling, in terms of which SARS would agree with the taxpayer's tax treatment of the transaction.

The amendment to section 23M is a welcome clarification of the application of the section. By providing an apportionment of the amount that would be deemed not to be subject to tax in South Africa, it clarifies its applicability and ensures that only the amount on which tax would not have been paid in terms of the withholding tax on interest is disallowed.

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List of Abbreviations

CILSA	Comparative and International Law Journal of Southern Africa
CIR	Commissioner for Inland Revenue
DTA	double taxation agreement
GAAR	General Anti-Avoidance Rule
OECD	Organisation for Economic Co-operation and Development
SARS	South African Revenue Service
SCA	Supreme Court of Appeal