SUGGESTED APPROACH

to Drafting Interest Deductibility Legislation

(Excluding the Banking and Insurance Sector)

An ATAF Publication

AFRICAN TAX ADMINISTRATION FORUM

FORUM SUR L'ADMINISTRATION FISCALE AFRICAINE

Copyright notice

The African Tax Administration Forum (ATAF) acknowledges the significant contribution of the World Bank Group whose support and specialised comments added significantly to the quality of this publication.

Series: *ATAF's International Taxation and Technical Assistance Publication*

INTRODUCTION

About this Suggested Approach

ATAF members have reported that the use of third party and related party interest is one of the most prevalent and simple of the profit-shifting techniques used in Africa and poses a significant risk to African tax bases. The fluidity and fungibility of money makes it a relatively simple exercise to adjust the mix of debt and equity in a controlled entity.

Most countries tax debt and equity differently for the purposes of their domestic law. Interest on debt is generally a deductible expense of the payer and taxed at ordinary rates in the hands of the payee. Dividends, or other equity returns, on the other hand, are generally not deductible and are typically subject to some form of tax relief (an exemption, exclusion, credit, etc.) in the hands of the payee. While, in a purely domestic context, these differences in treatment may result in debt and equity being subject to a similar overall tax burden, the difference in the treatment of the payer creates a tax-induced bias, in the cross-border context, towards debt financing. The distortion is compounded by tax planning techniques that may be employed to reduce or eliminate tax on interest income in the jurisdiction of the payee.

In the cross-border context, the main tax policy concerns surrounding interest deductions relate to the debt funding of outbound and inbound investment by groups. Parent companies are typically able to claim relief for their interest expense while the return on equity holdings is taxed on a preferential basis, benefiting from a participation exemption, preferential tax rate or taxation only on distribution. On the other hand, subsidiary entities may be heavily debt financed, using excessive deductions on intragroup loans to shelter local profits from tax. Taken together, these opportunities surrounding inbound and outbound investment potentially create competitive distortions between groups operating internationally and those operating in the domestic market.

Most African countries are capital importers and will be net borrowers rather than net lenders. Taxpayers in African countries are usually the subsidiaries referred to and will usually be net payers of interest rather than net payees. The tax deductibility of interest payments and potential profit shifting through excessive interest payments is therefore of high priority to most African countries.

In some cases African countries have no specific interest deductibility rules to address this profit shifting risk and only have a general deduction rule which limits the tax deductible interest to that interest which has been incurred wholly and exclusively in the production of taxable income. Such a rule provides little protection against the tax planning strategies used to profit shift through excessive interest payments by injecting needed funding into the enterprise by way of debt rather than equity.

Many African countries have tried to address such strategies through legislation that restricts the tax deductible interest by applying a fixed ratio rule linking interest deductibility to the level of equity in an entity, typically through thin capitalisation rules based on a debt/equity test. The main advantage of such a test is that it is relatively easy for tax administrations to obtain relevant information on the level of debt and equity in an entity and it also provides a reasonable level of certainty to groups in planning their financing. However, set against these advantages are a number of important disadvantages. A rule which limits the amount of debt in an entity still allows significant flexibility in terms of the rate of interest that an entity may pay on that debt. Also, an equity test allows entities with higher levels of equity capital to deduct more interest expense, which makes it relatively easy for a group to manipulate the outcome of a test by increasing the level of equity in a particular entity.

In recent years, countries have increasingly introduced fixed ratio tests based on an entity's interest/earnings ratio, which has been found to be a better tool to combat base erosion and profit shifting. In these tests, the measure of earnings used is typically earnings before interest, taxes, depreciation and amortisation (EBITDA). Most countries presently use a tax measure of EBITDA.

This fixed ratio approach issue of an entity's interest/taxable earnings ratio was recommended in the Action

4 Report of the G20/OECD BEPS (Base Erosion and Profit Shifting) Project. Through its Cross Border Taxation Technical Committee ATAF actively participated in the BEPS project's work on Action 4 and are of the view that the recommendations in the Action 4 report provides an appropriate basis for drafting interest deductibility rules in Africa.

The Suggest Approach is based on a fixed ratio rule which limits an entity's net interest deductions to a fixed percentage of either its taxable income or its profit, measured using earnings before interest, taxes, depreciation and amortisation (EBITDA) based on tax numbers. This is a straightforward rule to apply and ensures that an entity's interest deductions are directly linked to its economic activity. It also directly links these deductions to an entity's taxable income, which makes the rule reasonably robust against planning.

A fixed ratio rule provides a country with a level of protection against base erosion and profit shifting, but such an approach does not take into account the fact that groups operating in different sectors may require different amounts of leverage, and even within a sector some groups are more highly leveraged for non-tax reasons. The Suggested Approach therefore, provides the option of combining a fixed ratio rule with a group ratio rule which allows an entity to deduct more interest expense in certain circumstances.

The Suggested Approach also provides for further options depending on a country's specific policy objectives. These include an option to remove entities which pose the lowest risk from the scope of a general interest limitation rule by applying a De Minimis threshold based on a monetary value of net interest expense. Taxpayers falling below this threshold may deduct interest expense without restriction.

Rules which link interest deductions to EBITDA raise issues where an entity's interest expense and earnings arise in different periods. This may be the result of volatility in earnings which means the ability of a company to deduct interest changes from year to year, or because an entity has incurred interest expense to fund an investment which will give rise to earnings in a later period. To reduce the effect of these issues, there is an option in the Suggested Approach which permits taxpayer's to carry forward disallowed interest expense or unused interest capacity for use in future periods. It is suggested countries consider imposing limits on such carry forwards.

Contact persons

Should you have questions or comments on the attached, please feel free to contact the ATAF Secretariat on:

Telephone: +27 12 451 8800
E-Mail: info@ataftax.org