

**THE DEDUCTIBILITY OF INTEREST EXPENDITURE
IN LEVERAGED BUYOUT TRANSACTIONS
UNDER SOUTH AFRICAN INCOME TAX LAW
A CRITICAL EXAMINATION OF RECENT DEVELOPMENTS**

by

DAVID DEETLEFS

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Statement

Research dissertation presented for the approval of the Senate in fulfilment of part of the requirements for a Postgraduate Diploma in Tax Law (PG. Dip. Tax Law) at the University of Cape Town. The other part of the requirement for this qualification was the completion of a programme of courses.

I hereby declare that I have read and understood the regulations governing the submission of PG. Dip. Tax Law dissertations, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation conforms to those regulations.

David Deetlefs

15 September 2014

PART I – OVERVIEW

1 Introduction

During the 2012 United States presidential contest between then Democratic Party nominee Barack Obama and his Republican challenger, Mitt Romney, much was made by both sides of Mr Romney's experience at Bain Capital, the fabled private equity firm which Mr Romney founded and ran before moving into politics. Whilst Mr Romney's supporters contended that such experience was the prescribed tonic for the financial woes America faced after the onset of the global financial crisis and would help to solve the deepening unemployment faced by America, Democratic Party supporters and Mr Romney's detractors argued that private equity industry destroyed, not created, jobs, and served only as a vehicle to enrich its investors and managers to the detriment of the companies which it invested in.

At the core of the Democrats' argument were, by layman's standards, fairly complex debates surrounding the tax treatment of the income earned by private equity firms' managers and investors and the effects on the companies which were targets of the leveraged buyout transactions which they conducted. Whilst a part of this debate circled the treatment of carried interest (being the interest of the private equity firms' managers in the outcome of the transactions), much of the controversy centred around what was portrayed as an abuse of corporate interest deduction principles, which typically allow for the deductibility of interest on debt used by an acquirer to finance a leveraged acquisition. The application of this latter principle has arguably been the primary driver behind the growth of the private equity interest from its turbulent beginnings to its current status as a multi-trillion dollar global industry and asset class in its own right. In recent years, however, this same principle has globally been the subject of much debate, and its application is often maligned for putting the interests of the acquirer ahead of the risks imposed on the target firm, its stakeholders and employees.

Although the United States' presidential election may have brought corporate tax policy in respect of private equity and leveraged buyout (or **LBO**) transactions into the spotlight and the general principles governing the tax treatment of such transaction to the attention of the general public for the perhaps first time, the subject has increasingly come under scrutiny by tax authorities and practitioners. Recent tax reforms have targeted the industry

in the United States and Europe¹ as well as more recently, closer to home in South Africa, where the private equity industry has mushroomed since its beginnings following a spate of privatisations in the late 1990s.² It is clear that the private equity industry's economic importance and high public profile has ensured that it will continue to attract greater scrutiny from tax authorities globally. In this respect, the South African revenue authorities: the South African Revenue Service (**SARS**) and the Department of the National Treasury (the **Treasury**) have indicated on several occasions both concerns about, and an interest in, various facets of the industry. In the last 3 years a slew of amendments to the Income Tax Act No 52 of 1968 (the **Act**), have firmed SARS' stance on the matter, and provided fodder for comment by the private equity industry, whilst significantly altering the tax landscape for all participants in South African leveraged transactions.

The aims of this paper, then, are twofold: first, to provide an overview of the South African tax law principles governing the deductibility of interest expenditure incurred by taxpayers in respect of LBO transactions, as altered by the recent changes to the Act, and secondly, to critically consider and comment on the nature and perceived effect of such amendments.

A high-level understanding of the highly-leveraged transactions for which the private equity industry is so well known will be needed to judge the effects of recent changes wrought to the South African tax landscape in relation to (in SARS' view) excessive

¹ Interest deductibility has been one key area of focus. As discussed later in this paper, tax authorities are globally moving to protect their tax bases by tightening the regulations on how — and how much — interest may be deducted. Along with South Africa; Finland, Germany, and Spain have also introduced new (and tighter) thin capitalization regimes, and Australia, Belgium and the Netherlands are also in the process of doing the same, whilst in Japan, new rules limit the deductibility of interest expense on loans from non-Japanese related parties and on loans guaranteed by related parties. In France, a new mechanism aims to limit the deduction of interest related to debt used to acquire shares in companies in other jurisdictions. 'Global M&A tax survey and trends' *EY*, 2012, available at http://www.ey.com/GL/en/Services/Tax/Global_M_A_tax_survey_and_trends, accessed on 12 March 2014.

² Funds under management by private equity firms have grown almost 500% in the past 14 years, to R162.2 billion in 2013. SAVCA & KPMG 'Venture Capital and Private Equity Industry Performance Survey of South Africa covering the 2013 calendar year', *South African Venture Capital Association*, June 2014, available at <http://www.kpmg.com/ZA/en/IssuesAndInsights/ArticlesPublications/General-Industries-Publications/Documents/2014%20KPMG%20SAVCA%20Private%20Equity%20Survey%20-%20final.pdf>, accessed on 15 July 2014.

interest tax deductions. Accordingly, in order to assess the effectiveness, extent and consequences of these changes and the current state of play in South Africa, this paper begins with a brief overview of the private equity industry together with a consideration of the use of the typical private equity transaction structure.

2 Private equity and LBOs

2.1 What is private equity?

Private equity is, in the broadest sense, not a modern phenomenon; history is littered with examples of the financing of private ventures by the wealthy for a share in profit and glory generated by those willing and able to take the risks required. From Queen Elizabeth I's support of Sir Francis Drake's privateering and Columbus' sponsorship by King Ferdinand and Queen Isabella' of Spain in the 16th century to today's multibillion dollar private equity firms such as The Blackstone Group, KKR and The Carlyle Group, centuries of wealthy capitalists have entrusted their money to advisors and risk-takers who have been entitled to retain a portion of the returns of their own benefit.

In a modern context, the beginnings of the private equity industry are usually traced to the emergence of highly leveraged transactions carried out by corporate raiders in the 1980s. Then, as now, the term private equity generally denotes the investment of equity capital in private, as opposed to publicly listed companies,³ but the processes and transactions which have brought the industry its reputation are somewhat more complex. To facilitate this process private equity firms raise capital from investors and use the proceeds to make investments in acquisitions of (typically private) companies, or interests in companies, with a view to improving the prospects and results of such companies. Thereafter, such interests are disposed of in a defined period to generate a profit for their investors. In the United States particularly, the private equity industry has a storied history, and the firms and their principals are household names, with many private equity firms' transactions being the subject of intense media coverage and

³ *Ibid.*

critically acclaimed books. In South Africa, whilst the scale of private equity is smaller, the industry's growth has continued unabated since the 1980s when deregulation and unbundling of state-owned enterprises provided fuel for growth in South Africa. Today, the South African private equity landscape is dotted with both international and local firms eager to cash in on Africa's projected growth over the upcoming decades.

Although there is no standardized structure for private equity firms or investments, private equity firms usually raise 'funds' which are structured as legal partnerships, with investors contributing capital in their capacity as limited partners and having rights to participate in the majority of the profits, and the private equity manager acting as general partner and earning a fee (typically 2% of the value of the fund plus 20% of the value of the profits generated). From a tax perspective, partnerships are generally viewed by tax authorities as tax transparent 'pass-through' entities, that is to say, the income of the partnership is treated as income of the partners and is not taxed in the hands of the partnership, but in the hands of the partners.

2.2 Private equity transaction structures: Leveraged buyouts

Similarly, while there are no hard-and-fast rules as to what constitutes a private equity transaction (other than, perhaps, the nature of the purchaser), private equity firms typically purchase private closely-held companies or take private publicly traded companies and restructure their operations out of the glare of public scrutiny before selling the companies in part or in whole, or offering the shares in the company through an initial public offering and listing.

2.2.1 *Leverage*

One characteristic feature of private equity transactions is the use of debt, or leverage, in the purchase of the target company from existing shareholders. Instead of merely using investor's funds to facilitate the purchase of acquisition targets, private equity firms tend to borrow heavily to finance the payment of the purchase consideration to vendors. Indeed, during their halcyon days in the 1980s, (and prior to the completion of a nifty public relations exercise) private equity firms were widely known as 'leveraged buyout' firms and typical transactions involved in excess of 80% debt and

only 20% equity.⁴ In the wake of the 2008 global financial crisis, debt : equity levels have typically been closer to 40:60.⁵ On exit from the investment, all the profit after repayment of debt and financing charges is distributed to private equity investors and managers; the leveraging of the transaction translating into far superior returns on equity investors' capital.

To illustrate by way of a simplified example, in a transaction where the purchase price of R100m paid for a company (Company A) is funded purely by the purchaser's equity and Company A is later sold for R200m, the profit generated by the sale is R100m – a gain of 100% measured against the initial investment. By contrast, where the R100m purchase price for Company A is funded by a combination of 20% equity and 80% debt, on the sale of the stake for R200m, after repayment of the R80m loan (and any financing charges) and the initial R20m equity investment, R100m (less any financing charges paid in respect of the debt) is available for distribution – a hypothetical gain of 500% (less any financing charges) when measured against the purchaser's initial R20m equity investment.⁶

2.2.2 *Interest deductibility and tax shield advantages*

From a tax perspective, international tax norms generally recognise interest paid in respect of debt as a business expense which is deductible from taxable profits for companies, and so (subject to the restrictions and limitations discussed in this paper) private equity firms have an additional incentive to leverage investments. This is because of the so-called tax shield generated by increased borrowings – increased

⁴ In 1988 the average equity contribution to LBOs conducted in the United States was 9,7%. J Olsen 'Note on Leveraged Buyouts' *Center for Private Equity and Entrepreneurship, Tuck School of Business at Dartmouth* (1999), available at http://pages.stern.nyu.edu/~igiddy/LBO_Note.pdf, accessed on 15 July 2014.

⁵ Although having recovered somewhat since 2008, the average equity contribution in LBO transactions in the United States and Europe today is usually around 40%. In African transactions, equity contributions are typically somewhat higher at between 70% and 80%, reflecting both the poorer access to capital on the continent and the relative risk aversion of African banks. 'Analysis of Private Equity Multiples in South Africa', *Riscura Fundamentals*, available at <http://www.brightafrica.riscura.com/analysis-of-private-equity-multiples-in-africa.php>, accessed on 15 July 2014.

⁶ As Theodore Forstmann, one of the pioneers of the private equity industry and founder of the private equity firm Forstmann Little, is reported to have said, 'The "L" in LBO is what makes it so profitable'.

interest and finance charges related to increased levels of borrowings ultimately reduce the amount of tax payable and lead to higher absolute aggregate returns to debt and equity investors.

To illustrate this, assume a company, Company B, has a Net Asset Value of R1 billion and generates Earnings Before Interest and Taxes of R200m. Assume further that Company B is solely funded by R1 billion in equity contributions from shareholders, and thus has no interest payments to make to lenders. In this example, Company B would generate a Net Profit Before Tax of R200m and (assuming a flat tax rate of 28%) would be able to distribute profits after tax of R144m to shareholders.

Meanwhile an almost identical company, Company C, with identical Net Asset Value and Earnings Before Interest and Tax is funded by 70% equity (i.e. R700m) and 30% debt (i.e. R300m), which carries financing charges at an interest rate of 10% per annum. Whilst Company C would still generate Earnings Before Interest and Taxes of R200m, after deducting R30m in interest charges it would only generate a Net Profit Before Tax of R170m and be able to distribute profits after tax of R122.4m to shareholders. However, Company C's aggregate returns to both debt and equity investors is R152.4m, comprising the R30m in interest paid to lenders, and equity returns to shareholders of R122.4m – R8.4m more than the returns to investors generated by Company B.

The additional amount available to investors in the latter scenario is equal to the reduction in tax paid due to the deduction of interest in determining the taxable income of Company C. This effect is known as the interest tax shield. Because no corporate tax deductions are generally available to companies on distributions made to equity investors, companies therefore have an additional incentive to use debt rather than equity. However, debt and equity have fundamentally different characteristics and the use of debt is not without its risks; historically many private equity investments have failed under the heavy load of debt repayments forced upon them as a result of LBOs.

Despite this, the use of significant debt continues to be an important part of such transactions; due to (a) the expectation of the deductibility of interest (albeit only provided that the transaction is appropriately structured), and (b) what is typically termed the 'double taxation of dividends'. The latter terms refers to the perceived

double taxation of returns on equity (as opposed to debt): with corporate profits being taxed first in the hands of the company and then in the hands of the shareholders through dividends tax on distributions and capital gains tax on any realisation of shares held; whereas corporate earnings applied to service and repay debt are taxed only once, in the hands of the lender.⁷

In this context, both internationally and in South Africa, much of the public debate around private equity has focussed on the effects of debt financing and the effects of the incentives provided by deductibility of interest both for companies, on the one hand, and the fiscus, on the other. From a policy perspective, the use of excessive debt has been argued to both increase the risk of individual business failures and more generally to introduce systemic credit risk into domestic markets. Perhaps more pertinently, from the perspective of the revenue authorities, the use of LBO structures has the potential to undermine the tax base and reduce tax revenues to the fiscus. As fiscal revenues have declined alongside economic growth following the onset of the global financial crisis, LBO transactions have accordingly come under increasing scrutiny and been the subject of changing tax laws both at home and abroad.

The remainder of this paper will examine the South African taxation rules applicable to interest deductions, both generally, and specifically in relation to LBOs, and thereafter attempt to assess the suitability of such rules in context.

PART II – PRINCIPLES OF THE DEDUCTIBILITY OF INTEREST EXPENDITURE

3 General principles regarding the deductibility of expenditure and losses

The deductibility of expenditure, for the purpose of determining the taxable income on which normal tax must be levied, has been examined and developed by South African courts for the better part of last century. However, new and unique propositions continue

⁷ HM Somers *Leverage: The Tax Incentives* (1991) No 625, UCLA Economics Working Papers, UCLA Department of Economics.

to confront legislators, revenue authorities and the courts and challenge existing interpretations.

In general and in the absence of specific provisions, in determining the taxable income of a taxpayer, the deductibility of expenditure incurred is determined with reference to section 11(a) of the Act, which provides that:

'For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived –

(a) expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature . . . '.

This section must be read in conjunction with section 23(g), which prohibits the deduction of any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purpose of trade.

For the sake of completeness, the term 'taxable income', referred to in the preamble to the section 11(a) is calculated by deducting from 'gross income' as defined in section 1, amounts exempted from tax in terms of sections 10 and 10A of the Act (such as, for example, dividend income) (the result being 'income' as defined), and then deducting from income 'all the deductions allowed . . . to be deducted [from] or set off . . . ' .⁸ The generation of (non-exempt) income is therefore a prerequisite for the deduction of expenditure.

This proposition is generally referred to as the 'general deduction formula' and can be seen to comprise five key elements, namely that deductions shall be allowed from a taxpayer's taxable income in respect of (1) *expenditures and losses* (2) which are *actually incurred*; (3) *in the production of income*; (4) are *not of a capital nature* (5) and are incurred for *the purposes of carrying on a trade*.

Accordingly, much of the juridical commentary on the deductibility of expenditure centres around considerations of these five elements and in particular, around what,

⁸ Section 1 of the Income Tax Act 58 of 1962.

exactly, constitutes the production of income (and indeed what constitutes income) as well as attempting to clarify where expenditures and losses are not of a capital nature. Of all the elements, however, the two most significant in LBO transactions are the determinations of whether an expense is incurred in the production of income (and indeed, what constitutes income), and when one can be said to incur an expense for the purposes of trade.

In determining whether income is produced, the courts have held that the 'income' referred to is taxable income, as indicated in the pre-amble to section 11, and accordingly excludes tax-exempt income, such as dividends.⁹ As discussed later in this paper, this determination has been of significant historical importance in the structuring of leverage buyout transactions. Where the courts have been called upon to assess whether an expense has been laid out for the purposes of trade, it has typically been in the context of whether an activity is carried on for the purposes of trade where no profit is gained, or in certain circumstances, expected to be gained. In this respect it has been held that whilst the possibility of attaining a profit is an important, and in certain instances, decisive factor, in determining whether the expenditure is laid out or expended for the purpose of carrying on a trade, it is not the only factor.¹⁰ In the context of leveraged buyout transactions where the acquired target company, may, post-acquisition, be rendered loss-making (at least in the short-term) due to the imposition of significant interest costs,¹¹ the importance of this determination from the perspective of the private equity industry cannot be understated.

⁹ *CIR v Nemojim (Pty) Ltd* 1983 (4) SA 935 (A) at 946H-947C.

¹⁰ *ITC 1404* 48 SATC 1 where the court held that although the taxpayer had incurred losses in the operation of its business, the losses were incurred in the carrying out of a trade, as on the facts the taxpayer had intended, at least in the medium term, to make a profit.

¹¹ The 2007 buyout of Edcon Holdings Limited (**Edcon**) by private equity firm Bain Capital for R25bn is a striking case in point – despite rising revenues Edcon recognized a net loss after interest in the year following its acquisition, whereas it had realized a profit after interest the year before. 'Edcon Holdings Limited Annual Report for the period ended 29 March 2008', *Edcon Holdings Limited*, available at https://www.edcon.co.za/pdf/annual_reports/annual_report_2008.pdf, accessed 30 June 2014.

Edcon continues today to struggle with its debt service requirements to this day - see S Thomas 'Edcon: Fallen Superstar', *Financial Mail*, available at <http://www.financialmail.co.za/moneyinvesting/2014/06/12/edcon-fallen-superstar>, accessed 20 June 2014.

4 Specific Principles Regarding the Deductibility of Interest Expenditure

In the context of a leveraged buyout transactions, the pertinent question asked by dealmakers in structuring transactions is often whether the interest incurred by the taxpayer in respect of debt use to finance the transaction may be deducted. This question often turns on whether that interest expenditure can said to be incurred in the production of income. As noted in the general principles canvassed above, interest on debt borrowed to acquire shares has historically (in the absence of the taxpayer being deemed to be a share dealer or there being an ulterior purpose for the acquisition) not been deductible, as shares cannot be said to generate taxable income, only exempt dividend income.

Given that the shares in a company are often the target of the acquisition,¹² transaction participants have come up with novel ways in order to ensure the deductibility of interest in a share acquisition, notwithstanding the principles laid out above. Whilst SARS have not historically sought to challenge such structures, these have come under examination more recently. As dealt with more fully in the Part III, this examination has primarily been drive by SARS concerns around so-called 'excessive' interest tax deductions, leading to tax base erosion, which SARS (and other tax authorities) view as a threat to tax revenues, tax sovereignty and tax fairness.

4.1 General

The deductibility of interest expenditure is an enduring source of conflict between the Commissioner for SARS (**Commissioner**) and taxpayers, particularly in the context of LBO transactions where transactions often appear (at least to the Commissioner) to be structured in a manner which will ultimately lead to depriving the fiscus of tax revenue.¹³ Whilst there are various factual scenarios which can give rise to such an outcome, the most common is that the lender is exempt from tax or taxed at a low rate in respect of the

¹² Commercially, there may be various reasons to prefer a share acquisition to a business or asset acquisition, other than merely tax incentives. For example, acquiring an investment in a business as an ongoing concern (rather than through an outright share purchase) places all non-assignable contracts at risk of termination.

¹³ SARS, in fact, attacked the Edcon's tax treatment of interest payable on the financing of the acquisition of its Bain Capital on this basis. The parties ultimately reached a settlement agreement.

interest income (for example, a non-resident¹⁴ or a pension fund¹⁵) and the borrower still receives a tax deduction in respect of the interest expense.

The remainder of this section of the paper will briefly present the principles specifically applicable to the deductibility of interest expenses in the determination of taxable income in a general context, as developed by the courts, whilst the following section shall examine the specific changes wrought to the Act over the preceding 3 years by the Treasury in an effort to tackle 'excessive' interest deductions.¹⁶

4.2 Definition of 'interest'

Section 24J (*Incurral and accrual of interest*) of the Act legislates the deduction of interest and principally serves to regulate the timing of the incurrence and accrual of interest in respect of debt instruments (i.e. interest-bearing arrangements). Though the term 'interest' is now defined in section 24J of the Act, as including, inter alia, the gross amount of interest or related finance charges, discount or premium payable in respect of any financial arrangement, the term had previously been judicially defined by Schreiner JA in *Commissioner for Inland Revenue v Genn & Co (Pty) Ltd*¹⁷ as payment made for the use of money, akin to rent. The spirit of this definition continues to inform the interpretations of the statutory definition.

4.3 Deductibility of interest expenditure

Section 24J contains the same requirements for deductibility that interest be incurred 'in the production of income' and 'for the purposes of carrying on a trade' as outlined in the general deduction formula and to this end provides that –

¹⁴ Section 10(1)(h).

¹⁵ Section 10(1)(c).

¹⁶ As discussed later in this paper, the notion of what constitutes 'excessive' interest is not always clear, and the rationale given by the Treasury in this respect appears quite subjective.

¹⁷ *CIR v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A) wherein Schreiner JA stated that 'the commission together with the interest formed in effect one consideration which the company had to pay for the use of the money for the period of the loan'

'(2) Where any person is the issuer in relation to an instrument during any year of assessment, such person shall for the purposes of this Act be deemed to have incurred an amount of interest during such year of assessment, ... which must be deducted from the income of that person derived from carrying on any trade, if that amount is incurred in the production of the income'.¹⁸

Accordingly, where it is paid in respect of monies borrowed to finance the production of income, interest is generally deductible, and where it is incurred in respect of monies borrowed to be applied otherwise than in the production of income (i.e. not in connection with the income-earning business of the taxpayer) it will generally be disallowed.¹⁹ The case law on the deductibility of interest expenditure which preceded the introduction of section 24J still provides guidance on the application of this principle to LBO transactions. In accordance with the general principles governing deductibility of expenditure, the interest expense must therefore be incurred in connection with the production of income. Of course, interest expenditure itself cannot accurately be said to generate income, and it is the borrowings which give rise to the interest payments or accruals which must bear a sufficiently close connection to the production of income in order for the expense to be deductible.

In the event of leveraged acquisition of the business and assets of a company, the borrowings of the purchaser are used to finance the payment of the purchase consideration to company, as seller of the business and assets. In such a case the interest incurred in financing the acquisition of assets will generally be said to be sufficiently closely connected to the production of income of the taxpayer (where it has acquired income-producing assets), and as such the expenditure may be deducted, regardless of whether the assets are fixed or current assets,²⁰ provided that the interest expenditure incurred is not a capital nature. In this regard, interest expenditure incurred or paid is generally seen to be of a revenue nature. But, where the debt giving rise to the interest is

¹⁸ Section 24J(2)

¹⁹ *Financier v COT* 1950 SR 69.

²⁰ *CIR v Genn & Co* supra (n17).

used to fund the acquisition of an asset which does not produce income, the interest would be deemed to be of a capital nature.

Accordingly, prior to the recent amendments to the Act, a leveraged acquisition of shares in a company would not give rise to an allowable deduction in respect of the relevant interest expenditure to the extent that the shares produce only tax-exempt income. The judgments given in the cases of *CIR v Shapiro*²¹ and *CIR v Drakensberg Gardens*²², prior to the recent amendments to the Act, serve as useful illustrations of the application of this principle.

4.3.1 *CIR v Shapiro*

In this instance, the taxpayer applied monies borrowed to purchase shares in a private company. As part of the acquisition transaction the taxpayer was appointed as the managing director of the company, with salary, housing allowance, and commission payable as a result.

The Commissioner disallowed the deduction of the taxpayer's interest paid on his borrowings as a deduction in the calculation of his taxable income. On appeal to the provincial division, the taxpayer contended that the interest expense was incurred in respect of borrowings in connection with the salary earned by the taxpayer (in his capacity as managing director). This submission was, however, rejected by the court on the basis that the purchase of the shares merely facilitated the appointment of the taxpayer as managing director. Accordingly, the income which was produced in connection with the purchase (i.e. dividends) was deemed to be tax-exempt income, and the interest expenditure could not be said to have been incurred in the production of income.

²¹ *CIR v Shapiro* 1928 NPD 436.

²² *CIR v Drakensberg Gardens* 1960 (2) SA 475 (A).

4.3.2 *CIR v Drakensberg Gardens*

In this case the Court held that the taxpayer, a hotel company, was entitled to claim a deduction for the interest charges incurred on borrowings used to acquire shares in a property owning company which leased premises to the taxpayer. The Court agreed that the taxpayer's purpose in borrowing the monies to purchase the shares in the company was to ensure security of tenure and all rights for the hotel, and was therefore sufficiently closely connected to meet the requirement that the expense be incurred in the production of income.²³

Prior to the amendments to the Act discussed in Part III below, it has thus been considered trite law that interest expenditure on borrowings to acquire shares in a company which resulted only in the receipt of dividends for the acquirer would not satisfy the general deduction formula. In such instances, interest expenditure would not have been incurred in the production of income and would therefore not be allowed as a deduction.

4.3.3 *Other relevant tax legislation*

Sections 41 to 46 of the Act provide for tax-neutral treatment of the transfer of assets in intra-group transactions (i.e. between companies forming part of the same group). The most commonly utilised form relief, in the context of LBO transactions, is that provided by section 45 of the Act, which applies in any transaction where the acquirer and target company form part of the same group of companies at the closing of the transaction. In terms of section 45(2) of the Act,–

(2) Where a transferor company disposes of–

(a) a capital asset in terms of an intra-group transaction to a transferee company which acquires it as a capital asset–

²³ *CIR v Drakensberg Gardens* supra (n 33) at 285.

(i) the transferor company must be deemed to have disposed of that asset for an amount equal to the base cost of that asset on the date of that disposal; and

(ii) that transferor company and that transferee company must, for purposes of determining any capital gain or capital loss in respect of a disposal of that asset by that transferee company, be deemed to be one and the same person with respect to-

(aa) the date of acquisition of that asset by that transferor company and the amount and date of incurral by that transferor company of any expenditure in respect of that asset allowable in terms of paragraph 20 of the Eighth Schedule; and

(bb) any valuation of that asset effected by that transferor company as contemplated in paragraph 29 (4) of the Eighth Schedule'.

Effectively, by treating the transferor and the transferee company as 'one and the same person' this section allows qualifying transactions to be largely protected from the normal tax consequences (taxable profits and capital gains, dividend tax, recoupment of allowances) which would usually be applicable to such transactions, with the tax effects 'rolled-over' to a later date when the relevant assets cease to be part of the group.

Whilst, on the face of it, section 45 appears to apply only to transactions where a group of companies merely rearranges its internal structure and affairs, as discussed in the following sections of this paper, this seemingly innocuous section has generated a significant amount of controversy and legislative upheaval due its use in LBO transactions. As will be seen in the discussion in the following section on the typical structure employed in a LBO, the use of section 45 has historically allowed purchasers to deduct interest on the acquisition of assets, yet still ultimately retain a corporate structure which allows for a shareholding in a company which owns the relevant assets, rather than direct ownership of the assets themselves – despite the fact that debt incurred for the purposes of acquiring a shareholding cannot be said to be incurred 'in the production of income'.

5 Typical structure of a leveraged buyout transaction and interest deductions

5.1 Typical structure and interest deductions

Although there are a number of concerns and factors competing for attention in any transaction, not least of all being the commercial rationale, tax savings are a key transaction driver²⁴ and, all else being equal, may influence the parties decisions around the structure of the transaction.²⁵ As discussed earlier in this paper, this may be particularly the case in a private equity transaction, where the acquirer intends to sell the acquired company to realise a profit at the end of the term of its fund's investment, and so its returns are judged more favourably where its initial investment is minimised by the employment of greater debt and the acquisition target's earnings are increased by the reduction in taxes and the application of the tax shield effect.

As highlighted in the section above, dividends constitute tax-exempt income²⁶ and accordingly, where a taxpayer pays interest on monies borrowed to finance the acquisition of shares, such expenditure would, prior to recent amendments to the Act, not be deductible in the hands of the taxpayer as it would not be said to incurred in the production of income. However, in situations where the taxpayer has been able to show that the income produced as a result of the acquisition financed by the borrowings is not tax-exempt income (for instance, a salary or management fee), the courts have allowed the deduction of a portion the relevant income expenditure.

As a result of this distinction between interest deductibility in share and asset acquisitions, leveraged buyout acquisitions of businesses and assets in South Africa have typically made use of the intra-group relief provisions contained in the corporate rules, and in particular, the provisions of sections 44, 45 and/or 47 in order to take advantage of the various benefits of leveraging described in Part I above, including, no doubt, the

²⁴ 'Global M&A tax survey and trends', *EY* op cit (n1).

²⁵ Importantly, South African courts have consistently applied the view expressed in *CIR v Conhage (Pty) (Ltd) 1999 4 SA 1149* that 'within the bounds of any anti-avoidance provisions in the relevant legislation, a taxpayer may minimise his tax liability by arranging his affairs in a suitable manner'.

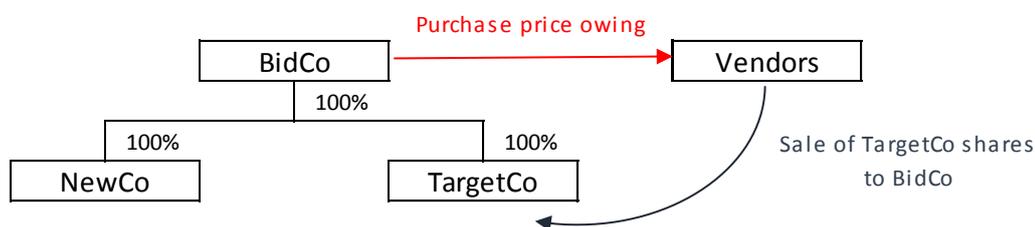
²⁶ Section 10(1)(k).

tax shield advantages thereof. To this end, a number of such transactions have similar structures, which although they may differ from transaction to transaction, are frequently conducted along the same broad lines; described below in their simplest form.

Step 1: A private equity fund incorporates a company (**BidCo**) to make an offer to the vendors (**Vendors**) of the target business (**TargetCo**) and to carry out the transaction. Simultaneously, another company (**NewCo**) would be established as a wholly-owned subsidiary of BidCo.

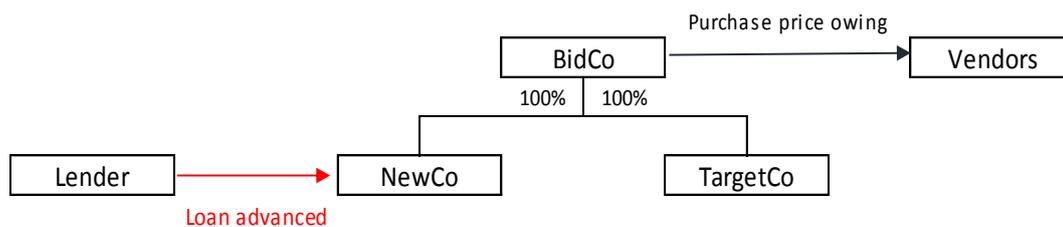


Step 2: BidCo acquires all the issued shares in the target company (**TargetCo**) from the shareholders of TargetCo (**Vendors**) for an agreed purchase consideration, payable by the creation of a loan account in the books of BidCo in favour of the Vendors.

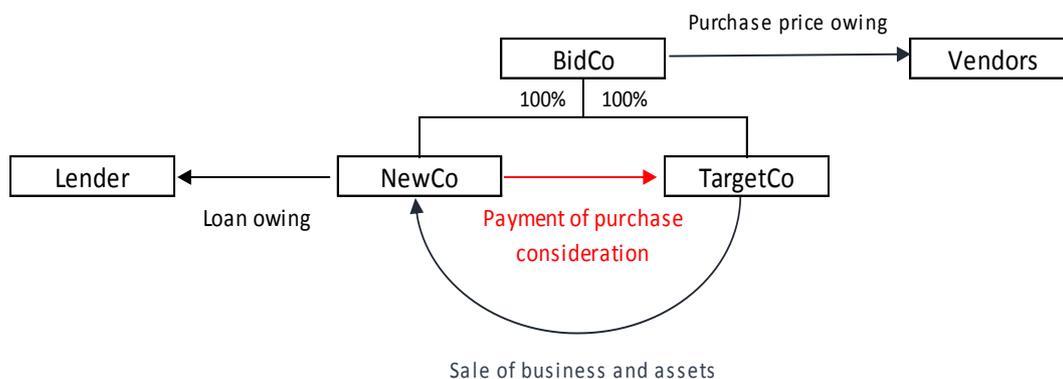


Following the transaction, BidCo and TargetCo will form part of the same group, and BidCo will be indebted to the Vendors in respect of an amount equal to the agreed purchase consideration.

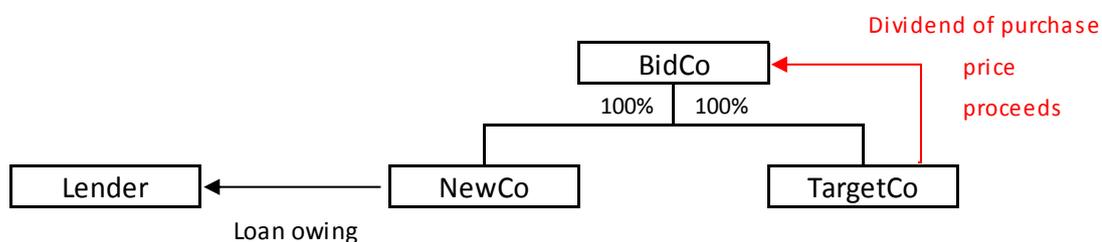
Step 3: NewCo borrows debt from lenders (typically banks and other financial institutions) (the **Lender**), so that NewCo is indebted to Lender, and placed in funds



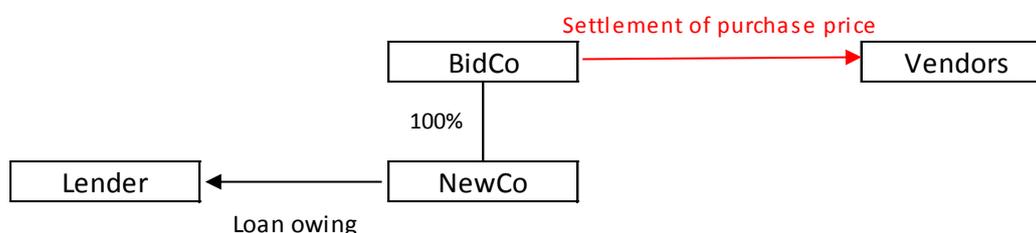
Step 4: Acquisition by NewCo of the business and operating assets of the TargetCo, from TargetCo in accordance with the intra-group provisions of section 45 (both NewCo and TargetCo being owned by BidCo and hence forming part of the same group), for a purchase consideration equivalent to that payable by BidCo to the Vendors.



Step 5: Distribution by TargetCo to BidCo of proceeds received from NewCo as purchase consideration in terms of Step 4, typically as dividend



Step 6: Settlement by BidCo of its liability to the Vendors using the proceeds of the dividend set out in Step 5 above, and winding-up of TargetCo, such that, BidCo owns only NewCo, which now owns the business and operating assets of TargetCo (and which is indebted to the Lenders)



Naturally, numerous variations of the above structure exist (e.g. the lender first provides a bridge loan to BidCo to finance the acquisition and following the completion of the acquisition, provides a longer term loan to NewCo, which distributes the proceeds of the term loan to BidCo to enable it to settle the bridge loan): but each instance the effect is that the debt is 'pushed-down' from the acquirer, BidCo, to the NewCo, as owner of the assets, and the debt burden is shifted onto the target business of the acquisition (now housed in NewCo). The acquirer therefore purchases a profitable, income-producing, and tax-paying entity which, through a judicious use of debt and shrewd structuring, remains an earnings producing, cash-generative (before payment of interest and taxes) business, but lowers the tax payable and increases the net returns to (debt and equity) investors through the application of the tax shield effect.

In order to more fully appreciate the rationale for the employment of what appears to be, at first blush, a somewhat circular and unnecessarily complex structure to achieve quite a simple outcome, one must bear in consideration the fundamental requirements governing the deduction of expenses in South African law, outlined in section 4 above, and in particular, the requirement that the expenditure be connected to the production of income. As indicated earlier in this paper it has historically been the case that as shares produce (tax-exempt) dividend income, expenditure connected with acquisition of shares will not meet this requirement and thus not be deductible.

As an aside, it should be noted that in South Africa, this structure has a number of uses and is often employed in the context of broad based black economic a (**BBBEE**)

acquisition schemes, where the use of debt is not only desirable, but necessary to enable BBEE participants to acquire a meaningful stake.

PART III – RECENT CHANGES TO THE TAX LANDSCAPE

6 History of recent amendments

In order to accurately assess the prevailing legislation and SARS stance on the deductibility of interest in LBOs, it is useful to briefly review the shifting landscape of the past few years and the amendments which have brought us to the current position.

6.1 Suspension of section 45 of the Act

During 2010 and 2011, in the context of slowing a global economy and concomitant declining fiscal revenues, SARS (along with the revenue authorities a number other countries), intensified its close examination deductions in respect of what was viewed as 'excessive' leveraging and consequent interest deductions in LBO and other transactions.

²⁷ Such transactions had been the subject of closer scrutiny in the years leading up to the onset of the global financial crisis, where SARS had previously taken issue with so-called 'funnel schemes': aggressively structured transactions where interest was deducted by the borrower, but received by the lender as tax-exempt dividend income. According to SARS, losses to the fiscus from such deals in 2011 exceeded R3 billion.

In early June 2011, as SARS sought to stem the flow of future losses from transactions conducted in this manner, the Treasury proposed to suspend, with immediate effect and for a period of 18 months, the use of section 45, through the introduction of an amendment to the Act in terms of the Draft Taxation Laws Amendment Bill, 2011 (**Draft TLAB 2011**).²⁸ As noted in Part III of this paper, section 45 has historically been used

²⁷ 'Background Note: 2011 Draft Taxation Laws Amendment Bills: Revised proposals on section 45 intra-group, hybrid shares and related matters' *National Treasury and SARS*, 3 August 2011, available at <http://www.treasury.gov.za/public%20comments/Background%20note%20section%2045.pdf>, accessed on 1 June 2013.

²⁸ In terms of section 75(1)(b) of the Draft TLAB 2011, section 45 was to be amended by the insertion of a new proviso to section 45, in terms of which, with effect from 3 June 2011, section 45 (and the consequent rollover

in the context of a leveraged acquisition of shares to ensure the tax deductibility of interest which would otherwise have been available if the parties to the transaction had elected to structure the transaction as an asset sale. SARS and the Treasury's specific concerns in this respect related to transactions where debt was 'pushed-down' by the acquirer into the target company to facilitate the deduction of 'excessive' acquisition-related interest costs, thereby reducing the returns to the fiscus.

Facing a significant outcry from the business community and participants in such transactions, SARS and Treasury launched a series of consultations with transaction participants, corporate finance advisors, lawyers, tax practitioners and accountants in the process of seeking comments from the public on the effects of the Draft 2011 TLAB.²⁹ Whilst the business community and its advisors appeared to accept SARS and Treasury's view that section 45 schemes were susceptible to abuse, it was argued that the suspension severely hampered the ability of companies to conduct their group affairs in the ordinary course by legitimately reorganising their businesses.

Within two months the Treasury announced the lifting of the suspension; but the die was cast and South Africa's revenue authorities had signalled their intention to attack transaction structures which led to apparent excessive interest deductions and purportedly aggressive tax structures.

6.2 The introduction of section 23K: Limitation of deductions in respect of reorganisation and acquisition transactions

Despite the lifting of the suspension of section 45, it was clear that the South African revenue authorities still held deeply-seated concerns around the use of excessive debt

relief) would be inapplicable in respect of any disposal made on or after 3 June 2011 and prior to 1 January 2013. This 18 month period was intended to provide SARS and the Treasury an opportunity to assess the best manner in which to address the issue and stem the perceived losses to the fiscus. In addition to disrupting perfectly legitimate intra-group transfers, the proposed suspension had the unfortunate effect of jeopardizing transactions which the parties had accepted would be subject to section 45, but were still subject to the fulfilment of suspensive conditions to be affected.

²⁹ According to a statement released by the Treasury and SARS on 3 August 2011, over 30 consultations were held in respect of more than 50 transactions. 'Background Note: 2011 Draft Taxation Laws Amendment Bills', *National Treasury and SARS*, op cit (n27)

which eliminated substantial amounts of operating income for the targets of LBOs. However, SARS appeared to accept the argument made by transaction participants in the weeks following the suspension that commercially driven transactions which did not give rise to excessive tax leakage should be allowed to proceed.

In light of this, section 23K was introduced into the Act by the Taxation Laws Amendment Act 24 of 2011 as an ‘interim’ measure to stem losses to the fiscus whilst SARS formulated a more permanent solution. In terms of section 23K, deductions of interest associated with debt used by an acquiring company directly or indirectly for the purpose³⁰ of procuring, enabling, facilitating or funding the acquisition of any asset under so-called re-organisation transactions, being the transaction structures provided for under section 45 (as well as under section 44 (*Amalgamation transactions*) and section 47 (*Transactions relating to liquidation, winding-up and deregistration*)), would be disallowed unless a specific directive was obtained from SARS, regardless of whether such interest expenditure would otherwise have been deductible under the general principles of deductibility or any other specific provision.

Where an application was made, section 23K required the Commissioner to take into account the amount of interest incurred, received or accrued by parties to the transaction, including the lenders, and only issue a directive allowing the deduction of interest in the event that the Commissioner was satisfied that the issuing of the directive would not lead to a significant reduction of the aggregate taxable income of the parties involved in the transaction and therefore pose a threat to the tax base.³¹ Despite the fact that section 23K was only intended as an interim measure to replace the suspension of section 45, as SARS sought a more permanent solution, it went some way further by extending the date for SARS to implement a final solution by a year.

³⁰ It is notable that the requirement is that the debt actually be ‘used ... for the purpose of’ acquiring the assets under the reorganization transaction. This is in contrast to the requirement under the general deduction formula that the monies merely borrowed for that purpose, even if these are subsequently applied for a different purpose. It is arguable that the restriction imposed by section 23K would not cover such a situation.

³¹ Section 23K(4).

The introduction of the section was largely viewed unfavourably by transaction participants as it granted SARS a measure of discretion, thus leading to a degree of uncertainty for taxpayers in structuring their affairs. However, the regulations promulgated under section 23K were taken to presage the development of a more defined approach by providing by reference to factors which SARS would take into account, including the level of debt to equity of the acquiring company³² (i.e. a measure of the level of the leverage employed).

6.3 Section 24O: Incurral of interest in terms of certain debts deemed to be in the production of income

Following the introduction of section 23K, section 24O was introduced into the Act in January 2013 by the Taxation Laws Amendment Act 22 of 2012. Section 24O addressed the discrepancy which allowed taxpayers to gain tax relief when acquiring control of businesses through asset acquisitions, but not through share acquisitions. This was achieved by requiring the application of 23K (requiring taxpayers to apply to the Commissioner for a directive allowing the deduction of interest) to share acquisitions. This was done by way of the introduction of the definition of an 'acquisition transaction' into the Act.

In terms of section 24O of the Act, an acquiring company would be entitled to deduct the interest incurred by it on loan funding utilised to purchase (or refinance the purchase of) the shares of a target company where the target company was an operating company, provided that, at the close of the day of the acquisition transaction, the two companies formed a group of companies, with the acquiring company being the controlling group company in respect of the target company.³³ In such circumstances, any interest incurred

³² Section 23K(7).

³³'Operating company' is defined in section 24O(1) as 'as any company (i) that carries on business continuously, and in the course or furtherance of that business provides goods or services for consideration; or (ii) that is a controlling group company in relation to the acquiring company. 'Controlling group company' means a company which directly or indirectly holds shares in at least one other company (hereinafter referred to as the 'controlled group company), to the extent that (i) at least 70 percent of the equity shares in each controlled group company are directly held by the controlling group company, one or more other controlled group companies or any combination thereof; and (ii) the controlling group company directly holds at least 70 per cent of the equity shares

by the acquiring company in respect of such loan funding would be deemed to be (i) incurred in the production of the company's income (notwithstanding that only dividend income would likely be forthcoming), (ii) laid out or expended for the purposes of trade and (iii) incurred in respect of income received by or accruing to the income of the acquiring company.

In addition, section 24O(2) states that:

- '..any interest incurred by that company in terms of that debt must be deemed to have been –
- (i) so incurred in the production of income of that company;
 - (ii) laid out or expended by that company for the purposes of trade; and
 - (iii) incurred in respect of an amount received by or accrued to that company that constitutes income;' (emphasis added).

To fully comprehend the impact of section 24O, one needed to also take into account the accompanying amendment to section 23K which expanded the application of section 23K to acquisition transactions. This meant that where such acquisition transactions met the conditions prescribed by section 24O and the Commissioner was amenable to granting a deduction on the basis provided for in section 23N, deductions for interest could now be claimed.

Although section 23K, read with section 24O, were explicitly described at the time by SARS and the Treasury as an interim measure, the shift away from the historic prohibition of deduction of interest on the acquisition of shares to a system which acknowledged the exigencies of corporate dealmaking and leveraged acquisition structures was no small step. Despite this, the flaws of section 23K, most notably, the discretionary power of the Commissioner and the uncertainty this system created were widely criticised by the private equity community and their advisors and it was clear that a more permanent solution was needed.

in at least one controlled group company. 'Group of companies' means two or more companies in which one company is a controlling group company in relation to the others.

6.4 Section 23N: The Final Solution?

With effect from 1 April 2014, section 23N was introduced into the Act by the Taxation Laws Amendment Act 31 of 2013. The section largely replaced section 23K (which was deemed to only apply in respect of interest deductions claimed on debt used in terms of reorganisation transactions carried out between 3 June 2011 and 31 March 2014 and acquisition transaction carried out between 1 January 2013 and 31 March 2014).³⁴ Though section 23N, like section 23K, served to compulsorily limit the deduction of interest incurred in respect of debt financing utilised to fund or reorganisation and acquisition transactions, the net effect of these changes was to provide partial relief to taxpayers by allowing the deduction of interest expenditure to a degree in prescribed circumstances.

In this respect, section 23N specifically limits deductions in respect of interest payable on debt used to finance, or refinance, any transaction carried out under the auspices of section 45 or section 47 (i.e. reorganisation transactions) as well as under acquisition transactions (as defined under section 24O).

The amount of interest that may deducted in such circumstances is limited to 40% of the acquirer's adjusted taxable income, being the taxable income of the acquirer determined in the normal manner, reduced by interest received or accrued, controlled foreign company net income and recovered or recouped amounts in terms of capital allowances. The taxable income is further adjusted by the addition of any interest incurred, all capital allowances and 75% of the acquirer's rental income.³⁵ The 40% limitation itself is measured against the higher of the acquirer's adjustable taxable income in the year in which the reorganisation or acquisition transaction occurred and the year in which the interest expenditure is incurred. The limitation applies for the year in which the relevant transaction occurred and for the five years afterwards.

³⁴ Section 23K(10).

³⁵ Section 23N(1).

Whilst private equity industry initially publicly welcomed the changes brought about by section 23N as a good move away from the discretionary system employed by section 23K,³⁶ its members quickly raised concerns around the inflexibility of the section, and these, as well as other critical assessment are discussed in Part V of this paper below.

PART V – EVALUATION AND ASSESSMENT

7 Critical considerations

As discussed earlier in this paper, recent moves by tax authorities in South Africa to implement interest deduction limitations have purportedly been driven, in part, by the principle of ensuring that interest deductions claimed by taxpayers are incurred in terms of *bona fide* commercial arrangements and not in terms of schemes designed to artificially allocate returns to entities with different applicable tax regimes, rates or to companies with tax credits to avoid payment of tax and thereby reduce returns to the fiscus. In this respect, it is submitted these efforts and the amendments produced as a result should be judged first, by the extent to which they effectively limit such 'abusive' interest deductions and go no further than necessary (i.e. do the amendments adequately and effectively achieve their stated purposes), and secondly, by whether remedies already existed which could have met the aims of the legislators (i.e. were the amendments in fact necessary). In order to meet their stated aim of reducing tax-arbitrage situations, it is therefore suggested that legislators should have sought to devise measures directed specifically at potentially abusive structures where schemes are constructed with artificially high debt or interest rates or otherwise designed with little commercial rationale other than the avoidance of tax.

Accordingly, the changes wrought by section 23K, section 24O and section 23N will be assessed by measuring the possible outcomes of their applications in reorganisation transactions and acquisition transactions, against the purposes behind their introduction.

³⁶ 'SAVCA welcomes proposed changes interest tax deductibility for companies' *South African Venture Capital Association*, 27 February 2014, available at <http://www.savca.co.za/wp-content/uploads/2014/02/SAVCA-welcomes-proposed-changes-interest-tax-deductibility-for-companies.pdf>, accessed on 31 March 2014.

It will be argued that the 'one size fits all approach' applied by the South African revenue authorities is overly broad and may in certain circumstances impede parties from giving effect to genuine commercial intentions by limiting their ability to effectively structure their affairs.

8 Assessment

Given that South African revenue authorities have repeatedly indicated that the imposition of cap on interest deductions is intended to achieve the dual aims of protecting against the erosion of the tax base and reducing excessive leverage to avoid systemic risk,³⁷ a logical starting point in assessing the recent changes is to review the necessity and effectiveness of these amendments in light of their stated purposes.

In addition, one can seek to assess the changes against more objective criteria. The father of modern economics, Adam Smith, surmised that the four canons of a good tax were (i) efficiency: the cost of collection must be low relative to the yield, (ii) certainty: the timing and amount to be paid must be certain to the payer, (iii) convenience: the means and timing of payment must be convenient to the payer, and (iv) equality: taxes should be levied according to ability to pay. Added to these sometimes by modern commentators are the following canons: productivity/adequacy; diversity; simplicity; flexibility; social objectives and functional efficiency.³⁸ Though not all of these are immediately applicable in the assessment of the newly introduced tax regime on interest deductions, certain of these criteria can be applied in measuring and weighing the limitations imposed.

³⁷ 'Media Release: Draft Taxation Laws Amendment Bill and Tax Administration Laws Amendment Bill, 2013' *National Treasury*, 4 July 2013, available at [http://www.sars.gov.za/Media/MediaReleases/Pages/4-July-2013---Taxation-Laws-Amendment-Bills-\(TLAB-2013\).aspx](http://www.sars.gov.za/Media/MediaReleases/Pages/4-July-2013---Taxation-Laws-Amendment-Bills-(TLAB-2013).aspx), accessed on 4 August 2013.

'Background Note: 2011 Draft Taxation Laws Amendment Bills', *National Treasury and SARS*, op cit (n43)

³⁸ 'The 12 tenets of tax' *The Association of Chartered Certified Accountants*, 2011, available at <http://www.accaglobal.com/content/dam/acca/global/PDF-technical/tax-publications/tech-tp-ttt.pdf>, accessed on 10 July 2014.

8.1 Protecting against the erosion of the tax base

In line with the OECD Action Plan on Base Erosion and Profit Shifting, which identified limiting excessive interest deductibility as a focal area for the attention of tax authorities internationally,³⁹ SARS and the Treasury identified the payment excessive deductible interest⁴⁰ as a key driver behind the reform of the tax code, including the introduction of section 23K, section 24O, and most recently, section 23N.

The introduction of section 23N and the consequent 40% limitation on interest deductions represented a laudatory move from the discretionary system in operation under section 23K, introducing, as it did, a higher degree of certainty for taxpayers in structuring their affairs. Notwithstanding this improvement on the situation subsisting under section 23K, it is submitted that the current provisions governing interest deductions are overly broad in achieving its stated purpose. If the introduction of a general limitation on interest deductibility, as provided for in section 23N read with section 24O, is indeed intended to ensure that the tax base is protected, then it must follow that a necessary (or, at least, probable) consequence of leveraged transactions is a reduction of tax revenues for the fiscus. However, in most circumstances tax laws are essentially neutral in respect of debt: a rand paid or incurred in respect of interest which is deducted from one taxpayer's income is included in as income received or earned in another taxpayer's income. As the revenue authorities themselves have indicated,⁴¹ SARS' intention is to combat tax 'arbitrage' in circumstances where deductions are received by a tax-paying entity and no tax (or comparatively less tax) is paid by the person to whom the interest income receives or accrues. That being the case, it is argued

³⁹ *Action Plan on Base Erosion and Profit Shifting* OECD Publishing, 2013, available at www.oecd.org/ctp/BEPSActionplan.pdf, accessed on 30 June 2013.

⁴⁰ 'One of the most significant types of base erosion in South Africa comes in the form of excessive deductions by some corporates with income effectively shifted to a no-tax or low-tax are typically channelled as interest, royalties, service fees and insurance premiums. Of greatest concern is excessive deductible interest.' 'Proposed Limitations against Excessive Interest Tax Deductions' *National Treasury and SARS*, 29 April 2013, available at <http://www.sars.gov.za/Media/MediaReleases/Documents/Media%20Release%2029%20April%202013%20-%20Proposed%20limitations%20against%20excessive%20interest%20tax%20deductions.pdf>, accessed on 28 June 2013.

⁴¹ *Ibid.*

below that the legislation is overly broad and should instead have been structured so as to remedy the specific 'mischief' which it was intended to address.⁴²

When one considers the application of section 23N and section 24O in light of this, it is of particular note that, unlike the provisions of section 23K, the limitation imposed does not take into account the tax treatment of the interest received in the hands of the lender. Rather section 23N merely requires that debt has been used to finance or refinance a direct (i.e. acquisition transaction) or indirect (i.e. reorganisation transaction) acquisition of control of an operating company in order for it to be applied, and does not take into account whether there is a 'significant reduction of the aggregate taxable income of all parties who incur, receive or accrue interest'⁴³ in respect of the transaction, as section 23K does. The result of this is that the borrower's ability to deduct the interest expense is limited in *all* applicable circumstances, and the lender's obligation to pay tax on the interest earned is generally unlimited (or at least, not proportionally limited in connection with the interest limitation imposed upon the borrower). In such a situation, clearly inequitable situations can easily arise, and SARS may conceivably receive the benefit of effectively taxing the same incomes stream twice, first, by disallowing a portion of the deduction in the hands of the borrower, and secondly, by taxing it in the hands of the lender, which will include the interest income in its calculation of taxable income.

As a result of this over-breadth, it is submitted that the legislation covers situations which it was never intended to. Consider, for instance, the common use of group treasury companies, which act as *de facto* centralised banks for the coordination of the use of debt and the consolidation of control of capital deployment in many company group structures. In such a structure, a company is established through which a holding company centralises all of its inter-group lendings and borrowings. This approach has a

⁴² The 'mischief rule', first formulated in the 16th Century in *Heydon's Case* (1584) 3 Co. Rep. 7a requires courts to examine to the mischief which the legislature intended to remedy in drafting a relevant piece of legislation still plays a fundamental role in legislative interpretation under South Africa's constitutional democracy. See *S v Zuma* 1995 (2) SA 642 (CC) para 17, where Kentridge AJ granted the mischief rule a judicial stamp of approval in a South African constitutional context.

⁴³ As required in terms of section 23K(4)(b).

number of benefits, including, amongst other things, an ability to more effectively invest the group's surplus cash and the opportunity to provide loans from the group balance sheet to group companies at different rates and on different terms, providing a method for effective capital allocation. One presumably unintended effect of the wide application of section 23N, however, is to limit the ability of groups of companies to effectively manage this aspect of their internal financing in the ordinary course following an acquisition or series of acquisitions.

For example, following an acquisition carried out along the lines of the typical leveraged transaction structure detailed in Part III of this paper, the group's treasury function post-acquisition may be managed by a special purpose vehicle (SPV) which (i) is incorporated for the purposes of acquiring the target company or target companies, and (ii) is funded by the provision of both equity financing from the holding company and debt financing from external lenders. It is quite conceivable, and indeed, fairly common practice in the private equity industry, that the same SPV will be used as the holding company which acts as the acquirer of numerous businesses, such acquisitions being structured as either indirect share acquisitions under section 45, or direct share acquisition transactions, under section 24O in order to allow for the deduction of debt. The SPV uses the funds raised in its initial debt and equity capitalisations first, to, settle the purchase consideration owed to the vendors of the acquired companies or businesses, and secondly, to finance the operations of the newly acquired businesses by granting inter-group loans, on which it will charge it interest. The SPV may also charge management or administration fees to its newly acquired subsidiaries for its services, including capital allocation and coordinating interactions with lenders on issues ranging from negotiation of debt terms to covenant reporting.

In this instance, it is entirely likely, that, regardless of the level of debt (which, admittedly, may be significant), the levels of interest income accruing to the SPV on operational funding provided to its subsidiaries (which would be expected to roughly equivalent to its financing charges) and of management fees which will be received by the SPV (being the only income streams available to it in this example) may be only marginally more than the interest expense it owes the banks. Taking into account the 40% limitation imposed by section 23N on the calculation of the adjustable taxable

income of the SPV, the SPV may thus be placed in the unenviable position of being rendered loss-making but still owing SARS.

Again, the outcome of this situation may be easiest illustrated by applying some numbers to the facts above. Assume Company A is established to acquire a number of businesses and capitalised with the injection of R200m, evenly split between equity and debt, with the debt bearing interest at a rate of 10% per annum (i.e. R10m per year in interest if the debt facility is fully drawn down). Thereafter, Company A utilises a portion of the debt facility to acquire the shares in Company B for R40m and the unrelated Company C for R20m, in terms of acquisition transactions, as defined in section 24O. Company A utilises the balance (R40m) of the debt funding to lend R40m to Company B and Company C to finance their working capital requirements. Let us assume that Company A also charges interest at 15% per annum to Company B and Company C (i.e. R6m per year) as well as aggregate management fees of R4m per year. Commercially, Company A's shareholders and lenders may be quite happy with a structure, separating, as it does, Company B's prospects of success or failure from Company C's, but providing Company A with access to investment income and capital appreciation from its investments in its subsidiaries, and its lenders with a claim against the assets of Company A in such subsidiaries. The group is well capitalised, with R100m of equity capital still available for deployment. Assuming that Company A's sole taxable income streams comprise interest income on working capital financing and management fees for services provided to Company B and Company C, its adjusted taxable income for the year would be R14m,⁴⁴ of which it would only be entitled to deduct R7.6m in respect of interest costs associated with the acquisition transactions, notwithstanding that its financing costs are R10m (R6m relate to the acquisition transactions). There is therefore a R2.4m amount

⁴⁴ Calculation as set out in P Haupt & K Huxham *Notes on South African income Tax* (2014) at 565:

Taxable income for the year:	R10m
<i>Less:</i> Interest income received or accrued:	(R6m)
<i>Plus:</i> Interest expenditure incurred	R10m
Adjusted Taxable Income	R14m

which cannot be claimed as a deduction.⁴⁵ Company A only breaks even in this example (with no operating expenses): as it receives or accrues R6m in interest income and R4m in management fees, and incurs interest expenditure of R10m. Notwithstanding this, Company A is due to pay to SARS tax in respect of a 'profit' of R2,4m.

Whilst it may be argued that such a structure is unlikely, this is a structure often employed by private equity firms in building larger businesses, through 'bolt-on' acquisitions, as well that followed by certain investment holding companies (including certain listed companies), with the exception that in many instances, the SPV is in fact the listed entity *itself*. In such latter cases the entity plays the role of an investment holding company, which carries on no operations itself, but provides management, administration and funding services to its operating subsidiaries, as well as interfacing with lenders and bearing the costs of listing, maintaining a head office and managing capital allocation.

In such a situation, where both the lender and the borrower are South African resident tax-paying entities, absent any other permutations, there is no risk of tax-arbitrage and loss to the fiscus and it is submitted that the effects of section 23N reach too far. There is arguably no reason of principle that the fact that an enterprise which is not profit-making should be disallowed from deducting expenses properly incurred; and certainly not where such a structure does not in fact lead to a loss to the fiscus.

Of course, parties should, and are entitled to, structure transactions and their tax affairs to avoid such an outcome, but such a counterargument misses a fundamental criticism of the legislation – it is aimed at tackling a small subset of problematic transactions, namely those where an acquirer uses debt to acquire an operating entity and the net income to the fiscus is reduced as a result of an aggressive tax structure employed by the parties

⁴⁵Calculation as set out in P Haupt & K Huxham *Notes on South African income Tax* (2014) at 565:

40% of Adjusted Taxable Income	R5.6m
<i>Plus:</i> The amount of interest received or accrued	R6m
<i>Less:</i> The amount interest incurred on non-acquisition debts	(R4m)
Section 23N interest deduction is limited to	R7.6m

(i.e. a structure where the interest is deductible in the hands of the borrower, and not taxed, or taxed at a lower rate in the hands of the lender).

A possible solution to this is proposed in section 9 of this paper.

8.2 Excessive leverage

The outcomes discussed above could perhaps be accepted if SARS had taken a policy position that the use of debt to acquire businesses is fundamentally undesirable, but it would seem unlikely that this is the case. Indeed such a position would likely be untenable – the use of debt in a modern economy is a *fait accompli* and an essential foundation of modern economic theories of capital utilisation. Could one, then, perhaps, assume that SARS believe that excessive leverage poses a systemic risk to the South African economy⁴⁶ and that the level of the limitation imposed (i.e. 40%) by section 23N is indicative of a calculation by SARS of a generally acceptable level of leverage in an LBO?

Underlying an argument against the risks of leverage are broader issues around the different tax treatments applied to the two methods of raising capital, that is, debt or equity. The Private Equity Growth Capital Council, the United States' leading advocacy group for the private equity industry has raised several arguments for the preservation of the status quo in respect of interest deductibility.⁴⁷ First: as mentioned above, the tax code is generally neutral with respect to debt: interest income is usually included under taxable income and subject to normal income tax and interest expenses are usually deductible in the determination of taxable income. Secondly, debt and equity have different characteristics: each attracts a different class of investor, with different risk and reward appetites, which is important for businesses in different stages of growth; and

⁴⁶ Given the comparatively low levels of leverage cited in note 6 as being employed in South African LBOs, this seems unlikely.

⁴⁷ 'Interest Deductibility' *Private Equity Growth Capital Council*, available at <http://www.pegcc.org/issues/private-equity-and-tax-policy/private-equity-interest-deductibility/>, accessed on 30 June 2013.

furthermore the introduction of debt itself has been argued to introduce more disciplined capital management than pure equity funding.

For the private equity industry, specifically, although the introduction of interest-bearing debt, may result in a particular acquired target subsequently paying less in taxes by reducing its overall taxable income, all other things being equal, the same transaction will result in another tax-paying entity receiving such interest. It is arguably not the role of a revenue authority to impose market standards for commercial terms between contracting parties, but rather to fairly and efficiently tax the revenue generated by its citizens to support the state.

Of course, Treasury, as the manager of South Africa's economic policy, plays a role in determining the tax policy which is ultimately carried out by SARS, and indeed, one can argue, as the International Monetary Fund⁴⁸ has, that it is the ability of corporations to deduct interest payments but not returns on equity, such as dividends, has encouraged companies to finance their operations by debt rather than equity and thereby increased the levels of debt and fuelled the credit boom and subsequent market downturn. However, in a South African context the counterargument can be made that because capping companies' capacity to deduct interest effectively decreases their ability to finance their operations (because of a reduction in the tax shield effect), the economic incentives for lenders to invest in South Africa are decreased. Thus, from a policy perspective, the changes may be more damaging than helpful to the fiscus in the long run as South Africa's attractiveness as an investment destination is diminished.

Although a full comparative analysis of the positions adopted by revenue authorities in other jurisdictions lies beyond the scope of this paper, it is interesting to note that in many circumstances, the permitted levels of interest deductions in relation to group indebtedness and/or leveraged acquisitions abroad are measured using a number of criteria. Whilst in South Africa, the 40% cap is measured against the taxpayer's earnings

⁴⁸ C Cottarelli 'Debt bias and other distortions: Crisis-related Issues in Tax Policy' *International Monetary Fund*, June 12, 2009, available at <https://www.imf.org/external/np/pp/eng/2009/061209.pdf>, accessed on 28 September 2013.

(or adjusted taxable income), such a measurement only indirectly reflects the level of indebtedness of the business. By electing to measure the taxpayers financing costs rather than actual levels of indebtedness, the revenue authorities and legislators have missed the opportunity to accurately and precisely identify and target excessively leveraged transactions. Although such an approach can be merited for its simplicity (as it is indeed the interest deductions that SARS are concerned about), as a measurement of the indebtedness of the taxpayer, such an approach is flawed, failing as it does, to take into account the actual levels of debt employed by the purchaser. In the example canvassed in section 8.1 above, for example, at the closing of the acquisitions of Company B and Company C (before the advance of working capital funding), Company A has a debt : equity ratio of 0.6 : 1 – not an excessively leveraged entity by any measure.

No method of course, is free from flaws, but it is for precisely this reason that I would argue that in assessing whether a tax-payer is indeed over-indebted and thus whether such indebtedness is potentially abusive, other tests should be applied alongside that imposed by section 23N. This would allow a more holistic picture of the relevant transaction and taxpayer to be presented.

For example, one manner in which it could be determined whether a company's indebtedness is commercially reasonable following an LBO would be to measure its indebtedness against the level of indebtedness to other companies in the group to which the company belongs, as well as to the group as a whole. If the company's debt ratio does not exceed that of its group companies as a whole, then it can be presumed that the individual company is bearing its fair share of the group's overall debt and financing costs.⁴⁹ Another method might include assessing the debt : equity levels employed by the transaction participants in an LBO, on the basis that the greater the level of equity employed, the less likely the transaction will fail under the debt load.

⁴⁹ Variations of this methodology are employed in interest deduction limitation legislation in Germany and France. 'Deductibility of Interest Expenses – the EU Crackdown', *Taxand*, 9 July 2012, available at <http://www.taxand.com/taxands-take/news/deductibility-interest-expenses-%E2%80%93-eu-crackdown>, accessed on 25 March 2014.

8.3 Is this best way?

Arguments of principle and policy aside, the matter seems finally settled, at least for the time being, from SARS and the Treasury's perspectives and the cap on interest deductions appears to be here stay. Was this, however, the best judicial method to achieve the revenue authorities stated aims? Perhaps one of the most trenchant criticisms that can be levelled against the limitations introduced by section 23N is not that it goes too far, but that it goes where it ought not to have gone at all. The principle of interest deductibility have been virtually unchanged for a period of over 50 years since the enactment and promulgation of the Act, and arguably for good reason.

It is submitted that the collective jurisprudence of the cases discussed in this paper, and those which space has not allowed an examination of, point to a well-developed framework for determining the deduction of expenditure; one which is based on a simple and easily understood principle: namely, in determining the taxable income of a taxpayer, expenses will be deductible where incurred in the production income for the purposes of carrying on a trade, and not where such expenses are deducted to solely to facilitate a reduction in the taxpayer's taxes and thereby reduce the income to the fiscus. Absent any proof of excessive leverage in South Africa's financial markets and without a clearly articulated policy on how leveraged transactions inherently and necessarily cause losses to the fiscus, it is my view that the developed areas of our law around anti-avoidance and sham transactions should suffice. Even if one accepts that legislators and revenue authorities should seek to limit interest deductions through legislation, that legislation should be designed to accurately and precisely tackles such concerns through rules which, when applied, does not adversely affect or hamper genuine commercial transactions beyond of the ambit of such aims.

In this respect, it is useful to have reference to the case of *ITC 1530 54 SATC 261*, where the court held that SARS would be entitled to disallow a deduction of interest expenditure where it was deemed to be excessive in relation to the risk taken by the lender on the loan. In reviewing the facts of the case the Special Court indicated that certain factors, such as the relationship between the lender and the borrower, the terms of the loan, comparative rates payable by borrowers in similar circumstance and whether ulterior motives were present in the transaction should be taken into account.

Similarly, (albeit in the context of deductions linked to executive pay) it has been held⁵⁰ that where the expense (in this case, remuneration) is so grossly excessive that it could not possibly be regarded in its total amount as producing income; or where it had been awarded for some ulterior motive such as, tax evasion, the court could disallow the deduction of the excessive portion of the expense on the basis that it was not laid out for the purposes of trade.

Such decisions, although not yet approved by the superior courts, lend weight to the proposition that the introduction of section 23N was unnecessary and that the concerns put forth by Treasury and SARS could have been dealt with within the existing legal framework – by attacking transactions which were without commercial rationale. At the very least one would hope that the factors outlined in these cases would be applied to restrict and refine the application of this section and that a more holistic view of the position of the borrower (as to the level of its indebtedness) and the lender (as to whether there was any risk of tax-arbitrage) would be incorporated.

Lastly, the revenue authorities handling of the process – including the apparently hastily conceived suspension and subsequent reinstatement of section 45, its application of a discretionary system, albeit for an interim period, and its consistent application of retroactive provisions in relation to the issue of interest deductibility – will have detracted from any view which investors may have taken of South African as stable emerging market investment opportunity, where the rule of law is enshrined and consistently applied. Despite the recent statements by SARS which indicate that the Treasury are taking public feedback into account, the solution proposed by the insertion of section 23N of the Act, with its seemingly arbitrary 40% limitation, is no great step towards developing a system which satisfies the canons of a good tax.

⁵⁰ *ITC 569 13 SATC 447* at 449.

PART VI - CONCLUSION

9 Conclusion

Although the implementation of a cap on interest deductions is far from unprecedented (and, indeed, gaining traction) in the international tax community, it would appear that the South African legislation has a number of flaws and inadequacies which could be easily addressed. As currently crafted, it is submitted that the legislation is overly-broad and reaches beyond the mischief it was intended to prevent, with potentially chilling effects for investment and commerce in the country. But, precedents do exist, both in our law and in comparative jurisdictions, for provisions to be incorporated into the Act to address the shortcomings highlighted in this paper.

For private equity firms and other participants in LBOs in South Africa, the system imposed by sections 23N and 24O is one which should perhaps be expected given both the global trend towards limiting interest deductions and the peculiar local pressures faced by the South Africa revenue authorities, where a minority of taxpayers support a far greater population. However, notwithstanding such social objectives, taxpayers are entitled to expect that revenue authorities act reasonably and seek to impose taxes on parties in a manner that promotes certainty, fairness and flexibility in structuring their affairs.

Despite this, the uncertainty, lack of flexibility and inequality imposed by the system introduced by the recent amendments to the Act arguably creates as many problems for taxpayers as it purportedly solves for the revenue authorities. There is significant scope for the improvement of the relevant sections, and it is hoped that revenue authorities continue to heed the requests of the business community to improve the current position.

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