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Impact of China's investment on the South African tax base

by Peter Dachs

The news that China has committed to invest approximately R200-billion in South Africa was greeted with much fanfare throughout the country. Approximately ZAR33-billion of this will constitute a loan to Eskom, which is particularly good news given the funding requirements of the entity. A loan will also be advanced to Transnet in the amount of ZAR4-billion.

However, we should be very clear that this is a business deal for China, which will want to receive an arm's length return for the various loans from the China Development Bank and the Industrial and Commercial Bank. It will therefore be interesting to see what interest rate is proposed for the various loans and, in particular, in respect of the loans to Eskom given the company's poor credit rating. The interest charged on these loans has not been made public, however, we know that the Eskom loan has a term of fifteen years and the Transnet loan a term of five and a half years.

From a South African tax perspective, given the magnitude of the investment, this will have a significant impact on South Africa's tax base given that it seems these loans will be made to South African taxpayers including Eskom and Transnet.
In terms of South African tax law, interest is tax deductible on a yield to maturity basis, provided that the borrower is carrying on a trade and the interest is incurred in the production of income for the borrower.

Therefore, interest on loans to, for example, fund working capital or acquire capital assets, should be tax deductible for the borrower. Of course, for taxpayers such as Eskom, the deduction would simply increase their assessed loss for tax purposes, thereby postponing the time until they return to tax paying status.

The issue of interest deductibility in a cross border context is very topical in international tax circles. In this regard, base erosion and profit shifting ("**BEPS**") is referred to by the Organisation for Economic Cooperation and Development (the "**OECD**") as tax planning strategies that exploit gaps and mismatches in tax rules to shift profits to low or no-tax locations.

The OECD states that, working together in the OECD/G20 BEPS Project, over 60 countries jointly developed 15 Action Plans to tackle tax avoidance, improve the coherence of international tax rules and ensure a more transparent tax environment.

The BEPS Action 4 Report deals with ways to limit interest deductibility in respect of cross border loans. The OECD'S Final Report on the BEPS Action 4 Plan recommended a three tiered approach to limiting interest deductions in a cross border context. In respect of the core rule, entities should only be allowed to deduct interest up to a fixed percentage of earnings before interest, tax, depreciation and amortisation. The OECD has provided a recommended range of acceptable ratios of between 10% and 30%.

In this regard, South Africa, like most countries, has rules limiting interest deductions where such interest is paid to a non-resident. The main rules in this regard are transfer pricing/thin capitalisation and certain statutory provisions contained in the Income Tax Act, 1962.

Section 31 of the Income Tax Act sets out South Africa's transfer pricing rules. These rules will apply, broadly speaking, to any transaction that has been entered into between a resident and a non-resident that are related parties to each other and where any of the terms or conditions agreed upon is not of an arm's length nature.

These rules therefore only apply in respect of transactions between related parties and would not apply to the extent that funding is advanced by, for example, the China Development Bank to South African entities such as Eskom.

Section 23M of the Income Tax Act applies a formula which limits the tax deduction for the borrower in respect of interest paid, inter alia, to a non-resident. However, in order for section 23M to apply, the debtor must be a South African resident for tax purposes; the debtor and the creditor must be in a controlling relationship; and the interest incurred must not be subject to tax in the hands of the person to whom it accrues during that year of assessment. These provisions would therefore also not be relevant since the loans from the China Development Bank or the Industrial and Commercial Bank will be made to unrelated parties in South Africa.

Therefore, South Africa does not have any rules protecting its tax base in respect of transactions such as the envisaged loans by the China Development Bank or Industrial and Commercial Bank. While the BEPS Action 4 Report suggests that a formula limiting the tax deduction of interest in all circumstances should apply, South Africa has not implemented this proposal.

South Africa does impose withholding tax on interest paid to non-resident lenders. This is set at 20%. However various double tax agreements reduce the withholding tax to a lower percentage. The double tax agreement with China reduces the rate to 10%. The China Development Bank operates from multiple jurisdictions. It may therefore choose to advance the loan funding or a portion thereof from a jurisdiction that has a 0% withholding tax on interest for South Africa.

It is therefore possible that the interest on the loan will be fully tax deductible in South Africa for the borrower. No restriction will be placed on the ratio of debt:equity in respect of the relevant investments. In addition, there is no formula limiting the tax deduction in respect of the interest given that the parties will not be related to each other. Finally, it is possible that, depending on the jurisdiction from which the loan is advanced, no South African interest withholding tax would be charged thereon.

Let's now contrast that with the position where the investment is made in the form of equity. In simple terms, while interest payments are generally tax deductible, dividends are not. In addition, dividends tax at a rate of 20% will be levied on dividends paid to non-resident entities. This rate is reduced in terms of the China/South Africa double tax agreement to 5%.
If, and to the extent that the funding comes in the form of equity investments in South African entities, the tax equation looks very different. There is no tax deduction for the issuing company in South Africa and dividends tax at a rate of 20% (reduced to 5% in terms of the double tax agreement with China). In addition, unlike interest, virtually all of South Africa's double tax agreements allow South Africa taxing rights in respect of dividends paid to non-residents. It would therefore not be possible for an equity investment into South African entities to be routed through a jurisdiction that does not allow South Africa taxing rights in respect of dividends paid.

Furthermore, if the equity subscribed is in respect of shares in "land rich" companies, South Africa would also be entitled to impose capital gains tax on any gain made on the shares at the time of their eventual disposal by the Chinese investor.
Let's use a simplified example with certain assumptions in order to illustrate the principles set out above. Assume the entire ZAR200-billion is invested by way of loan funding to South African entities and interest is charged at the prime rate over a period of 10 years. The value of the interest deduction is ZAR200-billion x 28% x 10% = ZAR5.6-billion a year for 10 years. In terms of this example, on a non-present value basis, ZAR56-billion will be lost to the South African fisc.

If the loan is denominated in a foreign currency, then the interest rate is likely to be lower than the prime rate, but any exchange difference (which economic theory predicts will be a loss as the rand depreciates against the foreign currency) will be tax deductible for the South African borrower.

Now, to illustrate the principles, let's assume that the entire ZAR200-billion comes in the form of an equity investment, which pays an annual dividend of 5%.

No tax deduction will be granted to any South African entity. Instead, dividends tax will be levied on the dividend at a rate of 5%, i.e. ZAR500-million of tax collected by South Africa annually. On a non-present value basis, this results in a ZAR5-billion tax collection over, for example, 10 years. In addition, there may be some capital gains tax on the ultimate disposal of the equity investments.

In conclusion, interest on the loan funding from the China Development Bank and Industrial and Commercial Bank will be fully tax deductible for the South African borrowers assuming the general requirements for a tax deduction are met.

Furthermore, given that, unlike in respect of dividends tax, many of South Africa's double tax agreements have not been renegotiated in order to provide South Africa with taxing rights in respect of interest, it is possible that no interest withholding tax will be imposed on the interest paid to the China Development Bank or Industrial and Commercial Bank. The Chinese investments could therefore be very costly for the South African fisc.

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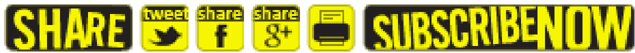

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