

# **Thin capitalisation in South Africa, including a critical analysis of the Draft Interpretation Note on the determination of the taxable income of certain persons from international transactions**

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## **ABSTRACT**

This dissertation endeavours to analyse the anti-avoidance measures implemented (and planned for the future) in South Africa to combat the practice known as "thin capitalisation".

It critically analyses the Draft Interpretation Note on the determination of the taxable income of certain persons from international transactions: Thin capitalisation.

It concludes that the arms-length approach is not suitable for South Africa and that it is essential that a system of advance pricing agreements be implemented.

## DECLARATION

I, Marvan Beukes, hereby declare that the work on which this dissertation is based is my original work (except where acknowledgements indicate otherwise) and that neither the whole work nor any part of it has been, is being, or is to be submitted for another degree in this or any other university.

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Date:

17/2/2014

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## Chapter 1 - Introduction

Tax havens refer to low-tax jurisdictions that offer investors opportunities for tax avoidance. Due to the fact that existing corporate tax codes in most countries allow interest payments to be deducted from taxable income, the rise of tax havens gives multinational companies a great incentive to use internal debt as a means of avoiding taxation. One of the more common strategies is known as 'interest stripping', which involves generating interest deductions in the high-tax host country by directing interest payments to affiliates in the low-tax haven country.

To secure tax revenues and to campaign against tax havens, many countries have introduced transfer pricing rules, including thin capitalisation rules, to regulate the amount of deductible interest paid to the shareholders.<sup>1</sup>

The very first transfer pricing legislation was adopted in 1915 in the United Kingdom during World War I, with the following amendment to section 41 of the Income Tax Act of 1842<sup>2</sup>:

*Prov 31. — (1) Section forty -one of the Income Tax Act, 1842 shall, so far as it relates to the taxation of non-residents, be extended- (a) so as to make non-resident persons chargeable to income tax in the name of any branch or manager as well resident as in the name of any factor, agent, or receiver ; and*

...

*(3) Where a non-resident person not being a British subject or a British, Indian, Dominion, or Colonial Firm or Company, or branch thereof, carries on business with a resident person, and it appears to the Commissioners by whom the assessment is made that, owing to the close connection between the resident and the non-resident person, and to the substantial control exercised by the non-resident over the resident, the course of business between those persons can be so arranged, and is so arranged, that the business done by the resident in pursuance of his connection with the non-resident produces to the resident either no profits or less than the ordinary profits which might be expected to arise from that business, the non-resident person shall be chargeable to income tax in the name of the resident person as if the resident person were an agent of the non-resident person.*

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<sup>1</sup> Hsun Chu - Optimal Thin Capitalisation Rule in a Simple Endogenous Growth Model with Tax Havens Australian Economic Papers Volume 51, Issue 3, pages 123–133, September 2012

<sup>2</sup> Provision 31 of Finance (No. 2) Act, 1915. [Chapter 89.] (United Kingdom) – available online: [http://www.archive.org/stream/financeno2act19100gearich/financeno2act19100gearich\\_djvu.txt](http://www.archive.org/stream/financeno2act19100gearich/financeno2act19100gearich_djvu.txt)

*(4) Where it appears to the Commissioners by whom the assessment is made or, on any objection or appeal, to the general or special Commissioners that the true amount of the profits or gains of any non-resident person chargeable in the name of a resident person with income tax cannot in any case be readily ascertained the Commissioners may, if they think fit, assess the non-resident person on a percentage of the turnover of the business done by the non-resident person through or with the resident person in whose name he is chargeable, and in such case section fifty-three of the Income Tax Act, 1842, shall extend so as to require returns to be given of the business so done by the non-resident through or with the resident in the same manner as returns are to be given under that section of the profits or gains to be charged.*

Thin capitalisation is a specific branch of transfer pricing, defined by Olivier and Honiball as “the intentional funding of a company with debt rather than with equity in order to maximise the remittance of deductible interest”.<sup>3</sup>

Thin capitalisation refers to the situation in which a company is financed through a relatively high level of debt compared to equity. Thinly capitalized companies are sometimes referred to as “highly leveraged” or “highly geared”.<sup>4</sup>

In South Africa, thin capitalisation typically becomes an issue in cases where a South African taxpayer is debt funded either directly or indirectly by non-resident connected persons. The funding of a South African taxpayer with excessive intra-group, back-to-back or intra-group-guaranteed debt may result in excessive interest deductions thereby depleting the South African tax base, especially as interest received by or accrued to a non-resident is not subjected to similar rates of taxation than other forms of taxable income:

Before 1 January 2013, an amount of South African sourced interest received by or accrued to a non-resident during any year of assessment was exempted from income tax, provided such non-resident did not spend more than 183 days in aggregate in South Africa (where the non-resident is a natural person) or carried on business through a permanent establishment in South Africa at any time during that year.<sup>5</sup>

With effect from 1 January 2013, interest received by or accrued to a non-resident that is not a controlled foreign company, is subject to a withholding tax (10% on implementation, currently 15%)<sup>6</sup> (subject to the terms of any applicable double taxation treaty).

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<sup>3</sup> Glossary of South African International Tax Terms in International Tax a South African Perspective (Third edition - 2005) by Lynette Olivier and Michael Honiball

<sup>4</sup> OECD (2012), Thin capitalisation legislation a background paper for country tax administrations (Pilot version for comments). Available at [http://www.oecd.org/ctp/tax-global/5.%20Thin\\_Capitalization\\_Background.pdf](http://www.oecd.org/ctp/tax-global/5.%20Thin_Capitalization_Background.pdf)

<sup>5</sup> Section 10(1)(h) of the Income Tax Act 58 of 1962

<sup>6</sup> Section 37J of the Income Tax Act 58 of 1962

Since 1 January 2013, the section 10(1)(h)-exemption only applies to interest income which is not subject to the interest withholding tax (e.g. certain interest payments made in respect of listed debt or in respect of any debt owed by any bank, in terms of section 37K).

Since South Africa became a democracy in 1994 and the end of economic sanctions, the country is increasingly taking its place at the global economy. More and more foreign businesses are venturing and investing into the South African economy. Conversely, South African businesses are also venturing abroad.

As a result, it has become much more important, from the South African taxation authorities perspective, to protect the tax base against highly geared foreign investments in South African resident businesses.



## Chapter 2 - Problem statement

Transfer pricing is problematic from a legal point of view in the sense that it measures something that is subjective, as the concept involves the measurement of a "reasonable" transfer price, in the opinion of the measurer, in a particular set of circumstances.

This was already acknowledged and addressed in the very first transfer pricing legislation implemented in 1915 in the United Kingdom, as mentioned in the introduction:

Provision 31 of Finance (No. 2) Act, 1915<sup>7</sup>:

"...

*(6) The amount of percentage shall in each case be determined, having regard to the nature of the business, by the Commissioners by whom the assessment on the percentage basis is made, subject, in the case of an assessment made by the additional Commissioners, to objection or appeal to the general or special Commissioners.*

*If either the resident or non-resident person is dissatisfied with the percentage determined either in the first instance or on objection or appeal by the general or special Commissioners he may, within four months of that determination, require the Commissioners to refer the question of the percentage to a referee or board of referees to be appointed for the purpose by the Treasury, and the decision of the referee or board shall be final and conclusive."*

The Organisation for Economic Co-operation and Development (OECD) acknowledges the practical problems with transfer pricing (of which thin capitalisation is a branch): Apart from the OECD's guide on Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, it issued a separate report aimed at tax administrations named "Dealing Effectively with the Challenges of Transfer Pricing".<sup>8</sup>

As a result of the Katz Commission's second report, section 31(3) of the Income Tax Act was promulgated in 1995.<sup>9</sup> This was the first legislation with which the South African fiscal authorities addressed thin capitalisation.

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<sup>7</sup> Ibid

<sup>8</sup> OECD (2012), Dealing Effectively with the Challenges of Transfer Pricing, OECD Publishing. Available at <http://dx.doi.org/10.1787/9789264169463-en>

<sup>9</sup> Section 23 of the Income Tax Amendment Act 21 of 1995 which substituted section 31 of the Income Tax Act 58 of 1962

For years of assessment commencing on or after 1 April 2012, thin capitalisation is no longer dealt with by a separate subsection of section 31 of the Income Tax Act and is instead governed by the general transfer pricing provisions of subsection 31(2). SARS has also issued a draft Interpretation Note on the subject and is awaiting comments from the public.<sup>10</sup>

Most significant about this change is that taxpayers must determine the acceptable amount of debt on an arm's length basis.

This mini-dissertation is a discussion of thin capitalisation in South Africa, including a critical analysis of the Draft Interpretation Note. It concludes on whether the arm's-length approach is appropriate for South Africa, as well as proposing a solution on how to avoid disagreements between a taxpayer and SARS.

This mini-dissertation refers to legislation and information as effective at 15 April 2013.

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<sup>10</sup> Draft Interpretation Note on the determination of the taxable income of certain persons from international transactions: Thin capitalisation – available online:  
<http://www.sars.gov.za/home.asp?pid=677>

### Chapter 3 – Financing models for companies

A company is typically financed (or capitalised) through a mixture of debt and equity.

Debt capital is represented by funds borrowed by a business that must be repaid over a period of time, usually with interest.

Schreiner JA, in his minority judgment in the Lever Brothers case, described interest as “the fruit of the money”.<sup>11</sup>

Debt financing can be either short-term, with full repayment due in less than one year, or long-term, with repayment due over a period greater than one year. The lender does not gain an ownership interest in the business and debt obligations are typically limited to repaying the loan with interest. Loans are often secured by some or all of the assets of the company.

Equity capital is represented by funds that are raised by a business, in exchange for a share of ownership in the company. Equity financing allows a business to obtain funds without incurring debt, or without having to repay a specific amount of money at a particular time.<sup>12</sup>

As explained in the introduction, thin capitalisation refers to the situation in which a company is financed through a relatively high level of debt compared to equity. Thinly capitalised companies are sometimes referred to as highly leveraged or highly geared.<sup>13</sup>

A company may be thinly capitalised for some or all of the following reasons:

- It is carrying a greater quantity of interest-bearing debt than it could sustain on its own;
- The interest charged is in excess of the commercial rate for the loan(s) which it is carrying;
- The duration of the lending is greater than would be the case at arm’s length;
- Repayment or other terms are more disadvantageous than could be obtained in an arm’s length arrangement

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<sup>11</sup> 14 SATC 1 at page 17

<sup>12</sup> USLegal.com – Equity Capital Law & Legal Definition – Available at <http://definitions.uslegal.com/e/equity-capital/>

<sup>13</sup> Thin Capitalisation legislation a background paper for country tax administrations – Initial draft issued by the OECD August 2012 (Pilot version for comments) – Available at [http://www.oecd.org/ctp/tax-global/5.%20Thin\\_Capitalization\\_Background.pdf](http://www.oecd.org/ctp/tax-global/5.%20Thin_Capitalization_Background.pdf)

In assessing whether borrowing is on an arm's length basis, it is essential to consider all the terms and conditions of the lending, not just the narrow concerns of amount and rate. The arm's length approach assumes that borrowing will be on a sustainable basis, so that the business must be able to trade, invest and meet its other obligations as well as servicing the debt. The consideration is not just what it could have borrowed, but what it would have borrowed.<sup>1415</sup>

### The choice of debt or equity

A foreign investment may be financed either through a loan (debt) or through shareholding (equity). Investments in instruments with characteristics of both (hybrid instruments), or instruments that derive their value from other instruments (derivatives) is also a possibility.

It is not always straight-forward to distinguish between the different instruments – Mr Pravin Gordhan remarked in his 2013 Budget Speech before Parliament:

*“The Budget Review outlines various measures proposed to protect the tax base and limit the scope for tax leakage and avoidance .... outstanding difficulties in the distinction between debt and equity will be addressed”<sup>16</sup>*

Debt is easy to use as a tax-planning tool, arguably easier to put in place and exploit than the transfer pricing of goods and services. It is a simple option to purchase assets using debt, producing tax-deductible interest, rather than using equity with dividends that are not tax deductible. All things being equal (no block on the flow of dividends, for example) the reward may be similar whether the form of the investment is equity or debt, but the tax consequences of choosing one option over than the other can be marked, as explained below:

Tax payable is higher where the company employs equity rather than debt, as interest paid is deductible and reduces taxable income. This is one reason why debt is usually regarded as the cheaper form of finance for the borrower. However, the more interest paid to parties which is independent from the shareholders, the fewer profits there are to distribute as a return to shareholders. Therefore, although there are obvious tax advantages to financing using loan capital, these will be weighed against other factors and other interests.<sup>17</sup>

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<sup>14</sup> Her Majesty's & Revenue & Customs - INTM571015 - Thin capitalisation: practical guidance - introduction: What is thin capitalisation? Available online at

<http://www.hmrc.gov.uk/manuals/intmanual/INTM571015.htm>

<sup>15</sup> The Australian Board of Taxation – Review of the Thin Capitalisation Arm's Length Debt Test Discussion Paper (Media Release 045, 2013) Available online at

[http://www.taxboard.gov.au/content/Content.aspx?doc=publications\\_and\\_media/media\\_releases/045.htm&pageid=008](http://www.taxboard.gov.au/content/Content.aspx?doc=publications_and_media/media_releases/045.htm&pageid=008)

<sup>16</sup> National budget speech by Pravin Gordhan, Minister of Finance, 27 February 2013 – available online

<http://www.treasury.gov.za/documents/national%20budget/2013/speech/speech.pdf>

<sup>17</sup> Her Majesty's & Revenue & Customs - INTM571015 - Thin capitalisation: practical guidance - introduction: What is thin capitalisation? Available online at

<http://www.hmrc.gov.uk/manuals/intmanual/INTM571015.htm>

Legally, there are major differences between an equity investment and debt:

An equity investment involves the contribution of capital in return for shares. As a result, the investor has no assurance of any return. Debt involves the lending of money to the company which is often evidenced by the issuing of debentures to the creditor in exchange for a fixed return.<sup>18</sup>

A debenture is a type of debt instrument, similar to a bond, that is not secured by physical assets or collateral. Debentures are documented in an indenture which is a written agreement between the issuer and holder and sets out specific rights as to repayment of capital and interest. Debentures provide higher rates of financial return and are usually more rewarding than government bonds or bank investments. At the end of the lending period, issuing companies usually offer the choice of converting the debentures for shares. Interest is paid to investors whether or not the issuing company makes a profit or not. Debentures are transferable from investor to investor and the cost of debt is lower than the cost of equity or preference shares as interest is tax deductible.<sup>19</sup>

Equity is usually provided for an unlimited period and is subject in full to the risks of the venture. Providers of equity also bear all the risks associated with the business of a company. Debt, on the other hand, is usually provided for a limited period and is from a legal point of view not subject to the risks of the venture. As a result if a company experiences financial difficulties the rights of creditors will take precedence over the rights of shareholders.

In return for capital a shareholder can expect dividends. The return that creditors receive on their investment takes the form of interest and not dividends. As dividends can only be declared when a company makes profits, the return of an equity investor is uncertain.

As shareholders have no guaranteed return on their investment, they cannot insist on security that they will receive dividends, because, from a legal point of view, a company cannot, for example, register a bond over its immovable property which may be called up if the expected dividends are not distributed. In practice the problem is often overcome by insisting that the holding company of a company in which the equity investment is made undertakes to acquire the shares at a price which will put the shareholder in the same financial position had the dividends been distributed. Debt, on the other hand, is often secured by the registration of a bond over immovable property or some other form of adequate security.

Apart from the right to share in the profits of the company, a capital contribution usually enables the shareholder to participate indirectly in the management of the company by exercising its voting rights attached to the shares.<sup>20</sup> Creditors do not generally have the right to participate in the management of the debtor, but during

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<sup>18</sup> Cross-border Financing in International Tax a South African Perspective (Third edition - 2005) by Lynette Olivier and Michael Honiball, citing Cilliers et al - Corporate Law 2001.

<sup>19</sup> Johannesburg Stock Exchange – Equity-market products – Available at <http://www.jse.co.za/products/Equity-Market-Products/Equity-Market-Product-Detail/Debentures.aspx>

<sup>20</sup> *ibid*

business rescue proceedings they are entitled to notice of, and participation in, each court proceeding, decision or meeting.<sup>21</sup>

A company is usually not obliged to repay a capital investment, whereas debt has to be repaid.

Similar to an investor in equity taking inheritant risks, the investment has the potential for unlimited growth. Equally, as a creditor does not participate in the risk of a debtor, his or her return is limited to the interest agreed upon.<sup>22</sup>

The neat division of company finance into equity and debt does not in reality do justice to the enormous diversity of financial instruments available. A wide variety of instruments incorporate elements of both equity and debt. Usually, these financial instruments are referred to as hybrid instruments, or mezzanine finance.<sup>23</sup> Hybrid financial instruments are neither typical equity nor typical debt and often lead to classification conflicts, especially in cross-border-transactions. Although hybrid instruments may be issued for a variety of non-tax reasons, taxation issues have a considerable impact on management's financing decisions with respect to hybrid instruments.<sup>24</sup>

Tax treatment of hybrid instruments varies among countries. This may cause severe distortions to most countries efforts to ensure single taxation of the yield (e.g. avoiding the taxation of specific income which is also subjected to tax in other jurisdictions). The use of hybrid financial instruments for intra-group financing offers the chance of possible double-non taxation.<sup>25</sup> This conflict can arise due to a lack of international tax harmonization or tax coordination qualification, for instance, a specific hybrid instrument is classified as debt in one country, and as equity in the other country.<sup>26</sup>

However a parent company that wishes to finance its foreign subsidiary via hybrid instruments faces uncertainties in multiple ways: The chance of double non-taxation is connected to the risk of misclassification and double taxation, as complex equity finance may be classified as debt finance by a tax jurisdiction, and vice versa. The

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<sup>21</sup> Section 145 of the Companies Act, 2008 (Act No. 71 of 2008)

<sup>22</sup> Cross-border Financing in International Tax a South African Perspective (Third edition - 2005) by Lynette Olivier and Michael Honiball, citing Cilliers et al - Corporate Law 2001.

<sup>23</sup> Eberhartinger, Eva and Pummerer, Erich and Göritzer, Andreas (2010) Cross-border Intra-group Hybrid Finance and International Taxation. Discussion Papers SFB International Tax Coordination, 33. SFB International Tax Coordination, WU Vienna University of Economics and Business, Vienna. Available at: <http://epub.wu.ac.at/618/>

<sup>24</sup> Eberhartinger, Eva and Six, Martin Alexander, Taxation of Cross-Border Hybrid Finance - A Legal Analysis (September 14, 2007). Intertax 2009. Available at SSRN: <http://ssrn.com/abstract=1080549>

<sup>25</sup> Aschauer, Ewald, Eberhartinger, Eva and Panny, Wolfgang, Cross-Border Hybrid Finance and Tax Planning: Does International Tax Coordination Work? (July 6, 2010). International Tax Coordination: An interdisciplinary perspective on virtues and pitfalls, M. Zagler, p. 115, Routledge, 2010. Available at SSRN: <http://ssrn.com/abstract=1635158>

<sup>26</sup> Eberhartinger, Eva and Pummerer, Erich and Göritzer, Andreas (2010) Cross-border Intra-group Hybrid Finance and International Taxation. Discussion Papers SFB International Tax Coordination, 33. SFB International Tax Coordination, WU Vienna University of Economics and Business, Vienna. Available at: <http://epub.wu.ac.at/618/>

existence of a double tax convention does not necessarily reduce the expected total tax burden.<sup>27</sup>

While tax treatment has no necessary connection with accounting treatment<sup>28</sup>, the legal substance of hybrid instruments is similarly important for both tax law purposes and the accounting principle of substance above form. The application of International Accounting Standard IAS32 Financial Instruments: Presentation may therefore be relevant, which deals with whether an instrument issued by an entity should be classified as debt or equity. The fundamental principle is that on initial recognition the instrument is classified either as a financial liability or as an equity instrument.<sup>29</sup>

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<sup>27</sup> Aschauer, Ewald, Eberhartinger, Eva and Panny, Wolfgang, Cross-Border Hybrid Finance and Tax Planning: Does International Tax Coordination Work? (July 6, 2010). International Tax Coordination: An interdisciplinary perspective on virtues and pitfalls, M. Zagler, p. 115, Routledge, 2010. Available at SSRN: <http://ssrn.com/abstract=1635158>

<sup>28</sup> Commissioner for Inland Revenue v Felix Schuh (Pty) Ltd 1994 (2) SA 801 (A) at 813F

<sup>29</sup> International Accounting Standard IAS32 Financial Instruments: Presentation, part of International Financial Reporting Standards (IFRSs), issued by the International Accounting Standards Board. Available at <http://www.ifrs.org/Pages/default.aspx>

## Chapter 4 – Historic overview of thin capitalisation in South Africa

### Introduction

South Africa did not have any specific transfer pricing stipulations in its taxation acts before democratisation in 1994.

Prior to 1995, the exchange control regulations were ridged with regards to foreign loans to South African residents. The Exchange Control Department of the South African Reserve Bank applied thin capitalisation restrictions to foreign investors in terms of the Exchange Control Act and its Regulations.<sup>30</sup> In terms of these provisions, a debt to equity ratio of 3:1 was required.<sup>31</sup>

### Katz Commission

In the first report of the Katz Commission of 1994, it was noted that relaxation of exchange controls was under consideration, and that whilst the decision to effect such relaxation 'should not be influenced by tax considerations', the Commission tabled the tax considerations in respect of the removal of exchange control constraints.

It recommended the introduction of transfer pricing rules to protect the tax system against abuse as well as to prepare the system for any further relaxation of exchange controls. The proposed rules included inter alia:

- A combination of a debt to equity formula approach and an arm's length approach
- A statutory safe harbour ratio of 5:1
- Investors should retain the opportunity to present objective evidence that any excess over such safe harbour ratio was justifiable on an arm's length basis
- That excess interest be treated as a dividend, with the associated Secondary Tax on Companies charge being suitably applied.<sup>32</sup>

The evolution in the approach to and administration of South Africa's exchange control regulations necessitated the preparation by the Commission of a second report. This Second Interim Report was issued by the Commission on 28 June 1995

and tabled more specific recommendations regarding thin capitalisation, including a draft wording of both proposed legislation and a proposed practice note.<sup>33</sup>

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<sup>30</sup> International Tax A South African Perspective – Olivier & Honiball

<sup>31</sup> Currency and Exchanges Act 9 of 1933, read together with Exchange Control Regulations, 1961, as amended

<sup>32</sup> Katz Commission – Chapter 14 of the Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa (1994)



### Implementation of reforms

As a result of the Katz Commission's second report, section 31(3) of the Income Tax Act was promulgated in 1995.<sup>34</sup> In addition, Practice Note 2 (Income Tax: Determination of Taxable Income where Financial Assistance has been Granted by a Non-resident of the Republic to a Resident of the Republic) was issued by SARS on 14 May 1996 to clarify how the Commissioner of SARS will be applying the section.

Section 31 of the Act essentially required that an arm's length, market related price be paid or charged in respect of the cross-border supply of goods or services between connected persons. Should the Commissioner for the South African Revenue Service (SARS) be of the opinion that an arm's length price has not been paid or charged, he is entitled to adjust the consideration for the transaction in order for it to reflect an arm's length price, resulting in a potentially higher tax liability for the taxpayer.

Furthermore, the excessive portion of the consideration were at the stage when the section first became effective, subject to Secondary Tax on Companies (STC), since the payment were regarded as a deemed dividend under section 64(C)(2)(e) of the Act. The Commissioner were also entitled to impose additional tax of up to 200% on the under payment of tax, together with interest.

The Act did not define "excessive". However, according to SARS Practice Note 2 a ratio of 3:1 (loans to equity) was acceptable. Where the ratio exceeded 3:1, the provisions of section 31 were applicable.

### Exchange control

On 12 March 1997, Mr Trevor Manuel, then Minister of Finance, made inter alia the following remarks in his budget speech:

*"South African individuals and corporations will in future be allowed the freedom to transact internationally, as envisaged in the macroeconomic strategy. The package of exchange control reforms placed before this House today moves South Africa to a system with a positive rather than a negative bias and the Exchange Control Regulations will revised to accommodate this fundamental change in philosophy.*

*The objective is to reach a point where there is equality of treatment between non-residents and residents in relation to inflows and outflows of capital.*

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<sup>33</sup> Second Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa (1995) Government Printer, Pretoria.

<sup>34</sup> Section 23 of the Income Tax Amendment Act 21 of 1995 which substituted section 31 of the Income Tax Act 58 of 1962

*South African corporations will be allowed to raise foreign funding on the strength of their South African balance sheets; and when circumstances permit, South African corporations will be free to invest abroad a percentage of their assets (based on audited balance sheets) for portfolio investments;...*<sup>35</sup>

After these reforms to the exchange control regulations, the risks for the state of interest stripping became much more prevalent, for the following reasons:

- Section 10(1)(h) of the Income Tax Act provided that interest received by or accrued to a non-resident was entirely exempt from taxation
- Section 11(a) of the Income Tax Act did not place any cap on the deduction of interest payments

As the reforms allowed South African corporations to raise foreign funding on the strength of their South African balance sheets, interest on the foreign loans would start flowing out of the country, creating a tax deduction for the corporations, with no concurrent receipt of tax on interest income (owing to the then section 10(1)(h) exemption), opening up the taxation system for abuse by connected parties.

The Katz Commission's fifth report, issued right before the 1997 budget speech, recommended the re-introduction of non-residents tax on interest (NRTI) in respect of lenders connected to the borrower in foreign jurisdictions:<sup>36</sup>

*"... where interest flowing from a primary South African source to a non-resident constitutes a portfolio investment (i.e. payment to an unconnected lender), it should continue to be exempt from both normal tax and NRTI. In the case where it flows between connected parties, only the exemption from normal tax should apply. The exemption from withholding tax (NRTI) would therefore not apply between connected parties, in consequence whereof the NRTI will become a final withholding tax."*

### Changes of 2000

In 2000 small non-significant amendments were made to section 31.<sup>37</sup> A more significant amendment was made to Practice Note 2, which reduced the increment over the relevant interbank rate on a foreign currency denominated loan from a non-resident to a South African resident from 4% to 2%.<sup>38</sup>

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<sup>35</sup> National budget speech by Trevor Manuel, Minister of Finance, 12 March 1997 – available online <http://www.info.gov.za/speeches/1997/000223318p2003.htm>

<sup>36</sup> Katz Commission 5th Report – Basing the South African income tax system on the source or residence principle - options and recommendation par 6.2.2 – available online <http://www.treasury.gov.za/publications/other/katz/5.pdf>

<sup>37</sup> Taxation Laws Amendment Act No. 59 of 2000

<sup>38</sup> Government Notice 746 of 2002

## Changes of 2011

In 2010 it was announced that the South African transfer pricing rules would undergo a substantial redrafting process in order to align them with international best practice.

The new section 31 was promulgated in 2011 and became effective on 1 April 2012, applying in respect of all financial years commencing on or after that date.<sup>39</sup> (Refer to chapter 6 for a discussion of the new section 31).

According to the Explanatory Memorandum, the wording of section 31 was causing structural problems and uncertainty, as the literal wording unduly focused on isolated transactions as opposed to arrangements driven by an overarching profit objective.<sup>40</sup>

An example would be where, in some high-risk industries, a ratio of only 2:1 or less (debt to equity) is attainable in arms-length transactions. The wording of section 31, however, opened an opportunity for abuse by allowing a 3:1 ratio. On the other hand, in certain industries it may be perfectly acceptable to have a ratio of 5:1, but as this fell afoul of the stipulations of section 31, it hinders foreign investment in those industries.

In order to eliminate the above uncertainties, the new rules have been worded similar (not the same) to the wording of Article 9 of the OECD Model Convention on Income and on Capital (OECD Model Convention), with the focus on the economic substance of the arrangements between related parties, rather than the pricing of specific transactions.

The OECD Model Convention mentions "*the conditions made between the two enterprises had been those which would have been made between independent enterprises*".<sup>41</sup>

Accordingly, the latest version of section 31(2) will apply to any transaction, operation scheme, agreement or understanding where:

- that transaction constitutes an affected transaction; and
- any term or condition of that affected transaction is different from what would have existed had the affected transaction taken place between independent persons dealing at arm's length; and
- results or will result in any tax benefit being derived by a person that is party to the affected transaction.

The term "affected transaction" is defined in section 31(1) and includes any transaction, operation, scheme, agreement or understanding which has been directly or indirectly entered into or effected between or for the benefit of either or both a

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<sup>39</sup> Taxation Laws Amendment Act, 2011 (No. 24 of 2011)

<sup>40</sup> Explanatory Memorandum on the Taxation Laws Amendment Bill of 2011

<sup>41</sup> Articles of the Model Tax Convention on Income and on Capital, 2010 – available online <http://www.oecd.org/tax/treaties/47213736.pdf>

resident and a non-resident which are connected persons in respect to each other and where any of the terms or conditions agreed upon are not of an arm's length nature.

Where the above described requirements are met, the taxable income or tax payable by any person that is party to such a transaction, operation or scheme and derives a tax benefit must be calculated as if that transaction, operation or scheme had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm's length, in terms of section 31(2).

Accordingly, the discretion previously granted to the Commissioner to adjust the consideration has been replaced with an obligation on the taxpayer to calculate its taxable income, as if all transactions had been entered into on an arm's length basis (section 31(2)).

In addition, the automatic deemed dividend rules in respect of transfer pricing have been replaced with new rules deeming the amount of the transfer pricing adjustment (the primary adjustment) to be a loan by the South African taxpayer to the non-resident connected person (section 31(3)). As this deemed loan (the secondary transaction) constitutes an affected transaction, it attracts interest at an arm's length rate. SARS has indicated in the Explanatory Memorandum to the 2011 Amendment Bill, that the primary adjustment will not be regarded as a deemed loan, if "repaid" within the same financial year, in which the primary adjustment is made. This, together with the obligation on the taxpayer to calculate its taxable income on an arm's length nature now allows a taxpayer to make so-called "voluntary" transfer pricing adjustments without the current automatic "penalty" in the form of the deemed dividend rules and the subsequent obligation to pay STC.<sup>42</sup>

In line with the OECD's views<sup>43</sup>, SARS has stated that it views the issue of thin capitalisation as part of the transfer pricing mandate.<sup>44</sup> Accordingly, the previous section 31(3), which allowed the Commissioner to disallow the deduction of interest by a taxpayer where financial assistance has been provided and where the Commissioner regards such financial assistance as excessive in relation to the fixed capital of the taxpayer, was deleted with effect from 1 April 2012. With the deletion of the specific thin capitalisation provision, the 3:1 debt to equity ratio safe harbour provided in Practice Note No. 2 also disappeared.

Instead, the new rules require that the arm's length principle be applied to financial assistance in the same way it is applied to any other transaction, operation, scheme, agreement or understanding. In practice, this results that a taxpayer have to determine what amounts it would have been able to borrow (that is, it's lending

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<sup>42</sup> *ibid*

<sup>43</sup> Review of comparability and profit methods: Revision of chapters I-III of the Transfer Pricing Guidelines, 2010, par. 1.65 – available online: <http://www.oecd.org/tax/transfer-pricing/45763692.pdf>

<sup>44</sup> Draft Interpretation Note on the determination of the taxable income of certain persons from international transactions: Thin capitalisation, par. 2 – available online: <http://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2013-10%20-%20Draft%20IN%20Determination%20Taxable%20Income%20International%20Transactions%20Thin%20Capitalisation.pdf>

capacity) in the open market, on what overall terms and conditions, and at what price.<sup>4546</sup>

Although the introduction of the arm's length standard to the thin capitalisation rules seems to be commendable, in practice the application of the arm's length principle in the context of thin capitalisation has proven to be extremely difficult, as the factors considered by third party providers of financial assistance are often multi-faceted and not necessarily limited to an analysis of the debt to equity ratio. SARS has acknowledged this and has undertaken to issue an interpretation note in respect of the new transfer pricing rules in general and the application of the arm's length principle to thin capitalisation specifically before 1 April 2012.<sup>47 48</sup>

However, the said interpretation note was never published. Instead, The South African Revenue Service (SARS) released a draft interpretation note on thin capitalisation for public comment.<sup>49</sup>

In general, the Note provides guidance on the application of the arm's length principle in the context of determining whether a taxpayer is thinly capitalized under section 31 of the Income Tax Act and, if so, calculating taxable income without claiming a deduction for the expenditure incurred on the excessive portion of finance. In particular, guidance is provided on the following:

- determination of an arm's length amount of debt (paragraph 5.2)
- classification of debt and equity for purposes of arm's length testing (paragraph 5.3)
- determination of an arm's length interest rate (paragraph 5.4)
- timing issues (paragraph 5.5)
- primary and secondary transfer pricing adjustments (paragraph 6)
- risk assessment and selection of cases for audit (paragraph 7)
- documentation requirements (paragraph 8)

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<sup>45</sup> Article by Edward Nathan Sonnenbergs for Integritax - available online:  
[http://www.saica.co.za/integritax/2012/2044.\\_New\\_rules.htm](http://www.saica.co.za/integritax/2012/2044._New_rules.htm)

<sup>46</sup> Section 31(2) of the Income Tax Act

<sup>47</sup> Ibid

<sup>48</sup> Draft Explanatory Memorandum to the Draft Taxation Laws Amendment Bill, 2010, available online at  
[http://www.treasury.gov.za/legislation/draft\\_bills/Draft%20Explanatory%20Memorandum%20on%20the%20Taxation%20Laws%20Amendment%20Bill%202010%20-%2006%20Sep%202010.pdf](http://www.treasury.gov.za/legislation/draft_bills/Draft%20Explanatory%20Memorandum%20on%20the%20Taxation%20Laws%20Amendment%20Bill%202010%20-%2006%20Sep%202010.pdf)

<sup>49</sup> Draft Interpretation Note on the determination of the taxable income of certain persons from international transactions: Thin capitalisation – available online:  
<http://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2013-10%20-%20Draft%20IN%20Determination%20Taxable%20Income%20International%20Transactions%20Thin%20Capitalisation.pdf>

- application of the arm's length principle to potential thin capitalization situations involving permanent establishments (paragraph 9)
- the (non-)application of the thin capitalization rules to headquarter companies (paragraph 10)
- the (non-)application of the thin capitalization rules to highly-taxed foreign controlled companies (paragraph 11)
- the non-availability (currently) of an advance pricing agreement process in South Africa (paragraph 12)

When finalized, the Note will replace Practice Note No. 2 of 14 May 1996 and its Addendum of 17 May 2002, for years of assessment commencing on or after 1 April 2012. In the case of a year of assessment ending on 31 December, the first year of assessment to which the new legislation will apply is the year of assessment commencing on 1 January 2013 and ending on 31 December 2013.

The note advises that Practice Note No. 2 of 14 May 1996 "Income Tax: Determination of Taxable Income where Financial Assistance has been Granted by a Non-resident of the Republic to a Resident of the Republic" and its Addendum of 17 May 2002 are withdrawn by this Note for years of assessment commencing on or after 1 April 2012. The practice note remains applicable to transactions that fall within the ambit of section 31(3) for years of assessment commencing before 1 April 2012.

The SARS has invited public comments on the Note to be submitted by 30 June 2013.<sup>50</sup>

### Current events

South Africa introduced a new dividends tax on 1 April 2012. The withholding tax regime was widened, with the introduction of interest withholding tax (15%) from 1

July 2013, whilst the withholding tax on the royalties regime was to be overhauled, and the rate of tax would also increase from 12% to 15%, also effective 1 July 2013.

Pravin Gordhan, the Minister of Finance, announced in the 2013/14 Budget Speech that the effective date for the new interest and royalty withholding tax regimes will be

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<sup>50</sup> Draft Interpretation Note on the determination of the taxable income of certain persons from international transactions: Thin capitalisation – available online:  
<http://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2013-10%20-%20Draft%20IN%20Determination%20Taxable%20Income%20International%20Transactions%20Thin%20Capitalisation.pdf>

delayed until 1 March 2014.<sup>51</sup> The 2012 draft Taxation Laws Amendment Bill contained certain provisions whereby a deduction in respect of cross-border interest and royalty payments were deferred until the date of payment.<sup>52</sup> These provisions did not form part of the final 2012 Taxation Laws Amendment Bill when it was introduced in parliament for promulgation, and the provisions were deferred for introduction in 2013/14.<sup>53</sup>

The OECD released its initial report on base erosion and profit shifting on 12 February 2013.<sup>54</sup> The report discusses the key principles that underlie the taxation of cross-border activities, and focuses, amongst others on mismatches in entity and instrument characterisation (hybrids and arbitrage), and related party debt-financing.<sup>55</sup>

The National Treasury was moving to implement preventative measures. The 2012 draft Taxation Laws Amendment Bill contained certain provisions whereby debt would be reclassified as equity in certain instances (i.e. the instrument when reclassified will pay a dividend and not interest).

These new rules were excluded from the final 2012 Taxation Laws Amendment Bill when it was introduced in parliament for promulgation.

Instead, the provisions were deferred for introduction in 2013/14. It is proposed in the 2013/14 Budget that certain debt instruments, such as shareholder loans without a date of repayment or profit participation loans will be reclassified as equity.<sup>56</sup>

South Africa's revised transfer pricing rules that came into operation for years of assessment commencing 1 April 2012 and thereafter moved away from the safe harbour to an arm's length test. It is proposed in the 2013/14 Budget that connected party debt be limited so that the interest on this form of debt does not exceed 40 per cent of earnings after interest on other debts is taken into account.<sup>57</sup>

Ratio approaches determine the amount of deductible interest expense by reference to a specified ratio, such as the ratio of debt to equity. For example, the rules might allow interest payments on debt of up to two times the total amount of equity invested in the group affiliate. Any additional interest would not be deductible. This specified ratio is also known as a "safe harbour".<sup>58</sup>

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<sup>51</sup> National budget speech by Pravin Gordhan, Minister of Finance, 27 February 2013 – available online <http://www.treasury.gov.za/documents/national%20budget/2013/speech/speech.pdf>

<sup>52</sup> Draft Taxation Laws Amendment Bill, 2012, available online at [www.treasury.gov.za/public%20comments/TLAB/draft%20TLAB%202012%20for%20public%20comment.pdf](http://www.treasury.gov.za/public%20comments/TLAB/draft%20TLAB%202012%20for%20public%20comment.pdf)

<sup>53</sup> Taxation Laws Amendment Act, 2012 (Act No. 22 of 2012)

<sup>54</sup> The OECD Work on Base Erosion and Profit Shifting – available online <http://www.oecd.org/ctp/TheOECDworkonBEPS.pdf>

<sup>55</sup> The OECD Work on Base Erosion and Profit Shifting – p2 – "Key pressure areas"

<sup>56</sup> *Ibid*

<sup>57</sup> Cross Border Payments - Article by Ide Louw for Ernst & Young – available online at <http://www.ey.com/ZA/en/Services/Tax/2013-Budget---Ide-Louw---Cross-border-payments>

<sup>58</sup> Thin Capitalisation legislation a background paper for country tax administrations – Initial draft issued by the OECD August 2012 (Pilot version for comments) – Available at [http://www.oecd.org/ctp/tax-global/5.%20Thin\\_Capitalization\\_Background.pdf](http://www.oecd.org/ctp/tax-global/5.%20Thin_Capitalization_Background.pdf)

## Chapter 5 - The Commissioner of SARS's reasons for the changes to section 31(3) and his approach to thin capitalisation

Lee Corrick, Transfer Pricing Senior Specialist at SARS, made inter alia the following remarks at a presentation to the South African Fiscal Association in Cape Town on 25 October 2010<sup>59</sup>:

- The Commissioner may disallow interest, etcetera, if he/she considers the debt/equity ratio to be excessive.
- The amended legislation will ensure closer alignment to Article 9 of the Model Tax Convention – the wording is similar to that article.
- The amendments will ensure the focus is on the application of the arm's length principle, as it requires the arm's length terms and conditions to be applied.
- Three crucial questions will be under consideration (in a potential thin capitalisation scenario):
  - What could the South African resident have borrowed at arm's length?
  - What would the South African resident have borrowed at arm's length?
  - At what price?
- The legislation does not re-characterise excessive debt as equity, but disallows excessive interest as a deduction.
- Determining the arm's length terms and conditions may be difficult and complex.
- Safe harbours (refer to Chapter 4) were still under consideration by SARS:
  - Should there be one?
  - If so, what measure should be used?
  - At what level should any safe harbour be set?
- The new interpretation Note will cover a broad range of issues relating to the application of the amended legislation, for example, the issue of safe harbours.
- The aim is to issue the Interpretation Note before the amended legislation comes into effect.
- There will be a continued focus on addressing high risk issues.

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<sup>59</sup> South African Fiscal Association: Transfer Pricing in South Africa – seminar notes



- Risk assessment is seen as critical, in order to minimise the compliance cost burden for taxpayers and to maximise the use of SARS transfer pricing resources.
- There are no plans to introduce specific transfer pricing documentation requirements, but taxpayers need to be able to demonstrate that its taxable income has been calculated in accordance with the arm's length standard. Documentation required will thus depend upon the particular facts and circumstances of the case.
- Transfer pricing (including thin capitalisation) is often a fact intensive issue.
- Transfer pricing dispute resolution will consist of negotiation, mutual agreement procedure (MAP) and litigation. The vast majority of transfer pricing disputes are settled by negotiation and it require a pragmatic and reasonable approach by SARS and the taxpayer.
- SARS will look to negotiate where a reasonable resolution can be reached.
- SARS will enter into MAP where there is appropriate treaty wording.
- SARS does currently have some MAP cases and it is anticipated that the number of cases will grow over the coming years.
- Litigation is time consuming and expensive, however where a reasonable resolution cannot be reached, SARS will consider litigation in a transfer pricing dispute.
- SARS does not currently have an Advance Pricing Agreements Programme (APA). However, this is a matter SARS review on a regular basis.

From his remarks, the following can be inferred:

1. The previous ridged version of section 31(3) meant the arm's length principle did not necessarily apply, leading to the deduction of interest which would have been disallowed had arms-length principles been followed (probably why he stressed that the new legislation does not re-characterise excessive debt as equity, but disallows excessive interest as a deduction).
2. The Commissioner acknowledged that the establishment of arms-length terms and conditions may be difficult and complex.
3. The issue of safe harbours was still under discussion, but at the time it was expected to be addressed in the Interpretation Note, that was expected to be issued before the amended legislation came into effect.

4. SARS wanted to concentrate on high risk cases (hinting that there will already be clear indications that the arms-length principle has not been followed from the information at the Commissioner's disposal before an engagement with the taxpayer).
5. Even if the Commissioner is satisfied that the arms-length principle has not been followed (after an audit or investigation), it will be open for negotiation, or mutual agreement procedure, rather than litigation.
6. SARS were considering the implementation of an Advance Pricing Agreements Programme.

## Chapter 6 - Section 31 of the Income Tax Act (as effective from 1 April 2012)

Section 31 (as effective from 1 April 2012) has been made available in Annexure 1, for ease of reference.

Section 31 requires taxpayers to –

- determine whether the actual terms and conditions of any transaction, operation, scheme, agreement or understanding meeting part (a) of the definition of an “affected transaction” differ from the terms and conditions that would have existed if the parties had been independent persons dealing at arm’s length; and
- if there is a difference which results or will result in a tax benefit for one of the parties to the affected transaction, to calculate their taxable income based on the arm’s length terms and conditions of the affected transaction.

“Affected transaction” has a wide definition (attached as part of section 31 in Annexure A), but basically means any transaction, operation, scheme, agreement or understanding between connected persons (as defined in the Income Tax Act) and any term or condition of that transaction, operation, scheme, agreement or understanding is different from any term or condition that would have existed had those persons been independent persons dealing at arm’s length, where:

- One person is a resident; and the other person is not a resident
- One person is not a resident and any other person that is not a resident, but that has a permanent establishment in the Republic
- One person that is a resident and any other person that is a resident that has a permanent establishment outside the Republic
- One person that is not a resident and any other person that is a controlled foreign company in relation to any resident

The term “connected person” is defined in section 1(1) of the Income Tax Act. Sars has issued an Interpretation Note as guidance to its interpretation of “connected persons”.<sup>60</sup> Section 31(4) amends the section 1(1) definition where the transaction, operation, scheme, agreement or understanding relates to the granting of any financial assistance. Section 31(4) provides that the section 1(1) definition applies “(p)rovided that the expression ‘and no shareholder holds the majority voting rights in the company’ in paragraph (d)(v) of that definition must be disregarded”.

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<sup>60</sup> Interpretation Note no. 67 - 1 November 2012 – “Connected persons” – available at <http://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2012-67%20-%20Connected%20Persons.pdf>

If the actual terms and conditions of an affected transaction involving loans and other debt are not those that would have been agreed if the lender and borrower had been transacting at arm's length, and if this difference results in a tax benefit to any of the parties, then that taxpayer is required to calculate its taxable income based on the arm's length terms and conditions that should have applied to the affected transaction. This means that the interest, finance charges and other consideration relating to the excessive portion of the debt are disallowed as a deduction in computing the taxpayer's taxable income.

The terms and conditions of an affected transaction may be tax motivated, however this is not a requirement under section 31. An adjustment under section 31 may be required irrespective of whether or not the choice of funding was tax motivated.

In practice, a taxpayer will make a section 31 adjustment on their IT14 tax return.

According to the draft Interpretation Note, taxpayers must be able to demonstrate that debt which meets the definition of an affected transaction is at arm's length or that a tax deduction has not been claimed for the expenditure incurred on the portion of the debt that is not arm's length.

According to the draft Interpretation Note, the wording used in section 31 is wide and applies to transactions, operations, schemes, agreements and understandings that have been directly or indirectly entered into or effected between or for the benefit of either or both of the parties specified in the definition. The section is therefore far wider than a loan between two of the parties specified in part (a) of the definition of an "affected transaction".

Indirect funding includes, but is not limited to, back-to-back transactions with banks or other financial institutions (for example, one in which a non-resident member of an MNE places funds on deposit with a bank and the bank then loans funds to a South African resident member), the provision of guarantees by a non-resident member to a bank or other financial institution in connection with funding given by that bank or financial institution to a resident member or other arrangements in which funding provided by a foreign connected person is routed through one or more special purpose entities or other accommodating or tax-indifferent parties. In general, any funding provided indirectly will be treated as if the funding had been provided directly between the two connected parties.

In a case that involves indirect funding as a result of a guarantee provided by a non-resident connected person to a third party, the effect of the guarantee so provided will be ignored when determining how much the South African taxpayer could and would have borrowed.

Any interest, finance charges or other consideration payable for or in relation to or on that portion of the non-arm's length debt must be disallowed as a deduction in determining the taxpayer's taxable income. 'Other consideration' is wide and looks at all costs associated with the debt, for example, a foreign exchange loss on a foreign currency denominated loan.

Section 31 further provides for a secondary tax adjustment which arises from a primary transfer pricing adjustment. This means that in addition to the primary adjustment, the amount of the disallowed deduction is deemed to be a loan by the taxpayer that constitutes an affected transaction.

As a result, the taxpayer will have to calculate and account for interest income at an arm's length rate on the deemed loan. The accrued interest on the deemed loan will be capitalised annually for the purposes of calculating the deemed loan outstanding. The deemed loan and the interest calculated on it will be deemed to be payable until the amount is regarded as having been repaid to the taxpayer.

An amount will be regarded as having been repaid if, for example, the taxpayer is refunded the excessive interest or the other party pays the interest raised on the deemed loan. To the extent that the deemed loan is regarded as having been repaid to the taxpayer by the end of the year of assessment in which the primary adjustment was made, the section 31 primary adjustment will not be treated as a loan for the purposes of section 31.<sup>61</sup>

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<sup>61</sup> Draft Interpretation Note on the determination of the taxable income of certain persons from international transactions: Thin capitalisation – available online:  
<http://www.sars.gov.za/home.asp?pid=677>

## **Chapter 7 - Critical analysis of the Draft Interpretation Note on the determination of the taxable income of certain persons from international transactions: Thin capitalisation**

According to the Draft Interpretation Note on the determination of the taxable income of certain persons from international transactions: Thin capitalisation, each case will be decided on its own merits, taking into account its specific facts and circumstances.

### Application of the arm's length standard

The draft interpretation note refers to the OECD guidelines for guidance on the application of and adherence to the arm's length standard. Additionally, according to the said draft interpretation note, SARS will also consider the following additional points:

The interpretation note views the arm's length amount of the debt to be the lesser of the amount that could have been borrowed and the amount that would have been borrowed in a transaction between parties dealing at arm's length, according to the draft interpretation note.

The arm's length amount of debt thus may be nil in circumstances where a taxpayer with a very healthy balance sheet, excess cash reserves and spare borrowing capacity borrowed from an offshore parent company when all the relevant facts indicate that there was no business need or reason or commercial benefit for the additional finance.

According to the Note, a critical element of the arm's length debt test is the appropriate identification of what constitutes debt and equity and ensuring that all debt arrangements are taken into account. SARS's view is that independent parties dealing at arm's length would look to the economic substance of an item when assessing whether it is of a debt or equity nature or perhaps partly of a debt and partly of an equity nature. Accordingly, in determining the nature of a particular item the principles and treatment which would be adopted in financial statements prepared in terms of International Financial Reporting Standards (IFRS) are a good guideline, bearing in mind that the facts and circumstances of the particular case must always be taken into account in assessing whether any adjustments are required.

Debt for purposes of arm's length testing will therefore include, for example, straightforward loans, advances and debts. In addition, it will include things that are economically equivalent to debt such as finance leases, certain structured derivative financial instruments and components of hybrid instruments.

The Interpretation Note warns that the interest rate must also be arm's length. Again, the facts and circumstances of each case are critical. A taxpayer may have an arm's length amount of debt but the interest rate may not be arm's length or vice

versa. Alternatively, both the amount of debt and the interest rate may or may not be arm's length.

A taxpayer must reassess the appropriateness of the level of debt and interest from time to time. It is not possible to give a standardised frequency of time at which a taxpayer must reassess whether the amount of debt is arm's length. The frequency and timing will depend on the nature of the particular taxpayer's business. The Interpretation Note indicates that this would be the case even if the taxpayer does not prepare its accounts and financial records in terms of IFRS. The Interpretation Note is presumably referring to entities that are not companies or close corporations, like trusts or individuals.<sup>62</sup>

South Africa is not a member of the OECD and previously there was uncertainty on how much weight could be lent to the OECD commentary and guidelines.

On 8 May 2012 the Supreme Court of Appeal gave judgement in the Tradehold Ltd case. The judgement extensively made reference to the said OECD commentary and guidelines and as such, it is now clear that the said commentary and guidelines carry legal weight in considering thin capitalisation disputes.<sup>63</sup>

The terms "arms-length" have been discussed in various South African court cases. In *Hicklin v SIR*, the court held that 'dealing at arm's length was a useful and often easily determinable premise from which to start an inquiry. It connoted that in an arms-length transaction, each party was independent of the other and, in so dealing, would strive to get the utmost possible advantage out of the transaction for himself. As a result, in an arm's length agreement, the rights and obligations it created were more likely to be regarded as normal than abnormal. The means or manner employed in entering into it or carrying it out were also more likely to be normal than abnormal.'<sup>64</sup>

As the term "arms-length" is a subjective term, the prevalence of thin capitalisation is not always clear and its existence in a specific situation may not be accepted as a fact by different stakeholders in that situation.

The Organisation for Economic Co-operation and Development (OECD)'s guide on Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations highlights this dilemma by explaining the difficulty of comparing an independent entity's transactions with those of associated entities:

*"The arm's length principle is viewed by some as inherently flawed because the separate entity approach may not always account for the economies of scale and interrelation of diverse activities created by integrated businesses. There are, however, no widely accepted objective criteria for allocating the economies of scale or benefits of integration between associated enterprises.*

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<sup>62</sup> *Ibid*

<sup>63</sup> Commissioner for the South African Revenue Service v Tradehold Ltd (132/11) [2012] ZASCA 61 (8 MAY 2012)

<sup>64</sup> *Hicklin v SIR* 1980 1 SA 481 (A)

*A practical difficulty in applying the arm's length principle is that associated enterprises may engage in transactions that independent enterprises would not undertake. Such transactions may not necessarily be motivated by tax avoidance but may occur because in transacting business with each other, members of an MNE group face different commercial circumstances than would independent enterprises. Where independent enterprises seldom undertake transactions of the type entered into by associated enterprises, the arm's length principle is difficult to apply because there is little or no direct evidence of what conditions would have been established by independent enterprises. The mere fact that a transaction may not be found between independent parties does not of itself mean that it is not arm's length.<sup>65</sup>*

### Functional analysis

According to the draft interpretation note, a taxpayer is required to perform a functional analysis and a comparability analysis to support the appropriateness of their arm's length debt assessment.

It suggests that the following items be taken into account for performing the analysis:

- The funding structure which has been or is in the process of being put in place, including the dates of transactions, the source of the funds (immediate and ultimate), reasons for obtaining the funds, how the funds were or will be applied (the purpose of the funding) and the repayment terms.
- The business (a high level understanding covering the relevant industry, the business itself, details regarding the management team and external market conditions) and the plans of the principal trading operations (including the business strategy).
- The financial strategy of the business, including how capital is allocated, the relationship between capital and cash flows from operations and any changes relating to the funding transactions; and details regarding the principal cash flows and the sources of repayment of debt.
- The companies in the group structure which are affected by or involved in the funding transactions and any changes to the structure taking place over the course of the funding transactions.
- The taxpayer's current and projected financial position for an appropriate period of time, including the assumptions underlying the projections and cash flows (for example, the appropriateness of the intended repayment through sale of the asset (if applicable) or increased profits).

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<sup>65</sup> OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations – July 2010



- Appropriate financial ratios for the abovementioned periods (current and projected), for example:
  - Debt: EBITDA ratio
  - Interest cover ratio
  - Debt: Equity ratio
- Other indicators of the creditworthiness of the taxpayer, including, if available, any ratings by independent ratings agencies.
- The availability and quality of security.
- Whether or not the financial assistance is subordinate to the claims of other creditors.
- Terms and conditions of the funding arrangement such as the repayment terms, the period of funding and the cost of funding.

As the burden of proof with regards to an arm's length debt assessment and the position taken is on the taxpayer in terms of the Tax Administration Act, taxpayers must obtain comparable data, taking into account the quantitative and qualitative factors that third party lenders would typically consider when making lending decisions, to support the appropriateness of their arm's length debt assessment.<sup>66</sup>

According to the Interpretation Note, SARS is currently investigating the availability and appropriateness of a third party-provided South African-focussed database to assist with the assessment of the appropriateness of comparable data and the arm's length amount of debt. The databases being considered are used in conjunction with credit risk models from a quantitative perspective and scorecard models from a qualitative perspective. The databases, model and scorecard would ultimately provide a range of industry sector norm ratios (like Debt: EBITDA) based on credit ratings which, in conjunction with other relevant information provided by the taxpayer, can be used to assess the appropriateness of comparable data provided and ultimately the taxpayer's assessment of the amount it could and would have borrowed at arm's length.<sup>67</sup>

Mainstream thin capitalisation comparability data are not readily available in South Africa, which is critical for any comparability study. Various privacy laws protect the confidentiality of business information, while SARS is bound by section 69 of the Tax Administration Act and prohibited to divulge information submitted by a taxpayer.

While data sources may be readily available for other countries, the data must be country-specific to South Africa for it to be of relevance, as the South African market has its own, unique risks, competitor profiles and market maturity.

As a result, no exact comparable will be found in most cases, which will require the analysis to use other comparables and to make adjustments to make them relevant.

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<sup>66</sup> Section 102(1) of the Tax Administration Act, 2011 (Act No. 28 of 2011)

<sup>67</sup> Ibid

The more adjustments that need to be made, the less reliable the comparable is likely to be.

By applying logic, the following is some of the relevant data that will be needed to complete an analysis and should be available in a database:

- Sector where the business is operating
- The age of the business (e.g. established, start-up, etc.)
- Other factors, like its directors
- Turnover and profitability
- Economic outlook for the business
- The economic climate and outlook of the country
- Proportions of debt and equity per category of business

In the absence of relevant comparability data, an analysis will have to use as alternative sources, which may include:

- Bank agreements
- Financial sector practises
- Management accounts and budget forecasts
- Statements and information made available by the MNE's finance director
- Merger and acquisition documents

The functional analysis will require the user to think like a banker, in order to arrive at arms-length terms and conditions and to motivate his/her conclusion.

Historic information on the financial markets must also be available. For instance, you cannot merely accept that similar businesses must have the same debt/equity ratio at all times. The data on the comparability list could have been compiled when the economy was booming and cheap finance was readily available. At the time of the comparison, however, there may be a financial crisis with high interest rates and little businesses which will be willing to borrow or lend.

Different rules may apply in special circumstances, for instance, in a merger or acquisition scenario, businesses may be willing to use unconventional finance models or interest rates that look out of the ordinary. This will skew the data on the comparability lists.

With regards to the classification of debt and equity for purposes of arm's length testing, the Interpretation Note again refers to a database that will be available:

*"A taxpayer's credit rating, an approximation of which would be available from the use of the third party provided database, credit risk and scorecard models which SARS is investigating may be used as a basis to determine the arm's length interest rate in conjunction with relevant external third party data."<sup>68</sup>*

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<sup>68</sup> Ibid

The Interpretation Note does not address the issue of private equity. Private equity represents a class of investors, their funds, and their subsequent investments, which are made in private companies or in public companies with the goal of taking them private. Private equity investments are primarily made by private equity firms, venture capital firms, or angel investors, each with its own set of goals, preferences, and investment strategies, yet each providing working capital to the target firm to nurture expansion, new product development, or restructuring of the firms operations, management, or ownership. Business strategy will be unique and may use unconventional finance models or interest rates that look out of the ordinary.<sup>69</sup>

### The risk assessment

The Interpretation Note gives valuable insight into what SARS will view as risk factors when considering a taxpayer linked to an MNE.

“SARS will consider a taxpayer to be thinly capitalised if, amongst other factors, some or all of the following circumstances exist:

- The taxpayer is carrying a greater quantity of interest-bearing debt than it could sustain on its own.
- The duration of the lending is greater than would be the case at arm's length.
- The repayment or other terms are not what would have been entered into or agreed to at arm's length.”

SARS adopts a risk-based audit approach in selecting potential thin capitalisation cases for audit. In selecting cases, SARS will consider transactions in which the Debt: EBITDA ratio of the South African taxpayer exceeds 3:1 to be of greater risk.

From an audit risk perspective, SARS will consider a debt denominated in rand to be of higher risk if the following rate applies to the pricing of an inbound loan meeting part (a) of the definition of an “affected transaction”:

- A rate exceeding the weighted average of the South African Johannesburg Interbank Agreed Rate plus 2%.

A debt denominated in a foreign currency will be considered to be of higher risk if the following rate applies to the pricing of an inbound loan meeting part (a) of the definition of an “affected transaction”:

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<sup>69</sup> Private Company Knowledge Bank - Privco.com available at <http://www.privco.com/knowledge-bank/private-equity-and-venture-capital>

- A rate exceeding the weighted average of the base rate of the country of denomination plus 2%.”

The mention that the Note makes that SARS will consider transactions in which the Debt: EBITDA ratio of the South African taxpayer exceeds 3:1, indicates that a “safe harbour” may still practically continue to exist, notwithstanding the replacement of Practice Note 2.

The OECD defines a safe harbour as a statutory provision that applies to a given category of taxpayers and that relieves eligible taxpayers from certain obligations otherwise imposed by the tax code by substituting exceptional, usually simpler obligations.<sup>70</sup> In the specific instance of transfer pricing, the administrative requirements of a safe harbour may vary from a total relief of targeted taxpayers from the obligation to conform with a country’s transfer pricing legislation and regulations to the obligation to comply with various procedural rules as a condition for qualifying for the safe harbour.

SARS Practice Note 2 (effective for transactions up to 31 March 2012) contained a safe harbour - a loans to equity ratio of 3:1 was acceptable. Where the ratio exceeded 3:1, the provisions of section 31 were applicable.<sup>71</sup>

### The problem with “safe harbours”

The safe harbour mechanical test is subject to abuse because it disregards the economics of corporate finance.

The economic substance of a transaction having priority over its form has a strong foundation in South African tax law. In Erf 3181/1 Ladysmith<sup>72</sup>, Hefer JA said in the Supreme Court of Appeal:

*“... once it is found that the parties to the present agreements actually intended to structure their arrangement in the form of a lease coupled with a sub-lease and a building contract, there is really an end to the matter, because in that event effect must be given to each agreement according to its tenor. This is plainly not so. That the parties did indeed deliberately cast their arrangement in the form mentioned, must of course be accepted; that, after all, is what they had been advised to do. The real question is, however, whether they actually intended that each agreement would mfer partes have effect according to its tenor. If not, effect must be given to what the transaction really is.”*

A safe harbour test make it susceptible to attempts to comply in form, but not in substance - international financiers are encouraged to abuse the safe harbour mathematical percentage that focus on the form of the transaction. Moreover, safe

<sup>70</sup> OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations – July 2010

<sup>71</sup> Practice Note 2 (Income Tax: Determination of Taxable Income where Financial Assistance has been Granted by a Non-resident of the Republic to a Resident of the Republic) - 14 May 1996. Available online <http://www.sars.gov.za/AllDocs/LegalDoelib/Notes/LAPD-IntR-PrN-2012-14%20-%20Income%20Tax%20Practice%20Note%202%20of%201996.pdf>

<sup>72</sup> Erf 3181/1 Ladysmith (Pty) Ltd and Another v Commissioner for Inland Revenue 1996 (3) SA 942 (A)

harbour tests are not necessarily accurate indicators of the real financial risks and rewards implicit in a corporation's capital structure. Thus, since the measure do not separate cases of abusive thin capitalization from cases of economically- justified high leverage, the provision will not necessarily apply to some thinly capitalized corporations to which it should apply. Likewise, the provision will apply to some corporations that are not thinly capitalized.<sup>73</sup>

The OECD's Transfer Pricing Guidelines identifies the following additional Problems presented by use of safe harbours<sup>74</sup>:

1. The implementation of a safe harbour in a given country would not only affect tax calculations within that jurisdiction, but would also impinge on the tax calculations of associated enterprises in other jurisdictions.
2. It is difficult to establish satisfactory criteria for defining safe harbours, and accordingly they can potentially produce prices or results that may not be consistent with the arm's length principle.
3. From a practical point of view, the most important concern raised by a safe harbour is its international impact. Safe harbours could affect the pricing strategy of corporations. The existence of safe harbour "targets" may induce taxpayers to modify the prices that they would otherwise have charged to controlled parties, in order to increase profits to meet the targets and thereby avoid transfer pricing scrutiny on audit. The concern of possible overstatement of taxable income in the country providing the safe harbour is greater where that country imposes significant penalties for understatement of tax or failure to meet documentation requirements, with the result that there may be added incentive to ensure that the transfer pricing is accepted without further review.
4. Safe harbours would also provide taxpayers with tax planning opportunities. Enterprises may have an incentive to modify their transfer prices in order to shift taxable income to other jurisdictions. This may also possibly induce tax avoidance, to the extent that artificial arrangements are entered into for the purpose of exploiting the safe harbour provisions.
5. Safe harbours raise equity and uniformity issues. By implementing a safe harbour, one would create two distinct sets of rules in the transfer pricing area, one requiring conformity of prices with the arm's length principle and another requiring conformity with a different and simplified set of conditions. Since criteria would necessarily be required to differentiate those taxpayers eligible for the safe harbour, similar and possibly competing taxpayers could, in some circumstances, find themselves

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<sup>73</sup> Robert J. Misesy Jr., Unsatisfactory Response to the International Problem of Thin Capitalization: Can Regulations Save the Earnings Stripping Provision, An, 8 Int'l Tax & Bus. Law. 171 (1991). Available at <http://scholarship.law.berkeley.edu/bjil/vol8/iss2/1>

<sup>74</sup> OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations – July 2010

on opposite sides of the safe harbour threshold, thus resulting in similar taxpayers enjoying different tax treatment

### The advantages of "safe harbours"

The OECD's Transfer Pricing Guidelines identifies the following advantages presented by use of safe harbours<sup>75</sup>:

Application of the arm's length principle may require collection and analysis of data that may be difficult to obtain and/or evaluate. Such complexity may be disproportionate to the size of the corporation or its level of controlled transactions.

Safe harbours could significantly ease compliance by exempting taxpayers from such provisions. Designed as a comfort mechanism, they allow greater flexibility especially in the areas where there are no matching or comparable arm's length prices. Under a safe harbour, taxpayers would know in advance the range of prices or profit rates within which the corporation must fall in order to qualify for the safe harbour. Meeting such conditions would merely require the application of a simplified method, predominantly a measure of profitability, which would spare the taxpayer the search for comparables, thus saving time and resources which would otherwise be devoted to determining transfer prices.

Another advantage provided by a safe harbour would be the certainty that the taxpayer's transfer prices will be accepted by the tax administration. Qualifying taxpayers would have the assurance that they would not be subject to an audit or reassessment in connection with their transfer prices. The tax administration would accept without any further scrutiny any price or result exceeding a minimum threshold or falling within a predetermined range. For that purpose, taxpayers could be provided with relevant parameters which would provide a transfer price or a result deemed appropriate to the tax administration. This could be, for example, a series of sector-specific mark-ups or profit indicators.

A safe harbour would result in a degree of administrative simplicity for SARS. Once the eligibility of certain taxpayers to the safe harbour has been established, those taxpayers would require minimal examination with respect to transfer prices or results of controlled transactions. SARS could then allocate more resources to the examination of other transactions and taxpayers.

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<sup>75</sup> Ibid

## Advance pricing agreements

The draft interpretation note states that South Africa does not have advance pricing agreements, a process whereby taxpayers and tax administrations agree on the amount of debt which will and will not be considered arm's length. The process is conducted in advance of the transactions being undertaken or in advance of filing a tax return.

It is submitted that it is critical that South Africa must institute a system of advanced pricing agreements, for the following reasons:

- As indicated by Mr Corrick (refer to Chapter 5), SARS wants to concentrate its audit efforts based on risk assessments. By having APA's, SARS is managing its own risk and the number of cases can be narrowed to companies without APA's.
- It benefits the taxpayer, as it create certainty and a stable business environment which promotes investment into South Africa
- Without APA's, there is a risk that SARS may not identify a risk. As an APA will be instigated by a taxpayer, it has the benefit to SARS that taxpayers come forward themselves with cases of thin capitalisation.
- Forward agreements will make thin capitalisation administration less resource intensive for SARS.
- If an MNE puts in more equity than debt as a result of an APA, the scope of double taxation is considerably minimised.

The United Kingdom acknowledges the need for advance pricing agreements (the UK term is Advance Thin Capitalisation Agreement or ATCA) as follows on its website<sup>76</sup>:

*"HMRC recognises that thin capitalisation is a difficult area and one in which the majority of customers want to get the right result when their returns are filed. Usually a taxpayer makes a self-assessment, files the return and then waits to see if HMRC open an enquiry within the statutory time limit. This may not happen for nearly two years after the end of an accounting period and so perhaps the best part of three years from when a particular lending transaction took place. Over this sort of timescale there is plenty of scope for key personnel to have moved on, making subsequent reviews more time consuming. Therefore the treatment of particular financing arrangements for future tax returns has habitually been dealt with in advance of the enquiry framework through the procedures associated with the operation of the UK's double taxation treaties ('the treaty route', described at INTM57000+). In recognition of the benefits of this advance process, ministers have agreed to widen the scope of the Advance Thin Capitalisation Agreement (ATCA)*

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<sup>76</sup> Statement of Practice 04/07 - Advance Thin Capitalisation Agreements under the APA Legislation. Available <http://www.hmrc.gov.uk/cnr/sop-atca-v2.pdf>

*process by making it available to those for whom the treaty process would not be available.”*

ATCA's are very popular in the UK and covers 2/3 of the thin capitalisation workload of HMR&C.

#### Other topics covered by the Interpretation Note

The Interpretation Note furnishes some “documentation guidelines” for taxpayers and also explains how the Commissioner interprets the influence of tax treaties and permanent establishments. It advises that South Africa has reserved the right to use the version 7 of the OECD Model Tax Convention, immediately prior to the July 2010 update. Paragraph 2 of Article 7 of this Model requires that the profits to be attributed to a permanent establishment are those which that permanent establishment would be expected to make if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar market conditions.<sup>77</sup>

As South Africa interprets Article 7 in accordance with the Commentary as it stood before the 2010 Update, SARS will apply the arm's length basis when attributing profits to a permanent establishment, but will not accept notional charges or expenses in calculating the profits to be attributed to the permanent establishment. In applying the arm's length basis to potential thin capitalisation situations involving permanent establishments, SARS will apply principles consistent with this principle.

The permanent establishment will be viewed as a separate enterprise which is subject to the application of the arm's length basis but notional charges will not be permitted as a deduction. All criteria, including the risk assessment parameters, applied by SARS for thin capitalisation purposes to other entities will apply equally to the permanent establishments falling within the ambit of an affected transaction. The portion of debt which is provided to a non-resident (or a resident) and that is attributable to its South African (or foreign) permanent establishment, is a question of fact. SARS will consider all the relevant facts and circumstances of each case when considering this issue. SARS may therefore, for example, refer to the interest and other finance charges claimed by the permanent establishment as a deduction in the determination of its taxable income, as a factor in establishing what portion of the debt relates to the permanent establishment.

The Interpretation Note goes on to discuss the transfer pricing provisions with regards to headquarter companies and controlled foreign companies.

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<sup>77</sup> OECD Model Tax Convention on Income and on Capital – available at <http://www.oecd.org/ctp/treaties/oecdmtcavailableproducts.htm>



## Chapter 8 - Conclusion

### ARMS-LENGTH OR SAFE HARBOUR RATIO?

South Africa's main problem applying an arms-length approach, is the absence of usable comparability data. While it involves the same functional analysis and comparability study as mainstream transfer pricing, thin capitalisation requires the additional layer of financial market analysis. This lack of quality comparable data in the public domain, leaves room for subjectivity in any transfer pricing analysis.<sup>78</sup>

Although the OECD criticizes the safe harbour ratio approach<sup>79</sup>, the majority of the OECD's member countries have fully developed economies and most are part of the European Union where current and historic comparability data is available in abundance, but that is not the case locally.

Furthermore, an arm's length approach (without a safe harbour) will place large resource and skill requirements on SARS, as explained by the draft paper on thin capitalisation legislation issued by the OECD<sup>80</sup>:

*"In order to apply the arm's length approach, the tax auditor needs to understand the processes third party lenders uses to determine the maximum amount they would lend to a specific taxpayer. Tax authorities need to have expertise to step into the role of the third party lender and establish the specific characteristics of the group affiliate to determine an appropriate amount of debt.*

*In practice this means that, in implementing a pure arm's length approach:*

- iii. tax auditors need to gain significant understanding of third party lending practices*
- iv. ...and need to investigate the application of those criteria with regards to specific taxpayers,*
- v. And, inevitably, this will require a degree of judgment to determine the proper treatment for each factual situation."*

For these reasons, a arms-length approach is impractical and not appropriate for South Africa.

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<sup>78</sup> Transfer Pricing Trends & Challenges, article by J. Sweidan, 2012. Available online: <http://www.thesait.org.za/news/104395/Transfer-Pricing-Trends--Challenges.htm>

<sup>79</sup> OECD (2012), Thin capitalisation legislation a background paper for country tax administrations (Pilot version for comments), p. 12

<sup>80</sup> OECD (2012), Thin capitalisation legislation a background paper for country tax administrations (Pilot version for comments). Available at [http://www.oecd.org/ctp/tax-global/5.%20Thin\\_Capitalization\\_Background.pdf](http://www.oecd.org/ctp/tax-global/5.%20Thin_Capitalization_Background.pdf)

However, the safe harbour debt:EBITDA ratio of 3:1 referred to in the Draft Interpretation Note, may indicate that in practice, the safe harbour approach will still apply.

The safe harbour will become a starting point for investigations of SARS and provide certainty for taxpayers. If the majority of MNE's tries to stay within the parameters of a safe harbour, the tax base has already been guarded against border-line abuse.<sup>81</sup>

## AVOIDING DISAGREEMENTS BETWEEN A TAXPAYER AND SARS ABOUT THIN CAPITALISATION

According to the OECD, transfer pricing audits and enquiries can often involve significant amounts of tax and generally there is no single right answer.<sup>82</sup> This uncertainty makes it critical to have strong governance processes in place within SARS to address both issues of propriety and consistency in decision making.

In most transfer pricing cases acceptable outcomes are usually achieved through negotiation,<sup>83</sup> with both the tax administration and the MNE making compromises.

Advance rulings are NOT available to provide assurance for thin capitalisation purposes, as its purpose is to promote clarity, consistency and certainty regarding the interpretation and application of a tax Act.<sup>84</sup> Section 80 of the Tax Administration Act stipulates that SARS may reject an application for an advance ruling if the application:

*"a) requests or requires the rendering of an opinion, conclusion or determination regarding—*

...

*iii) the pricing of goods or services supplied by or rendered to a connected person in relation to the 'applicant' or a 'class member'"*

SARS should reconsider the absence of Advance pricing agreements as it will promote certainty and benefit both SARS and a taxpayer (refer to Chapter 7).

It may, in some cases, be that persons do not make much effort to achieve an arm's length price, despite a statutory responsibility to do so, perhaps because the

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<sup>81</sup> Draft Interpretation Note on the determination of the taxable income of certain persons from international transactions: Thin capitalisation, par. 7.1 – available online:  
<http://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2013-10%20-%20Draft%20IN%20Determination%20Taxable%20Income%20International%20Transactions%20Thin%20Capitalisation.pdf>

<sup>82</sup> OECD (2012), Thin capitalisation legislation a background paper for country tax administrations (Pilot version for comments). Available at [http://www.oecd.org/ctp/tax-global/5.%20Thin\\_Capitalization\\_Background.pdf](http://www.oecd.org/ctp/tax-global/5.%20Thin_Capitalization_Background.pdf)

<sup>83</sup> OECD (2012), Dealing Effectively with the Challenges of Transfer Pricing, OECD Publishing. Available at <http://dx.doi.org/10.1787/9789264169463-en>

<sup>84</sup> Section 76 of the Tax Administration Act

outcome is neutral within their "community of interests", which will in most cases a group of companies.<sup>85</sup> Such a lax approach may have dire tax consequences.

All indications are that SARS will negotiate with taxpayers regarding thin capitalisation issues and use the courts as a last resort. It is therefore important that taxpayers follow the documentation guidelines set out in the Draft Interpretation Note.

Taxpayers must be prepared to fully document their decision processes in relation to debt financing and provide corroborative evidence to support their borrowing position.<sup>86</sup>

If a case goes to court, the taxpayer will have to pass the "reasonable man" test, which will require an audit trail of documentation to see how the taxpayer has applied its mind.

In this regard it is important to keep section 102(1) of the Tax Administration Act in mind, which places the burden of proof squarely on the taxpayer.

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<sup>85</sup> Her Majesty's & Revenue & Customs - INTM571015 - Thin capitalisation: practical guidance - introduction: What is thin capitalisation? Available online at <http://www.hmrc.gov.uk/manuals/intmanual/INTM571015.htm>

<sup>86</sup> Where to with thin capitalisation? Article by Edward Nathan Sonnenbergs (28 September 2010), available online <http://www.ensafrica.com/news/where-to-with-thin-capitalisation?Id=327&STitle=tax%20ENSight>

**APPENDIX:**

**Section 31 of the Income Tax Act:**

1) *For the purposes of this section-*

*'affected transaction' means any transaction, operation, scheme, agreement or understanding where-*

*a) that transaction, operation, scheme, agreement or understanding has been directly or indirectly entered into or effected between or for the benefit of either or both—*

*i)*

*aa) a person that is a resident; and*

*bb) any other person that is not a resident;*

*ii)*

*aa) a person that is not a resident; and*

*bb) any other person that is not a resident that has a permanent establishment in the Republic to which the transaction, operation, scheme, agreement or understanding relates;*

*iii)*

*aa) a person that is a resident; and*

*bb) any other person that is a resident that has a permanent establishment outside the Republic to which the transaction, operation, scheme, agreement or understanding relates; or*

*iv)*

*aa) a person that is not a resident; and*

*bb) any other person that is a controlled foreign company in relation to any resident, and those persons are connected persons in relation to one another; and*

*b) any term or condition of that transaction, operation, scheme, agreement or understanding is different from any term or condition that would have existed had those persons been independent persons dealing at arm's length;*

*'financial assistance' includes the provision of any—*

*a)debt; or*

*b)security or guarantee.*

*2)Where—*

*a)any transaction, operation, scheme, agreement or understanding constitutes an affected transaction; and any term or condition of that transaction, operation, scheme, agreement or understanding—*

*i)is a term or condition contemplated in paragraph (b) of the definition of 'affected transaction'; and*

*ii)results or will result in any tax benefit being derived by a person that is a party to that transaction, operation, scheme, agreement or understanding,*

*the taxable income or tax payable by any person contemplated in paragraph (b)(ii) that derives a tax benefit contemplated in that paragraph must be calculated as if that transaction, operation, scheme, agreement or understanding had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm's length.*

*3)To the extent that there is a difference between—*

*a)any amount that is, after taking subsection (2) into account, applied in the calculation of the taxable income of any resident that is a party to an affected transaction; and*

*b)any amount that would, but for subsection (2), have been applied in the calculation of the taxable income of the resident contemplated in paragraph (a),*

*the amount of that difference must, for purposes of subsection (2), be deemed to be a loan that constitutes an affected transaction.*

*4)For the purposes of subsection (2), where any transaction, operation, scheme, agreement or understanding has been directly or indirectly entered into or effected as contemplated in that subsection in respect of—*

*a)the granting of any financial assistance; or*

*b)intellectual property as contemplated in the definition of 'intellectual property' in section 231(1) or knowledge,*

*'connected person' means a connected person as defined in section 1:*

*Provided that the expression 'and no shareholder holds the majority voting rights in the company' in paragraph (d)(v) of that definition must be disregarded.*

*a)Where any transaction, operation, scheme, agreement or understanding has been entered into between a headquarter company and—*

*a)any other person that is not a resident and that transaction, operation, scheme, agreement or understanding is in respect of the granting of financial assistance by that other person to that headquarter company, this section does not apply to so much of that financial assistance that is directly applied as financial assistance to any foreign company in which the headquarter company directly or indirectly (whether alone or together with any other company forming part of the same group of companies as that headquarter company) holds at least 10 per cent of the equity shares and voting rights;*

*b)any foreign company in which the headquarter company directly or indirectly (whether alone or together with any other company forming part of the same group of companies as that headquarter company) holds at least 10 per cent of the equity shares and voting rights and that transaction, operation, scheme, agreement or understanding comprises the granting of financial assistance by that headquarter company to that foreign company, this section does not apply to that financial assistance;*

*c)any other person that is not a resident and that transaction, operation, scheme, agreement or understanding is in respect of the granting of the use, right of use or permission to use any intellectual property as defined in section 231(1) by that other person to that headquarter company, this section does not apply to the extent that the headquarter company-*

*i)*

*grants that use, right of use or permission to use that intellectual property to any foreign company in which the headquarter company directly or indirectly (whether alone or together with any other company forming part of the same group of companies as that headquarter company) holds at least 10 per cent of the equity shares and voting rights; and*

*ii)*

*does not make use of that intellectual property otherwise than as contemplated in subparagraph (i); or*

d) any foreign company in which the headquarter company directly or indirectly (whether alone or together with any other company forming part of the same group of companies as that headquarter company) holds at least 10 per cent of the equity shares and voting rights and that transaction, operation, scheme, agreement or understanding comprises the granting of the use, right of use or permission to use any intellectual property as defined in section 231(1) by that headquarter company to that foreign company, this section does not apply to that granting to that foreign company.

b) Where any transaction, operation, scheme, agreement or understanding that comprises the granting of-

a)

financial assistance; or

b)

the use, right of use or permission to use any intellectual property as defined in section 231,

by a person that is a resident (other than a headquarter company) to a controlled foreign company in relation to that resident, this section must not be applied in calculating the taxable income or tax payable by that resident in respect of any amount received by or accrued to that resident in terms of that transaction, operation, scheme, agreement or understanding if-

i)

that resident (whether alone or together with any other company forming part of the same group of companies as that resident) owns at least 10 per cent of the equity shares and voting rights in that controlled foreign company;

ii)

that controlled foreign company has a foreign business establishment as defined in section 9D(1); and

iii)

the aggregate amount of tax payable to all spheres of government of any country other than the Republic by that controlled foreign company in respect of any foreign tax year of that controlled foreign company during which that transaction, operation, scheme, agreement or understanding exists is at least 75 per cent of the amount of normal tax that would have been payable in respect of any taxable income of that controlled foreign company had that controlled foreign company been a resident for that foreign tax year: Provided that the aggregate amount of tax so payable must be determined-

aa)

*after taking into account any applicable agreement for the prevention of double taxation and any credit, rebate or other right of recovery of tax from any sphere of government of any country other than the Republic; and*

bb)

*after disregarding any loss in respect of a year other than that foreign tax year or from a company other than that controlled foreign company.*



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**List of acronyms and abbreviations used:**

APA – Advanced pricing agreement

EBITDA – Earnings Before Interest, Taxes, Depreciation and Amortization

Income Tax Act – Income Tax Act, No. 58 of 1962, as amended

OECD - The Organisation for Economic Co-operation and Development

MNE – multinational enterprise

Tax Administration Act - Tax Administration Act, No. 28 of 2011, as amended