

# THE APPLICATION OF THE NEW THIN CAPITALISATION RULES IN SOUTH AFRICA

by

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## **ABSTRACT**

# **THE APPLICATION OF THE NEW THIN CAPITALISATION RULES IN SOUTH AFRICA**

by

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South Africa, together with similar countries world-wide, has taken active steps to counter the negative effects of the concept of “Base Erosion and Profit Shifting” by tightening its transfer pricing legislation. The South African 2010 Taxation Laws Amendment Act includes certain changes to bring the transfer pricing rules contained under section 31 of the Income Tax Act no 58 of 1962 up to date. These changes are aimed at bringing the South African transfer pricing legislation in line with the Organisation for Economic Cooperation and Development (OECD) guidelines. The new section 31 is aimed at shifting focus from the old transaction-based wording, to a more substance-focused approach. This implies, therefore, that safe harbours will no longer be the main determinant in establishing whether or not a company is thinly capitalised.

The major concerns raised by taxpayers regarding this new approach relate to the uncertainties with regard to its practical application.

Thus, the new amendments have brought about various challenges, including, the standardisation of procedures, reducing the cost of compliance, and developing broad databases that can assist with the determination of the arm's length price.

This study aims to analyse the practical difficulties with which taxpayers could be faced in the application of this new legislation. The study uses the United Kingdom to assess the effectiveness of the new thin capitalisation rules since their thin capitalisation provisions also appear to have been brought in line with the OECD guidelines.

**KEY WORDS:**

Thin capitalisation

Transfer pricing

International transactions

Connected person

Arm's length

Safe harbour

## OPSOMMING

### DIE TOEPASSING VAN DIE NUWE REËLS TEEN ONVOLDOENDE KAPITALISASIE IN SUID-AFRIKA

deur

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GRAAD: MAGISTER COMMERCII

Suid-Afrika, saam met soortgelyke lande in die res van die wêreld, het daadwerklike stappe geneem om die negatiewe gevolge van die begrip “Basiserosie en belastingafwenteling” deur middel van ‘n oordragprysbeleid teen te werk. Die Suid-Afrikaanse Wysigingswet op Belastingwette van 2010 sluit wysigings in wat poog om die oordragprysreëls in artikel 31 van die Inkomstebelastingwet nr 58 van 1962 op datum te bring. Hierdie wysigings het ten doel om die Suid-Afrikaanse oordragprysbeleid in ooreenstemming te bring met die riglyne van die Organisasie vir Ekonomiese Samewerking en Ontwikkeling (OESO). Die nuwe Artikel 31 van die Wet is daarop gemik om die fokus te verskuif van die ou transaksie-gebaseerde bewoording na ‘n meer substantiewe benadering. Die implikasie hiervan is dat die begrip van “veilige hawens” nie meer die hoof oorweging sal wees wanneer bepaal sal word of ‘n maatskappy voldoende gekapitaliseerd is nie.

Die vernaamste besware wat deur belastingbetalers ten opsigte van die nuwe benadering geopper word hou verband met die onsekerhede wat voortspruit uit die praktiese toepassing daarvan.

Die nuwe wysigings het nuwe uitdagings na vore gebring soos byvoorbeeld die standardisering van prosedures, die vermindering van die koste van nakoming en die ontwikkeling van ‘n breë databasis wat gebruik kan word in die bepaling van ‘n armlengteprys sonder bevoorregting.

Hierdie studie beoog om die praktiese probleme te ontleed wat belastingbetalers met die toepassing van die nuwe wetgewing kan ervaar. Aangesien die Verenigde Koninkryk reeds geruime tyd probeer om hul eie verskralde kapitalisasievoorsienings in lyn te bring met die OESO riglyne, het die VK die doeltreffendheid van die reëls teen onvoldoende kapitalisasie probeer bepaal.

### **Sleutelwoorde**

Verskralde kapitalisasie (onvoldoende kapitalisasie)

Oordragprysbepaling

Internasionale transaksies

Sakekennis (verwante onderneming)

Armlengteprys (sonder bevoorregting)

Veilige hawe

## TABLE OF CONTENTS

CHAPTER 1.....	1
INTRODUCTION .....	1
1.1 BACKGROUND .....	1
1.2 PROBLEM STATEMENT.....	3
1.3 PURPOSE STATEMENT.....	4
1.4 RESEARCH OBJECTIVES.....	4
1.5 IMPORTANCE AND BENEFITS OF THE PROPOSED STUDY .....	5
1.6 DELIMITATIONS .....	6
1.7 DEFINITION OF KEY TERMS.....	6
1.8 RESEARCH DESIGN AND METHODS.....	8
1.9 BRIEF OVERVIEW OF CHAPTERS .....	9
CHAPTER 2.....	11
LITERATURE REVIEW .....	11
2.1 Introduction.....	11
2.2 concept of thin capitalisation.....	11
2.2.1 Introduction .....	11
2.2.2 Inherent risk to the fiscus .....	12
2.2.3 Safe harbours.....	14
2.3 FORMER thin capitalisation rules IN SOUTH AFRICA.....	15
2.3.1 Introduction .....	15
2.3.2 Shortcomings in the former thin capitalisation rules in South Africa.....	19
2.4 new thin capitalisation rules.....	21



2.4.1	Introduction .....	21
2.4.2	Significant changes to the former thin capitalisation rules in South Africa .....	22
2.4.3	Recognising economic substance versus safe harbours.....	24
2.4.4	Challenges faced by the SARS with the application of the new rules .....	25
2.5	thin capitalisation rules IN THE UNITED KINGDOM .....	27
2.5.1	Tools applied by the HMRC in testing the arm's length principle .....	28
2.5.2	Domestic thin capitalisation.....	30
2.5.3	Advanced thin capitalisation agreements.....	31
2.6	Summary .....	32
CHAPTER 3.....		33
benefits and shortcomings of the new thin capitalisation rules .....		33
3.1	Introduction.....	33
3.2	Benefits of the new thin capitalisation rules .....	33
3.2.1	The application of the arm's length standard.....	33
3.2.2	Loopholes addressed in the new legislation.....	34
3.2.3	Onus of proof .....	38
3.3	shortcomings of the new thin capitalisation rules.....	39
3.3.1	Uncertainty about the application of the new section .....	39
3.3.2	Retrospective application .....	40
3.3.3	Issues with the proposed debt limitation rules.....	40
3.3.4	Introducing a safe harbour .....	41
3.3.5	Comparables and databases used.....	44
3.3.6	Other considerations .....	44
3.4	new disclosure requirements .....	44
3.5	Conclusion.....	45

CHAPTER 4.....	47
Conclusion .....	47
4.1 INTRODUCTION .....	47
4.2 A COMPARISON OF THE RSA, UK AND THE OECD MTC THIN CAPITALISATION RULES .....	48
4.2.1 The new RSA thin capitalisation rules compared to the previous legislation..	48
4.2.2 The thin capitalisation guidelines issued in the UK by the HMRC .....	49
4.3 THE APPLICATION OF THE ARM'S LENGTH PRINCIPLE TO THIN CAPITALISATION AS PER THE OECD GUIDELINES.....	49
4.4 RECOMMENDATION .....	50
4.5 FURTHER RESEARCH.....	51
LIST OF REFERENCES.....	52

## **APPENDICES**

APPENDIX F: Confirmation of language style guide compliance

## LIST OF FIGURES

Figure 1:	Inward Foreign Direct Investment compared to GDP (2011).....	2
Figure 2:	Loading of debt illustration .....	14
Figure 3:	Balance Sheet and Income Statement of Company XYZ Limited .....	16
Figure 4:	STC Calculation for Company XYZ Limited .....	19
Figure 5:	Balance Sheet and Income Statement of ABC Limited .....	35
Figure 6:	Calculation of Fixed Capital for ABC Limited.....	36

## LIST OF TABLES

Table 1:	Abbreviations used in this document.....	8
Table 2:	Comparison of documentation requirements.....	25
Table 3:	Thin Capitalisation rules in other countries.....	42

# THE APPLICATION OF THE NEW THIN CAPITALISATION RULES IN SOUTH AFRICA

## CHAPTER 1 INTRODUCTION

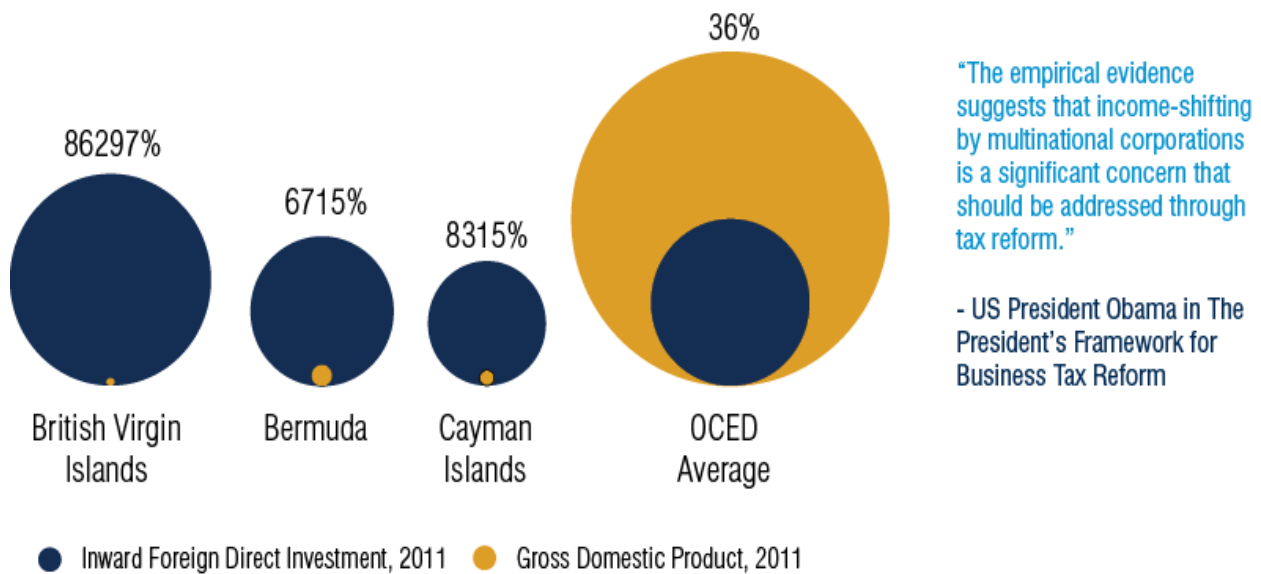
### 1.1 BACKGROUND

As a result of increased globalisation and the prevalent economic downturn which has been experienced in recent years, the concept of transfer pricing (TP) has received a great deal of attention in developing countries (*International Transfer Pricing*, 2012:175). The widely anticipated report on the issue of base erosion and profit shifting (BEPS) by multinational enterprises (MNEs) was released on 12 February 2013 by the Organisation for Economic Cooperation and Development (OECD). In this report, the tax treatment of related party debt financing and other related party financing structures was identified as the key problem area that should be addressed (Ernst & Young, 2013).

The Australian government has taken action against BEPS in ensuring that their corporate tax system is fair, sustainable and competitive. As part of their recent budget drawn up for the next four years, \$109 million has been allocated with the aim of increasing their compliance work targeted at activities that promote profit-shifting opportunities (Curson, 2013:38). The growing concern globally is whether many of the main rules of international taxation may not have kept pace with the changing global economy. The other issue is whether tax concepts which were developed during the industrial era have evolved and have become applicable to the era of the digital economy (Australian Government, 2013:34.)

The figure below provides a clear illustration of how the gross domestic product (GDP) compares with inward foreign direct investment in the OECD countries and also how the GDP compares with inward foreign direct investment in the British Virgin Islands, Bermuda and the Cayman Islands in 2011 (Australian Government, 2013:34).

**Figure 1: Inward Foreign Direct Investment compared to GDP (2011)**



“The empirical evidence suggests that income-shifting by multinational corporations is a significant concern that should be addressed through tax reform.”

- US President Obama in The President’s Framework for Business Tax Reform

Source: Australian Government (2013:34)

The above figure shows how MNEs apply schemes which shift profits across geographical borders with the aim of taking advantage of the various tax rates and paying low overall taxes in their groups. *“Transfer prices are used to calculate how profits should be allocated among the different parts of the company in different countries, and are used to decide how much tax the MNE pays and to which tax administration”* (Love, 2013). Therefore, stringent TP regulations are important in that they assist countries in protecting their tax base.

In his 2012 Budget Speech, the Minister of Finance, Pravin Gordhan highlighted TP as a key focus area for the South African Revenue Service (SARS), specifically in cases in which profits are shifted to other jurisdictions outside the Republic of South Africa (RSA) (Sweidan, 2011).

Section 31 of the Income Tax Act, No 58 of 1962 (the Act) which came into effect on 19 July 1995 and is supported by Practice Note (PN) 7 released in 1999, applies to transactions between an RSA taxpayer and its offshore-connected person. The legislation applies to the following two scenarios: (i) transfer pricing (referred to as “TP”), that is, the pricing of goods and services between offshore-connected persons and (ii) “thin capitalisation” (Silke, 2012:626-627). The term thin capitalisation refers to a condition in

which a company is financed through a relatively high level of debt as opposed to equity. Both these provisions were phrased with extensive application and were difficult to apply in practice (Corrick, 2012).

The announcement by SARS that Section 31 of the Act would undergo a substantial redrafting process was made in the middle of 2010. The third updated version of the new Section 31 was thereafter only introduced by the Minister of Finance to Parliament in 2011 in terms of the Taxation Laws Amendment Bill, No 19 of 2011. It came into operation on 1 April 2012, applying in respect of every financial year commencing on, or after that date (Brodbeck, 2011).

SARS finally published guidance in the form of a draft Interpretation Note (IN) on section 31 of the Act on 22 March 2013 and comments on this note were due by 30 June 2013. This draft IN aims to provide taxpayers in the RSA with guidance on the application of the new thin capitalisation rules since the primary legislation contained under section 31 does not provide such guidance. Thus, approximately three years has passed since the announcement of the new section 31 rules before the draft IN was released.

The revised version of section 31 contained changes which were aimed at aligning RSA's thin capitalisation rules in accordance with article 9 of the OECD Model Tax Convention ("MTC") on which these regulations were based (Brodbeck, 2011).

Due to the general complexity and prolixity of the regulations laid down in section 31 in respect of TP and thin capitalisation, the importance of careful examination and adaptation of the new rules by taxpayers and their advisors cannot be stressed enough.

## **1.2 PROBLEM STATEMENT**

Seligson (2010:8) points out that the wording of the new section 31 in regard to the manner in which its regulations should be applied lacks clarity and certainty of expression, and that the way in which it is drafted is somewhat opaque. Furthermore, the generality of the language used leaves too much to future extrinsic interpretation by SARS.

Recommendations around the implementation or design of thin capitalisation legislation are not addressed in the OECD guidelines. Nor, do they provide guidance for the appropriate debt to equity ratios that should be applied (Miller, Liebenberg, Lalor & Louw, 2012:2). Thus, the new legislation comes with its own challenges. Taxpayers will now not only have to provide SARS with comparables companies but will also have to provide and explain the underlying commercial justifications with regard to the structures and transactions upon which they have embarked (Nias & Ross, 2010).

From years of assessment commencing on, or after 1 April 2012, SARS will start denying interest deductions that are deemed to be excessive based on “the arm’s length principle” according to the OECD guidelines. This, therefore, implies that if a company’s year-end is 31 March 2013, the new thin capitalisation rules will have already applied to it for a year. This Legislation is new and has already been enacted and is effective, however, the draft IN (containing guidelines as to how SARS will apply the legislation) was only released on 22 March 2013 and is not very clear.

### **1.3 PURPOSE STATEMENT**

The goal of this study will be to analyse the key parameters which should be applied by taxpayers when testing the economic substance of a funding transaction. This will be done against the background of the new draft IN issued by the SARS, the OECD MTC and provisions of the UK thin capitalisation legislation.

This dissertation will enable taxpayers to have a better understanding and awareness of the rules and will ensure that the negative effects of these rules will be mitigated through a number of planning and structural opportunities.

### **1.4 RESEARCH OBJECTIVES**

More specifically, the objectives of this study will entail the following:

- To analyse the provisions of the new RSA thin capitalisation rules in comparison with the previous legislation;
- To analyse thin capitalisation guidelines issued in the UK by Her Majesty's Revenue and Customs ("HMRC"); and
- To compare the UK, RSA and the OECD MTC thin capitalisation rules.

## **1.5 IMPORTANCE AND BENEFITS OF THE PROPOSED STUDY**

In view of the increasing number of multinational corporations investing in the country, the growing number of local players and the position of RSA as an investment conduit into Africa, TP has become one of the main strategic risks faced by SARS (Brodbeck, 2012).

Since little is known regarding the application of the new thin capitalisation rules, this study will assist taxpayers by providing them with a general indication of circumstances in which the new rules will apply, to whom and how they apply. This will be based on the draft IN and other related sources that can be used.

As stated above, taxpayers are now faced with the risk and uncertainty of being audited by SARS without having the necessary clarity when it comes to the compliance requirements due to the late release of the draft IN. This study will therefore, not only assist taxpayers with interpreting the guidelines issued by SARS but also aims to illustrate what taxpayers should expect from its application by means of practical examples.

Taxpayers will therefore, be able to consider the application of the new thin capitalisation rules as soon as possible to avoid additional reporting responsibilities, risks of being exposed to financial losses, and penalties when SARS assesses them. SARS will also benefit in that voluntary compliance from taxpayers will reduce the need for audits and the amount of time an audit would require.

The findings from this study could also assist SARS in addressing loopholes, if any, in the new legislation based on the international comparisons of the thin capitalisation rules that have been conducted.



## 1.6 DELIMITATIONS

The scope of this study has some inherent limitations. As the application of the new thin capitalisation rules is the main focus of this study, several aspects of related party financial assistance transactions will not be discussed in detail. The study will only focus on the thin capitalisation aspects of the new legislation and not the entire arm's length principle on all transactions, operations, schemes, agreements or understandings according to the exact wording of section 31 of the Act. It will also not focus on international tax agreements that the RSA has entered into with other countries or their tax implications.

As such, the study will only examine aspects relating to reporting requirements and implications of the new rules as far as thin capitalisation is concerned.

## 1.7 DEFINITION OF KEY TERMS

The list provides brief definitions of the study's key concepts.

### **Advance pricing agreements (“APA”)**

The term APA refers to a procedural arrangement between a taxpayer or taxpayers and a tax administration intended to resolve potential transfer pricing disputes in advance. (OECD, 2010b:336.)

### **Affected transaction**

The term “affected transaction” is defined in section 31(1)(a) of the Act. This 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 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 (Brodbeck, 2011.)

### **Arm's length principle**

The arm's length principle takes place where: “... conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from

those which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued ...” (OECD, 2010b:23.)

### **Back-to-back loan**

This refers to a way of borrowing in which loans between connected parties are conducted through the use of an independent third-party intermediary (OECD, Not dated).

### **Controlled transactions**

This occurs where there are transactions between companies which are related companies with regard to each other (OECD, 2010b:25).

### **Controlled Foreign Companies**

A Controlled Foreign Company (CFC) is a foreign company in which RSA residents directly or indirectly hold more than 50% of rights to participate in the share capital / profit of the foreign company or more than 50% of the voting rights in that foreign company are directly or indirectly exercisable, by one or more residents. (Grant Thornton, 2011.)

### **Derivatives**

A derivative instrument is a contractual right that derives its value from the value of something else, such as a debt security, equity, commodity or a specific index. The most common derivative instruments are forwards, futures, options and notional principal contracts such as swaps, caps, floors, collars and credit derivatives. Unlike traditional debt and equity securities, these instruments generally do not involve a return on an initial investment. (OECD, 2010a:110)

### **Safe harbour**

According to Lowell (2012), a safe harbour refers to a certain parameter and therefore, if a transfer pricing result falls within that specific parameter, tax authorities would generally not be allowed to make an adjustment to that price for transfer pricing purposes.

### **Taxpayer**

Is defined by SARS (2012) as being, any person which is chargeable with any tax leviable under the Act. This therefore includes individuals, companies and trusts.

## Transfer pricing

Transfer pricing is defined in the draft IN on section 31 of the Act as: “the process by which connected persons set the prices at which they transfer goods or services between themselves” (SARS, 2013a:2)

## Thin Capitalisation

The term “thin capitalisation” refers to a condition in which a company is financed through a relatively high level of debt as opposed to equity (OECD, 2012b:3)

The abbreviations in this document are summarized in the table below.

**Table 1: Abbreviations used in this document**

<b>Abbreviation</b>	<b>Meaning</b>
APA	Advance pricing agreements
BEPS	Base erosion and profit shifting
EBITDA	Earnings before interest, taxes, depreciation, amortization and any exceptional items.
HMRC	Her Majesty’s Revenue and Customs
IN	Interpretation Note on section 31
MNE	Multinational enterprise
MTC	Model Tax Convention
OECD	Organisation for Economic Co-operation and Development
PN	Practice Note
RSA	Republic of South Africa
SARS	South African Revenue Service
STC	Secondary tax on companies
TP	Transfer pricing
UK	United Kingdom

## 1.8 RESEARCH DESIGN AND METHODS

The research design will entail a qualitative review and analysis of the literature that is available on the subject matter. I will therefore, be conducting a non-empirical research

study as the subject matter requires an analysis of the thin capitalisation legislation of the RSA and the UK.

The study will initially entail a comprehensive literature review using information contained in the public domain. This will include an analysis of the various public comments, periodical articles, journals and publications on the new RSA thin capitalisation rules. It should be noted that there is not much literature available on this topic since it is fairly new.

This study will also be analysing the thin capitalisation provisions as contained in the OECD MTC. The analysis will be based on measuring the effectiveness of thin capitalisation provisions as contained in the OECD MTC according to the UK and RSA new thin capitalisation rules. This will enable the researcher to determine whether the new RSA thin capitalisation rules contain the basic elements required to counteract tax manipulation through contrived thin capitalisation structures.

## **1.9 BRIEF OVERVIEW OF CHAPTERS**

Chapter one provides a background to the subject matter as well as the analysis to be performed on it. It introduces the problem statement and the research objectives of the current study. This is done in an attempt to highlight the importance and benefits of the study which is also discussed in the chapter.

In chapter two, the key notions behind the concept of thin capitalisation and the main tools which entities are required by revenue authorities to apply to prove compliance with the relevant thin capitalisation provisions are analysed. These tools are especially important in the industry and benchmarking analyses, as they are the foundation of a TP framework. The principle behind the comparability of companies and a balanced approach in terms of reliability and the problem it produces for taxpayers and tax authorities is also explored. The chapter also goes on to review the UK's thin capitalisation regulations and legislation, and also the measures used by HMRC in their application of the arm's length test when it comes to thin capitalisation cases.

Chapter three analyses the practicalities of applying the new thin capitalisation legislation. It analyses differences between the new and old thin capitalisation rules using practical examples. Based on these findings, conclusions are drawn on the effectiveness of the new legislation.

Finally, chapter four provides a summary of the findings and addresses the remaining research objectives that were posed at the beginning of the research. It also provides a conclusion and makes a recommendation to the SARS based on the findings and analysis conducted.

## **CHAPTER 2**

### **LITERATURE REVIEW**

#### **2.1 INTRODUCTION**

As explained in the background to this study, in view of this heightened focus by the SARS on TP, it is prudent that taxpayers update their TP reports and comply with the arm's length principle. The purpose of this chapter is to provide a background to the concept of thin capitalisation in order to ensure a better understanding of its importance in tax legislation.

#### **2.2 CONCEPT OF THIN CAPITALISATION**

##### **2.2.1 Introduction**

Typically companies are financed (or capitalised) through a combination of equity and debt. Therefore, the term thin capitalisation refers to a condition in which a company is financed through a relatively high level of debt as opposed to equity. The manner in which companies are capitalised will often have a significant impact on their profits (OECD, 2012b:3.)

In terms of section 11(a) read together with section 23(g) of the Act, the payment of interest on a loan by a taxpayer is generally deductible in the determination of its taxable income, while the payment of dividends on equity received is not. This situation, therefore gives a company predominantly funded by a loan a taxation advantage over a company funded mainly with equity capital. Where the investor is a resident of RSA and the recipient of such financial assistance is also a resident of RSA, there is no loss to the RSA fiscus as the interest deducted in the hands of the recipient would be taxable in the hands of the investor. However, in the case of a foreign investor, interest payments would normally be deductible under section 11(a) of the Act and the income would be taxed in the foreign country resulting to a loss to the RSA fiscus. Section 31(3) was enacted to counter such deviousness to the extent that the funding is not done at arm's length.

Increased interest in offshore companies investing and establishing businesses in the RSA has now made the concept of TP and thin capitalisation even more pertinent (Odendaal, 2012).

### **2.2.2 Inherent risk to the fiscus**

In most countries, with a similar taxation system as the RSA, interest expenses in relation to financial assistance are deductible but dividends paid are not. It is, therefore advantageous from a tax perspective for a parent company to provide capital to its subsidiaries by way of debt as opposed to providing equity capital (Green, 2004:3.)

Schüssler (2012) states that “South Africa’s companies pay the second highest effective tax rate among the biggest 60 economies in the world”. Webber (2010a:8.) refers to several studies which have found that companies would typically leverage additional debt on subsidiaries operating in countries imposing high income taxes. These studies also show that the additional debt is provided by the related entities within the same MNE, and this, therefore allows the company to reduce its tax rate without incurring additional trade expenses. In view of the above, it is therefore important for a country like RSA to implement strict thin capitalisation rules in order to prevent this occurring.

Thin capitalisation rules have also been known to be circumvented through channeling the financing through independent third parties and through the application of derivatives (OECD, 2013a:44). The new thin capitalisation rules now not only apply to loans between two offshore connected persons but to any transaction, operation, scheme, arrangement and understanding that has been entered into, or effected between, or for the benefit of, either or both of the parties involved. This definition is therefore wider as it applies to direct and indirect funding and implies that the legislation now also applies to situations whereby there is both direct and indirect control (SARS, 2013a:5.) The rules have, therefore been extended to also include transactions between CFC’s of RSA tax residents (Miller, Liebenberg, Lalor, & Louw, 2012:1). Thus, there has been considerable uncertainty and anticipation on the part of taxpayers pending the release of the IN (Miller, 2011).

A grey area which generally starts heated debates and controversy is created by intra-group financing transactions due to thin capitalisation safe harbour provisions being interplayed with TP rules. An arm's length consideration using the general TP rules may still be applied in practice where taxpayers have met the thin capitalisation rules using the safe harbour test (Musa, Nobrega, DeSouza, Agarwal, Miraglia & Russo, 2010:4)

The concept, treatment and definition of the thin capitalisation rules differ across the world. However, the purpose of every set of rules contained in each country is the same, namely, the avoidance of excessive debt financing and the parallel loss of revenue in the source country (Klostermann, 2007:8)

The diagram below illustrates a typical tax avoidance funding structure whereby a foreign parent company acquires another foreign company but then refinances this transaction through Australia. This refinancing structure involves the foreign parent company in using the Australian subsidiary, and lending it money in order to acquire the other foreign company. Thus, this Australian company would purchase the foreign company using a hybrid share which would result in an exempt dividend flow coming back to Australia. Interest deductions would also be claimed by the Australian company for the interest payments flowing back to the parent company (Australian Government, 2013:35.)



**Figure 2: Loading of debt illustration**



Source: Australian Government (2013:35)

More than \$2.5 billion was lost to the Australian fiscus through such structures in 2011 (Australian Government, 2013:35).

### 2.2.3 Safe harbours

The draft IN does not contain any safe harbours and does not provide enough guidance on how to determine and reach the arm's length amount in relation to thin capitalisation (Barnard, 2012:4).

There was a lot of public anticipation that there would be a so-called "safe harbour" provision in the new IN which would be somewhat similar to the provision in respect of the 3:1 ratio (Debt: Equity) which was previously applied by SARS in the withdrawn PN 2 of the Act. The 3:1 safe harbour provision was included under PN 2 and as a general guideline it meant that the thin capitalisation rules would not be applied by the SARS if the debt to equity ratio of a taxpayer did not exceed 3:1. The PN 2 also contained an interest rate safe harbour provision which applied to interest payments for financial assistance from offshore investors of up to three times the investor's fixed capital. Under this provision, thin capitalisation rules did not apply if the interest paid to an offshore-related party did not exceed prime plus 2 percentage points, if the loan was denominated in rand,

or the relevant interbank rate plus four percentage points, if the loan was denominated in any other currency.

The concept of “safe harbours” refers to the way in which the amount of interest to be deducted should be determined by applying a specific ratio as a reference, usually based on the ratio of debt to equity. However, these safe harbours differ from country to country and the basis for determining these ratios also differ. Some countries apply the total debt as a basis and others only use related party debt in their equation (OECD, 2012b:12.)

A study conducted by Buettner, Overesch, Schreiber and Wamser (2007:9) confirmed that one of the most effective methods in reducing tax avoidance by means of intercompany loans is through effective thin capitalisation rules. The authors of the study explain that the main issue in regard to safe harbour ratios is that the thin capitalisation rules would not apply if the companies’ debt to equity ratios falls within the prescribed safe harbour ratio.

Due to the move from applying only safe harbours to determine the excessive interest payments by RSA taxpayers, RSA will now be following a more commercially focused methodology (*International Transfer Pricing*, 2012:766). This approach, however, comes with its own challenges as far as its application is concerned, as RSA taxpayers do not know what to expect from the SARS as far as its application is concerned.

## **2.3 FORMER THIN CAPITALISATION RULES IN SOUTH AFRICA**

### **2.3.1 Introduction**

Before we start examining the provisions of the new section 31 in terms of the Taxation Laws Amendment Bill, No 19 of 2011 which came into operation on 1 April 2012, a brief summary of the old section 31(3) of the Act is important. Sulaiman (in West, 2010:9) briefly explained the rationale behind the initial introduction of section 31(3) of the Act as:

During the 1980’s, multinational companies were aggressively engaging in tax abusive thin capitalisation practices whereby they would finance companies through a high proportion of debt in relation to equity funding and thereby claim huge tax deductions in high-tax

jurisdictions and shift profits to low-tax jurisdictions. Internationally countries swiftly enacted thin capitalisation rules to counter these practices. South Africa (“SA”) only followed suit after it re-entered the international community in 1994 and pursuant to the recommendations of the SA Katz Commissions of Inquiry.

The objective of section 31(3) was, therefore, to disallow the deduction of the interest expense in relation to the excessive portion of debt granted from an offshore-related party. PN 2 essentially provided guidelines as to how the disallowable interest relating to excessive financial assistance was determined and the circumstances in which the Commissioner could exercise his discretion to allow a ratio of greater than 3:1.

Under the RSA’s previous thin capitalisation rules, when applying the conditions contained in section 31(3) the Commissioner was entitled to disallow the interest and finance charges relating to financial assistance which he considered excessive (Charalambous, 2013). The Commissioner would then deem this excessive amount of interest as a dividend resulting in Secondary Tax on Companies (STC) to be payable under section 64C of the Act (Odendaal, 2012). In terms of the Act this excessive interest calculation was based on a formula that SARS would apply when auditing taxpayers.

The example in the table below further illustrates how the provisions of the previous section 31(3) were applied to a company that was thinly capitalised using the guidelines provided under PN 2.

**Figure 3: Balance Sheet and Income Statement of Company XYZ Limited**

<b>BALANCE SHEET</b>	
<b>For the year ended 30 September 2004</b>	
<b>Assets</b>	
Non-current assets	80,500,899
Current assets	14,373,719
<b>Total assets</b>	<b>94,874,618</b>
<b>Equity and liabilities</b>	
Capital and reserves	<b>9,910,110</b>
Issued capital	500
Share premium	11,999,501

Accumulated (loss)/profit	(2,089,891)
<b>Non-current liabilities</b>	<b>74,121,155</b>
Deferred tax liability	50,245
Shareholder's loan	73,942,290
Finance loan	128,620
Current liabilities	10,843,353
<b>Total equity and liabilities</b>	<b>94,874,618</b>

<b>INCOME STATEMENT</b>	
<b>Year ended 30 September 2004</b>	
Turnover	20,950,297
Cost of sales	13,111,035
Gross profit	<b>7,839,262</b>
Operating expenses	9,442,847
Operating (loss)/profit	(1,603,585)
Interest paid	871,452
Net (loss)/profit before taxation	<b>(2,475,037)</b>
Taxation	80,372
Net (loss)/profit for the year	<b>(2,394,665)</b>
<b>Calculation of fixed capital:</b>	
Issued capital	500
Share premium	11,999,501
Accumulated (loss)/profit	(2,089,891)
	<b>9,910,110</b>
Adjustment for losses in current and previous 2 periods	
Current year	2,394,665
Previous year 1	-
Previous year 2	-
Fixed capital	<b>12,304,775</b>

Source: Jacobs (2009:9-12).

Based on the contents of the above table, company XYZ would perform the relevant thin capitalisation calculation as follows:

Financial assistance received from offshore related parties (i.e. shareholders loan)

=73,942,290

Therefore, the financial assistance/fixed capital ratio = 73,942,290/ 12,304,775  
= 6.00:1

which would be greater than the guideline ratio of 3:1. The company would, therefore, be thinly capitalised and the provisions of section 31(3) would then apply.

The excessive portion of the financial assistance would then need to be calculated as it would be the amount that will be disallowed as a deduction in terms of section 31(3) of the Act. This was calculated using the formula contained in the PN 2 outlined below:

$$A = \frac{B \times (C - D)}{C}$$

Where:

A = disallowable interest

B = total interest incurred

C = weighted average of all interest bearing financial assistance

D = greater of:

3 X the fixed capital at the end of the relevant year

the weighted average of all interest bearing financial assistance granted prior to July 1995,

which existed during that year

$$A = 871,452 \times (73,942,290 - (3 \times 12,304,775))$$

---

$$73,942,290$$

$$A = 436,395 = \text{Disallowable interest.}$$

In addition, the above amount that would be disallowed as an interest deduction would be in terms of section 64C (3)(e) (applicable at that time) be subject to STC at the rate prevailing on the date on which the adjustment was made, in this instance, 10%:

**Figure 4: STC Calculation for Company XYZ Limited**

<b>Calculation:</b>	
STC = 436,395 X 10% = 43,639	
The total assessment would be :	
Section 31 adjustment	436,395
Income tax @ 28%	122,191
STC @ 10%	43,639
<b>Total additional tax payable</b>	<b>165,830</b>

Source: Jacobs (2009:9-12).

### 2.3.2 Shortcomings in the former thin capitalisation rules in South Africa

Firstly, the provisions of the former section 31(3) rules did not incorporate the arm's length principle which is the international standard used for TP and also for thin capitalisation transactions. By not making provision for the application of this principle, a potential for double taxation and double non-taxation was created. Double non-taxation refers to a situation whereby the tax legislation of two countries would lead to extremely low tax, or no tax on certain activities (*International Transfer Pricing*, 2012:2).

Secondly, the fact that if taxpayers' debt to equity ratio did not exceed the 3:1 safe harbour rule or principle meant that they were exempt from being audited and were allowed to treat all interest as tax deductible. Furthermore, SARS gave consideration to a higher debt to equity ratio where the taxpayer could demonstrate that transactions were entered into for commercial and economic reasons rather than to gain a tax advantage. This therefore, created the potential for large-scale diversion of taxable profits out of the RSA and thus posed a considerable risk to the country's tax base (Corrick, 2010:2.) The above concepts will be expanded further in the next chapter.

As stated above, section 31(3) of the Act applied to a situation in which any person who was not a resident (investor) had granted financial assistance, whether directly or

indirectly, to a connected person (in relation to the investor). Section 1(1) of the Act, prior to 1 April 2012, defined a connected person as including:

all companies within a group consisting of two or more companies in which the controlling group company directly holds more than 50% of the equity shares in at least one controlled group company, and more than 50% of the equity shares of each controlled group company are directly held by the controlling group company, one or more other controlled group companies, or any combination thereof (Van Rensburg, 2008).

This definition implied that the previous thin capitalisation provision did not apply in the case of financial assistance provided to a branch of a foreign entity by its parent company because the branch and the foreign entity are deemed as one and the same company. Therefore, the transaction did not take place between two taxpayers.

The old thin capitalisation rules also contained a concession provision, particularly in respect of start-up businesses and for companies with trading losses incurred in the initial stages of a business' life. The PN provided that the annual net trading losses sustained during the current and immediately preceding tax years should be limited to losses sustained for the years of assessment during which the investor had granted financial assistance to the resident, and that these losses may be added back to their fixed capital to be used in calculating the excessive financial assistance. This provision, therefore, meant that companies consistently making losses could possibly fall within the 3:1 ratio as these losses were added back in the calculation when assessing their debt to equity ratio. Paragraph 6 of the PN also contained a concession provision in the case of a taxpayer who could prove that a higher level of debt to equity ratio than 3:1 was the result of agreements and transactions entered into for economic and commercial reasons rather than to obtain a tax advantage (SARS, 1996:6). A large-scale diversion of taxable income was, therefore, created and caused significant risk to the RSA fiscus because it was not clear whether the test for economic and commercial reasons was indeed applied according to the arm's length principle (Corrick, 2010:2).

Section 5.2.4 of the PN set a safe harbour provision in respect of the interest rate when the quantum of the financial assistance did not exceed the 3:1 ratio. However, it did not

stipulate whether the Commissioner could apply his discretion to the interest rate safe harbour in the same way as it was applied to the debt to equity safe harbour. Such an interpretation could, therefore, be open to a challenge from taxpayers.

## **2.4 NEW THIN CAPITALISATION RULES**

### **2.4.1 Introduction**

According to SARS, the previous version of the RSA TP rules focused on isolated transactions as opposed to arrangements which are driven by an overarching profit motive, and in this way raised a number of structural issues and uncertainties. This led to the emphasis being placed on the “price” and not on the “profit” in the TP rules which did not correspond to the wording in the associated enterprise article in the tax treaties concluded by RSA.

With the aim of ensuring that section 31 would correspond to the relevant wording in article 9 of the OECD MTC and to eliminate the above-mentioned uncertainties, the previous version of RSA section 31 was amended (Transfer Pricing Associated, 2011). The fact that the RSA is signatory to the OECD MTC therefore means that shifting the focus to now incorporate the arm’s length principle would allow fiscal adjustments made by the SARS to be effected more efficiently when dealing with OECD member countries (Miller et al, 2012:1).

The new thin capitalisation legislation is applicable for the years of assessment commencing on, or after 1 April 2012. This implies that, if a company’s financial year end is on 31 December for example, the new legislation will start applying to that company from 1 January 2013 (SARS, 2013a:4). In terms of the new section, thin capitalisation is incorporated into the general TP principles (Jones, 2013).

Under the new section 31 provisions, the taxpayer is therefore required 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 (SARS, 2013a:4).

The taxpayer must now determine the accepted amount of debt and prove that it falls within the arm’s length provisions, this should be based on what would have been agreed upon had the borrower and the lender been unrelated parties. This, therefore implies that taxpayers must now calculate their taxable income based on the arm’s length terms and conditions that should have applied to the affected transaction (Charalambous, 2013)

#### **2.4.2 Significant changes to the former thin capitalisation rules in South Africa**

With the aim of trying to improve the current anti-avoidance tax measures in relation to thin capitalisation, SARS engaged in discussions with the larger RSA banks with the aim of understanding their lending criteria. From this exercise it was determined that in many lending circumstances a simple debt to equity ratio is not a key determinant. This led SARS to re-evaluate how they calculated excessive debt (OECD, 2012b:10).

The most significant change is that taxpayers must determine the acceptable amount of debt using the arm’s length test basis. This generally implies that SARS will now be requiring taxpayers to consider the transaction from both the lender’s and borrower’s perspective (Charalambous, 2013). According to the general TP rules this will require the taxpayer to perform the relevant functional analysis of the parties involved in order to prove the arm’s length nature of the financing transaction in question.

The draft IN stipulates that in performing a functional analysis of the transaction, taxpayers should take into account the following relevant factors and information:

- the structure of the funding,
- the actual business of the taxpayer,
- the strategy of the business,
- the company’s current and projected financial position,
- the relevant financial ratios with regard to the abovementioned periods, and
- the quality and availability of security (SARS, 2013a:7).

In contrast to the previous thin capitalisation rules whereby the disallowed interest was treated as a deemed dividend and attracted STC, under the new thin capitalisation rules this excessive interest, which has been disallowed, will result in an additional secondary adjustment which will be deemed to be a loan by the RSA taxpayer responsible for paying the interest. The relevant interest income on this loan will have to be calculated at an arm's length price and the accrued interest capitalised annually for the purpose of calculating the outstanding deemed loan. (SARS, 2013a:10). However, the draft IN does not stipulate how the adjustment for the excessive debt will be effected. According to the previous thin capitalisation rules this should generally be capitalised annually for the purposes of calculating the excessive loan.

The Tax Administration Act 28 of 2011 affected on 1 October 2012 introduced a new administrative non-compliance penalty on taxpayers who fail to comply with an obligation that is imposed by a tax Act. This penalty provides that SARS "must" impose an administrative non-compliance penalty should it be satisfied that a non-compliance penalty has been incurred. This new provision is different from the old section 75B provision which stated that SARS "may" impose the relevant penalty if it was satisfied that non-compliance existed (Croome & Strydom, 2013). This, therefore, implies that due to the fact that the new section 31 has changed from an adjustment provision to a taxing provision and the onus of proof or the obligation to prove compliance with the arm's length provision has now shifted from SARS to the taxpayer, SARS now has the power to impose the full effect of the penalty (Jones, 2013).

As stated above, SARS has done away with safe harbour rules with regard to the acceptable debt to equity ratio and interest rates in the new legislation. However, the draft IN contains ratios which can be used as risk identifiers. These ratios are not safe harbours and do not preclude SARS from auditing taxpayers falling within the range of the ratios. It must also be noted that the RSA does not currently have APA's (SARS, 2013a:16).

The newly issued draft IN provides that the undermentioned financial ratios are appropriate for the current and projected periods and should be taken into account when performing a functional analysis of the relevant transaction in question.

- Debt: EBITDA ratio
- Interest cover ratio
- Debt: Equity ratio

The above ratios will be discussed in more detail in the next chapter. Although the draft IN does not prescribe specific safe harbours that SARS will apply, it does state that SARS will consider transactions in which the Debt: EBITDA ratio exceeds 3:1 to be of greater risk.

### **2.4.3 Recognising economic substance versus safe harbours**

Based on past experience, thin capitalisation negotiations in the UK were nothing more than a simple horse-trade over ratios without considering the commercial implications of each transaction. The UK approach, therefore, moved away from this approach and now provides taxpayers with an opportunity to justify their commercial arrangements (Ross, 2010).

The most appropriate method to be used when applying the new thin capitalisation provisions is contained under par 1.65 of the OECD guidelines. This generally states that the basic transfer pricing provision which considers the economic substance versus form will be applied (OECD, 2010b:51). Von Brocke and Perez (in Webber 2010b:19) write that “it was very simple for companies to circumvent the limit established by debt-to-equity ratio by increasing the equity of the financed subsidiary in a manner sufficient to push down as much debt as necessary”.

As previously mentioned, the idea behind applying the whole commercially focused approach to thin capitalisation cases sounds good in theory, the challenge will be its application in practice.

The burden for financing transactions will prove even more difficult to discharge as the credit processes of lenders and the resultant effect of these processes on their terms and conditions are so complicated. Getting comparable information could also prove to be a major challenge for taxpayers (Bakker & Levey, 2012:449)

#### 2.4.4 Challenges faced by the SARS with the application of the new rules

For SARS the new approach will result in a change in focus away from the quantitative analysis of the past to a more commercial and market-focused approach. This approach requires a detailed understanding of the specific facts and circumstances relating to the financing transaction. This could possibly result in making it more difficult for taxpayers in the RSA to obtain an interest deduction on funding received directly or indirectly from connected parties (Kellerman, 2010)

In the draft IN, SARS stated that guidance on the application of, and adherence to, the arm's length basis can be found in the OECD guidelines. The draft IN also specifies the level of documentation SARS expects to see in order to support the level of arm's length debt. Below is a table showing a comparison of the documentation requirements listed by the SARS in the IN compared to that required by the HMRC when applying for Advanced Thin Capitalisation Agreements (ATCA's).

**Table 2: Comparison of documentation requirements**

RSA Legislation	UK Legislation
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RSA Legislation	UK Legislation
<p>A description of the funding structure which has been, or is in the process of being put in place, including the dates of transactions, source of funds, reasons for funding and repayment terms.</p> <p>A description of the principal business activities together with a detailed business strategy.</p> <p>Copies of relevant funding agreements and other relevant documents pertaining to the funding activity.</p> <p>An analysis of the financial strategy of the business, including the allocation of capital and the changes in cash flow.</p> <p>A group structure covering all relevant companies and clearly setting out any changes to the structure taking place over the course of the funding transaction.</p> <p>A summary of financial forecasts which are contemporaneous with the funding transactions in question, projected as far as is meaningful in relation to the period of the funding transactions.</p> <p>Copies of the financial statements or management accounts just before the point in time the funding is obtained and after the funding transactions.</p> <p>An analysis supporting the borrower's view of the extent to which the connected party (or supported) debt is considered to be arm's length.</p>	<p>A description of the financing structure being put in place.</p> <p>A description of the trading strategy of the business/company/group.</p> <p>Copies of loan agreements and other relevant documents.</p> <p>An analysis of the financial strategy of the business, identifying the principle cash flows and the sources of repayment of debt.</p> <p>A group structure covering all relevant companies and clearly setting out any changes to the structure taking place over the course of the transactions.</p> <p>A summary of contemporaneous financial forecasts, projected for as much of the life of the ATCA as is meaningful, and ideally presenting a realistic range of potential scenarios.</p> <p>A clear indication of the source of the funds (immediate and, if appropriate, ultimate), the purpose for which they were borrowed and any repayment terms.</p> <p>A description of the business and the plans of the principle trading operations showing how capital is allocated and the relationship between capital and cash flows from operations.</p>

Source: (Miller, Froneman, Kruger, Liebenberg & Wolff, 2013;HMRC, 2013).

As per the above table and compared to the UK guidelines it appears that the draft IN covers most of the issues in relation to how the SARS aims at regulating thin

capitalisation. The table also clearly illustrates that the SARS had indeed considered the UK approach when drafting their guidance as the documentation requirements appear to be somewhat similar to that of the UK.

The fact that the official IN is still not released and yet taxpayers have the obligation to comply with the new regulations from years of assessment commencing on, or after 1 April 2012, could cause a lot of reluctance by taxpayers to comply with the law once it is applied.

The new thin capitalisation provisions may require greater scrutiny from SARS and a more detailed TP analysis, taking into account the specific facts and circumstances of each taxpayer. The rationale for debt funding as well as the economic environment in which an entity operates may then play a bigger role in determining the extent of the funding that will be acceptable to ensure an interest deduction. The arm's length test would, therefore, have to be applied in determining whether a company has been thinly capitalised. This is nothing more than an objective test to determine not only what a company could have borrowed, but what it would have borrowed in an arm's length situation (Kellerman, 2010).

The fact that the RSA is still a developing country means that SARS is faced with the challenge of developing and maintaining its professional knowledge and experience. These challenges specifically include losing expertise as TP experts move to the private sectors because the public sector is often faced with cost constraints (OECD, 2012a:69). This will be a serious challenge which the SARS will have to address when this new legislation is applied.

## **2.5 THIN CAPITALISATION RULES IN THE UNITED KINGDOM**

In the UK TP disputes were initially resolved through negotiations between the taxpayer and HMRC because there had been limited case law to turn to for precedent. New rules with a fully integrated self-assessment policy came into effect for companies with years of assessments ending on or after 1 July 1999. The main reason for the new law was to replace a regimen that had lasted some 50 years with a fairer and more effective tax

system thereby also creating “a level playing field” for taxpayers and HMRC (Nias & Ross, 2010:1).

The first substantive court case in the UK came about when the tribunal found in favour of HMRC in DSG Retail and others versus HMRC. In this case, a related financial services group of companies engaged a third party intermediary in a business arrangement hoping that they would not fall within the TP provisions. The HMRC examined the arrangements as a whole and because it could be shown that the third party intermediary was engaged only because they would in turn enter into another contract with another company from the same group, the TP legislation applied (Field Fisher Waterhouse, 2010:4).

Subsequent to this court case, the HMRC then published a large amount of guidance material on its interpretation of the rules (*International Transfer Pricing*, 2012). Historically, the HMRC has never published safe harbour ratios with regard to thin capitalisation. The new guidelines also reaffirmed this notion (Ross, 2010).

According to Watson and Andrews (2012:4), HMRC had previously provided definitive ratios and rules of thumb (such as, 1:1 debt to equity or a 3:1 interest cover), which were applied as general guideline when determining arm’s length amounts of debt and arm’s length interest expenses.

HMRC applies a separate entity test when applying its thin capitalisation provision. This approach applies the arm’s length provisions as that “which would have been made as between independent enterprises”. This approach, therefore, tests the borrowing capacity of the borrower which is the debt that it could, and would have taken from an unrelated lender as an independent entity. This principle is constructed around article 9 of the OECD MTC and the OECD TP guidelines (HMRC, 2013).

### **2.5.1 Tools applied by the HMRC in testing the arm’s length principle**

Since 2004 the UK has been applying an arm’s length test to determine whether a UK entity is thinly capitalised or not, and does not apply a safe harbour to evaluate thin

capitalisation cases (*International Transfer Pricing*, 2013:793). In practice, the HMRC inspectors have been determining not only whether the sum borrowed could have been borrowed at arm's length, but also whether it would have been borrowed at arm's length. The UK has therefore, built considerable expertise in forming a judgment on when funding does not meet the arm's length test (HMRC, 2013).

The HMRC's thin capitalisation practical manual provides practical guidance on the processes and techniques of working thin capitalisation cases to a successful conclusion. This is a practical approach which generally takes certain elements into account to test the arm's length nature of the financing transaction and is published on the HMRC website for public use (HMRC, 2013).

The S&P Credit Model, or Moody's Riskcalc credit rating tools have been essential tools for TP practitioners in the UK in assessing the terms of intra-group debts. However, their use has been the subject of many debates within the HMRC. The HMRC also provides lengthened material on which ratios can be used for determining a company's debt capacity. However previous measures of debt to equity and EBIT interest cover still feature alongside the more current measures (Gordon-Brown, Saul & Clark, 2010:2). HMRC expects that there will often be "debt spikes" when there are major acquisitions and this will need to be catered for when negotiating these ratios. The HMRC, therefore, accepts as given that the company will return back to a "steady state" in a relatively short period of time. There is detailed guidance issued by the HMRC on what taxpayers should do in the case of such downturns (Ross, 2010).

UK companies are subjected to the "Worldwide Debt Cap" rules from accounting periods beginning on, or after 1 January 2010. The "World Wide Debt" cap applies to companies that are financed by a related party and that form part of a large group. These rules are aimed at restricting the tax relief measures applicable on interest payments by these UK companies. These rules ensure that the group's external financing expenses on a worldwide basis are not exceeded by the aggregate UK companies' tax deductions for financing expenses. However, these rules impose major burdens on groups as they are complicated to apply (KPMG LLP, 2009:1).



## 2.5.2 Domestic thin capitalisation

One of the most fundamental changes to the thin capitalisation rules in the UK included the removal of the TP exemption provisions applying to domestic intercompany loans from 1 April 2004 as is clear from the excerpt below (*International Transfer Pricing*, 2013:793).

An example of where UK-UK loans might present a real tax risk would be where a UK group company which has losses that are no longer available for group relief, provides a loan to a profitable fellow UK group member. A deduction for interest which is in excess of the arm's length amount can, in effect, transfer the benefit of that loss relief to another company which is able to use it. The borrower's increased interest deductions are tax effective in reducing its taxable profits while the lender's higher interest receipts have no tax effect because they are absorbed by its accumulated losses.

From this arrangement, the UK group would therefore get the benefit of the losses which would not have been generally allowed. In such circumstances, the TP regulations would be applied to deny the deduction on the excessive interest (HMRC, 2013).

Based on the above, the UK introduced thin capitalisation provisions applicable to UK to UK loans. Therefore, the UK thin capitalisation legislation does not only apply to offshore connected party loans but on financial assistance transactions between UK companies domiciled in the UK as well. This implies that a UK borrower needs to consider the application of the thin capitalisation rules even if it is not borrowing from overseas and has no non-UK ownership (Green, 2004:1) This could be an aspect which SARS should consider exploring in the future years as well.

Previously, the HMRC treated excessive interest payments from thinly capitalised domestic companies as divided payments and there was no specific debt to equity ratio set, however, a ratio of 1:1 was acceptable. Fearing that their legislation would be in contravention of the European law, the UK thin capitalisation rules were then repealed and replaced by the new rules in respect of domestic thin capitalisation with effect from 1 April 2004. The new rules now incorporated both TP and thin capitalisation into the same regimen and also started applying this legislation to resident-related parties (Dourado & de la Feria, 2008:14-15).

An important court case that played a pivotal role in the amendment of the UK thin capitalisation legislation in 2004 was the Lankhorst-Hohorst GmbH versus Finanzamt Steinfurt case. Lankhorst-Hohorst GmbH was a German taxpayer which incurred interest expenses paid to a Dutch-related party on debt that was in excess of the debt to equity safe harbour ratios in Germany. After the tax authorities disallowed these expenses, the case was referred to the European Court of Justice ("ECJ") to determine whether there was discrimination against foreign European Union ("EU")-owned companies. It was then confirmed by the ECJ that the thin capitalisation provisions had indeed infringed on the EU parent entity's freedom of establishment as this legislation only targeted foreign-owned companies (Deloitte & Touché LLP, 2002).

The ECJ gave its judgment on the Lankhorst-Hohorst GmbH case in December 2002, concluding that the then German thin capitalisation legislation was in breach of the freedom of establishment provisions of the EC Treaty (Devereux, Mokkas, Pennock & Wharrad, 2006:18).

### **2.5.3 Advanced thin capitalisation agreements**

In complying with the UK thin capitalisation rules, UK taxpayers were faced with difficulties and uncertainties and in recognition of this the HMRC introduced the ATCA's programme in April 2007 (Horrocks, Morgan, Forde & Harrowven, 2011).

UK taxpayers can enter into a ATCA'S with the HMRC as an alternative to a self-assessment. This could last for up to five years and can cover the whole group's arrangements with regard to financial assistance transactions. Entering into such an agreement with the HMRC would generally preclude them from challenging the arrangements (Ashurst LLP, 2007).

UK taxpayers were offered the opportunity of applying for these agreements by the HMRC in connection with the deductibility of interest arising from intra-group financial assistance through the tax treaty application procedure. Accordingly, taxpayers would invoke the terms of a bilateral treaty accordingly in order to remove the obligation to pay withholding tax on interest paid. (Horrocks et al, 2011.)

## 2.6 SUMMARY

Unlike the RSA market, the UK is a developed market with better access to quantitative systems, historical data and expertise in credit risk modeling of financial transaction. Faced with these challenges, the RSA needs to grow its human resource capacity and knowledge with regard to the administration of these new rules. A substantial investment in developing a strong TP expertise is therefore required to bring the SARS TP to the same level as its UK counterparts (Barnard, 2012:1).

The RSA regulations, through the revised Section 31 and the relevant draft IN, should provide guidance on the methodology to apply in performing quantitative adjustments along with practical examples. Adequate guidance on this front will go a long way towards reducing disputes and protracted litigations between taxpayers and SARS.

## CHAPTER 3

# BENEFITS AND SHORTCOMINGS OF THE NEW THIN CAPITALISATION RULES

### 3.1 INTRODUCTION

The tightening of RSA's fiscal position on thin capitalisation will certainly bring about certain challenges. These challenges will have to be balanced against the benefits and the revenue which will be raised. The previous chapter introduced the concept of thin capitalisation and also provided an understanding of the history behind thin capitalisation rules as well as the need for the new amendments. This chapter, therefore, focuses on the technical and administrative aspects involved in the application of the new thin capitalisation legislation.

### 3.2 BENEFITS OF THE NEW THIN CAPITALISATION RULES

As mentioned above, the new RSA thin capitalisation rules have introduced the arm's length standard to related party debt transactions and have done away with the 3:1 debt to equity ratio safe harbour which was previously applied. Taxpayers are now expected to prove that they have complied with the arm's length standard through detailed TP analysis which would include performing the relevant functional analysis, reviewing comparable companies and providing other quantitative and qualitative factors (Kadar, 2013:1). Introducing stringent thin capitalisation rules will ensure that there is a stable source of revenue in the country in order to fund important investments that promote a smarter, stronger and fairer country (Australian Government, 2013:35).

#### 3.2.1 The application of the arm's length standard

The main advantage of applying an arm's length standard for thin capitalisation is that there is a closer approximation of the debt the corporation could borrow at arm's length and therefore this approach eliminates the asymmetrical treatment amongst related party corporations compare to those that are not related (OECD Tax & Development, 2012b:9).

As mentioned above, the provisions of the previous thin capitalisation rules did not incorporate the arm's length principle which is the international standard used for TP and generally for thin capitalisation. Applying the arm's length standard reduces the potential effects of double taxation and double non-taxation through the application of the relevant tax treaties. Furthermore, the fact that the previous thin capitalisation rules allowed for interest as a tax deduction where the financial assistance to fixed capital ratio did not exceed 3:1 and also gave consideration to a higher ratio where the taxpayer could demonstrate that the transactions were entered into for commercial and economic reasons rather than to gain a tax advantage. This created the potential for the diversion of taxable profits out of RSA and was, therefore, a risk to the RSA tax base (Corrick, 2010:2).

### 3.2.2 Loopholes addressed in the new legislation

Previously, foreign investors would form branches in the RSA which had excessive debt whilst avoiding the thin capitalisation rules despite the fact that their main operations were contained within the RSA branch (Naidoo, 2010). The new thin capitalisation rules have been able to address this loophole as foreign owned RSA branches will now have to comply with its provisions.

The previous rules were not clear as to whether they included or excluded any third party debt when considering the financial assistance to equity ratio. The section stated the following:

Where any person who is not a resident .....**has granted financial assistance**.....whether directly or indirectly, to any connected person.....and the Commissioner is, having regard to the circumstances of the case, of the opinion that **the value of the aggregate of all such financial assistance** is excessive in relation to the fixed capital of such connected person.....” [emphasis added].

Therefore, the previous PN 2 did not make it clear whether the assessment of the economic and commercial reasons was according to an arm's length context. Thus, the Commissioner was required to have regard to the circumstances of the case. This would

entail looking at the “actual” facts rather than the facts within the arm’s length principle (Corrick, 2010:2).

Below is an illustrative example of how a company that would have not fallen within the thin capitalisation provision applying the old section 31(3) rules could now easily fall within the ambit of the new section 31 based on the new ratios highlighted by the SARS as risk indicators.

**Figure 5: Balance Sheet and Income Statement of ABC Limited**

<b>BALANCE SHEET</b>	
<b>For the year ended 30 September 2014</b>	
<b>Assets</b>	
Non-current assets	80,500,899
Current assets	14,373,719
<b>Total assets</b>	<b>94,874,618</b>
<b>Equity and liabilities</b>	
Capital and reserves	<b>9,910,110</b>
Issued capital	1,500
Share premium	18,740,501
Accumulated (loss)/profit	2,500,891
Non-current liabilities	<b>74,121,155</b>
Deferred tax liability	50,245
Shareholder's loan	73,942,290
Finance loan	128,620
Current liabilities	<b>10,843,353</b>
<b>Total equity and liabilities</b>	<b>94,874,618</b>
<b>INCOME STATEMENT</b>	
<b>Year ended 30 September 2014</b>	
Turnover	20,950,297
Cost of sales	(13,111,035)
Gross profit	7,839,262

Operating expenses (excluding depreciation and amortisation)	(9,442,847)
Operating (loss)/profit	<b>(1,603,585)</b>
Interest paid	(871,452)
Nett (loss)/profit before taxation	(2,475,037)
Taxation	(80,372)
Nett (loss)/profit for the year	<b>(2,394,665)</b>

Calculation of disallowed portion using the old section 31(3) rules:

Assuming the company made losses in the previous 2 years

**Figure 6: Calculation of Fixed Capital for ABC Limited**

Calculation of fixed capital:	
Issued capital	1,500
Share premium	18,740,501
Accumulated loss	2,500,891
	<b>21,242,892</b>
Adjustment for losses in current and previous 2 periods	
Current year	2,394,665
Previous year 1	1,900,542
Previous year 2	3,254,987
Fixed capital	<b>28,793,086</b>

Financial assistance - = 73,942,290

Therefore, the financial assistance/fixed capital ratio = 73,942,290/ 28,793,086  
= 2.56:1

This would be below the guideline ratio of 3:1. The company would, therefore, not be considered to be thinly capitalised and the provisions of section 31(3) would not apply. There would therefore not be any excessive portion of the financial assistance and interest to be calculated.

However, using the same example as above, but applying the new thin capitalisation provisions based on the risk-based approach which will be used by SARS in selecting potential thin capitalisation cases for review, the below mentioned calculations would have to be performed in respect of the debt to equity ratio and the Debt: EBITDA ratio.

### a. Debt: Equity ratio calculation

The new thin capitalisation rules do not contain the two-year add back concession which was previously allowed for taxpayers to add back their losses incurred in the previous two years when calculating their fixed capital. Therefore, the following calculation would have to be performed when calculating debt to equity for ABC Limited:

$$\begin{aligned} \text{Financial assistance} &= 73,942,290 \\ \text{Therefore, the financial assistance/fixed capital ratio} &= 73,942,290 / 21,242,892 \\ &= 3.48:1 \end{aligned}$$

Thus, the same taxpayer would be above the ratio of 3:1 and would be seen as a high risk taxpayer by SARS. As stated above the ratio of 3:1 is not a safe harbour ratio. However, SARS has stated that the ratio is merely indicative of the level of risk for the purposes of selecting cases. Given that SARS has on numerous occasions mentioned the fact that the 3:1 ratio was very generous compared to other countries, the fact that the taxpayer in the example in which the debt to equity ratio was less than 3:1 has only exceeded this ratio by 0.48, would in terms of the current legislation not guarantee a concession from SARS even if the taxpayer were to apply for one.

### b. Debt: EBITDA ratio calculation

This measures a company's leverage and shows how many years a company would take to pay back its debt (Investopedia, Not dated).

$$\begin{aligned} \text{Financial assistance} &= 73,942,290 \\ \text{Therefore, the financial assistance/ EBITDA ratio} &= 73,942,290 / (1,603,585) \\ &= (46.11: 1) \end{aligned}$$

SARS has mentioned that they will now consider transactions in which the Debt: EBITDA ratio of the RSA taxpayer exceeds 3:1 (SARS, 2013b:11). This would imply that ABC



would be flagged for TP risk based on the above Debt: EBITDA ratio based on the fact that they obtained a negative Debt: EBITDA ratio.

### c. Interest cover ratio calculation

The rationale behind an interest cover ratio is to demonstrate how easily a company can pay off interest on debt outstanding (Investopedia, Not date). However, the draft IN does not stipulate the ratio that would be indicative of the fact that a taxpayer could be high risk for interest cover.

Financial assistance- = 73,942,290  
Therefore, the interest cover ratio would be EBIT/interest expense  
= -1,603,585/ 871,542  
= (1.83):1

A business is seen to be having difficulties in generating the funds necessary to pay off its interest obligations if it has an interest coverage ratio below 1.0 (Kennon, Not dated). An interest cover ratio of -1.83:1 is clearly very low and would mean that SARS would in all likelihood audit this taxpayer.

### 3.2.3 Onus of proof

One other important change brought about by the new thin capitalisation rules is the fact that the taxpayer is now required to determine the acceptable amount of debt on an arm's length basis (SARS, 2013a:4). Previously, the onus of proof rested with the Commissioner to demonstrate that the transactions were not arm's length due to the lack of information on third party lending criteria in the RSA held by SARS, and SARS would struggle to prove this (Corrick, 2010:3). This implies that interest payments and other charges which relate to the excessive portion of the financial assistance will be disallowed as a deduction when calculating the taxable income by the taxpayer.

Transparency and certainty over the tax treatment of transactions between RSA taxpayers and foreign connected persons will, therefore, create a better inward investment climate.

Compliance by taxpayers will also reduce the need for audits, and if MNEs are seen to pay their fair share of taxes then this will encourage voluntary compliance among other taxpayers who have the perception that they are in business to exploit developing countries.

### **3.3 SHORTCOMINGS OF THE NEW THIN CAPITALISATION RULES**

The implementation of new legislation always comes with new challenges. SARS received various comments from the public addressing certain issues about the practicalities in applying the new legislation based on the draft IN. These are discussed briefly in the paragraphs below.

#### **3.3.1 Uncertainty about the application of the new section**

The draft IN does not provide a clear definition of what constitutes debt for purposes of calculating the Debt: EBITDA ratio. Thus, taxpayers are not sure whether to include non-interest bearing debt, trade debt, provisions and accruals. They also mention that apart from reference to IFRS for determining economic substance, SARS should also provide taxpayers with an extensive list of examples and guidelines of what it considers to be equity and debt (Mandy, 2013:9).

Paragraph 4.1.1 of the draft IN discusses the concept of direct and indirect funding. It goes on to explain that the new section is far wider than a loan between two related parties defined under the “affected transaction” definition. It also explains what indirect funding entails and provides an example. Comments received by taxpayers indicate that the draft IN should provide more clarification on how “indirect” the funding should be in order to fall under these provisions as the example provided in the IN is not extensive (Mandy, 2013:8).

According to the draft IN, taxpayers are required to reassess the appropriateness of their level of debt from time to time. The IN states that the frequency and timing will depend on the nature of the taxpayer’s business. Taxpayers require guidance as to on-going assessment from SARS as the current wording on the draft IN states that assessment will

depend on the taxpayer's business. Taxpayers also require further clarification as to whether debt should be measured at a point in time or at the weighted average of financial assistance in existence during that specific year (Mandy, 2013:10).

### **3.3.2 Retrospective application**

Taxpayers have raised concerns regarding the equity and fairness of the draft IN as it will apply with retrospective effect, they state that the application of the IN should only apply to years of assessment commencing on or after the date that the final IN is finalised. They state that changes to the safe harbour rules should, therefore, not be retrospective and should only apply to debt issued on, or after the date that the safe harbour is officially withdrawn by means of a general binding ruling. Or alternatively, they should be provided with a transitional period to re-arrange their affairs so as to bring them in line with the new legislation and its onerous requirements (Mandy, 2013:2).

The above concerns appear genuine. However, it should be remembered that when SARS introduced the thin capitalisation rules in the RSA in 1995, the PN 2 was only issued on 14 May 1996. However, taxpayers were expected to apply this legislation retrospectively as it was made clear by the wording contained under PN.2 in paragraph 4.1. In the calculation of the portion of interest that related to excessive financial assistance it reads as follows: "B" represents the total interest incurred during such year in respect of all financial assistance, contemplated in subsection (3), in existence during such year (whether or not such financial assistance was granted before, on or after 19 July 1995)" (SARS, 2012:1549). From this it appears that the Act does not compel SARS to issue guidance within a particular period after new legislation has been issued, however taxpayers are expected to apply it.

### **3.3.3 Issues with the proposed debt limitation rules**

On 29 April 2013 the RSA National Treasury proposed new rules which will be incorporated into the forthcoming 2013 Taxation Laws Amendment Bill. This rule will be issued in response to the government's concern over tax avoidance schemes that lead to base erosion issues in RSA. This new rule will be aimed at limiting the aggregate

deductions for interest associated with debt between entities of the same group (South Africa. National Treasury, 2013:3).

Due to the fact that this new rule will be targeting interest tax deductions which come about from intragroup financing transactions, there will be a double tax jeopardy that will interplay as taxpayers could be caught under these rules and the thin capitalisation rules at the same time. The draft IN states that there is no statutory safe harbour for thin capitalisation in the new legislation. However, the media statement issued by the South African National Treasury suggested that there will be a safe harbour when applying the new rules. Thus, the SARS will have to provide clarity on the tax implications for taxpayers in such a situation as the IN does not address this issue.

The presence of conflicting, or even overlapping rules in a single jurisdiction can complicate the structuring and pricing of intragroup debt for taxpayers. It should also be noted that the differences in pricing intragroup debt could increase the risk of a challenge from taxpayers and tax authorities even when dealing with relatively simple transactions (Rogers, Van der Breggen, M, & Yohanna, B, 2009:52).

#### **3.3.4 Introducing a safe harbour**

There is no doubt that the use of safe harbours is an effective means of managing resources but it also increases the potential risk to the tax base. Taxpayers have generally suggested that SARS should introduce a safe harbour especially for small and medium sized enterprises (Mandy, 2013:6). They have also suggested that SARS should introduce a safe harbour that is calculated at less than the previous 3:1 ratio. Below is a sample of the practices in other countries in applying thin capitalisation rules.

**Table 3: Thin Capitalisation rules in other countries**

Country	Limitation	Comments
Australia	Debt: Equity 3: 1	<p>In 2002, Australia’s thin capitalisation regime changed substantially, bringing in lengthy and complex legislation. A “safe harbour” debt amount has been introduced, with an alternative “arm’s length” test which can potentially increase the permissible interest. Exceptions made for certain financial businesses— authorised deposit takers.</p> <p>Interest in excess of the prescribed level is denied as a deduction. However, it is fully deductible if the company satisfies the arm’s length test.</p> <p>The Australian Tax Office has a well-organised and accessible website, with good search facilities.</p>
Germany	Limit to deductibility of interest (30% of income)	<p>The legislation was substantially revised in 2008.</p> <p>Interest deductibility is limited to 30% of taxable income before interest, taxes on income, depreciation and amortisation.</p> <p>Previously Germany had a widely available safe harbour: Debt: Equity ratio of 1.5: 1</p>
France	<p>Interest limitation by reference to third party rates</p> <p>Arm’s length measure for interest rate Debt: Equity 1.5:1 or 25% interest: operating income ratio</p>	<p>A new system was introduced from January 2007, applying limitations between related parties, and bringing in the arm’s length measure. Interest rate limitations :</p> <ul style="list-style-type: none"> <li>• deduction limited to an average of rates charged by lending institutions, or</li> <li>• the interest rate that the debtor company could have obtained from a third-party lender and</li> </ul> <p>Debt-based limitations :</p> <ul style="list-style-type: none"> <li>• overall indebtedness (Debt : Equity ratio), and Disallowed interest can be carried forward indefinitely at group level, but will be reduced annually by 5% from the second year after the expense was incurred.</li> </ul> <p>There is no differentiation between types of companies. Companies are considered on a stand-alone basis. Certain financial businesses and transactions are excluded.</p>

Country	Limitation	Comments
Japan	Debt: Equity 3: 1	Japanese thin capitalisation rules were revised in 2006. A Debt: Equity safe harbour rule applies to foreign-owned corporations. The 2006 rules extend this to third parties where foreign corporations guarantee[d] the borrowing.
China	Financial companies: Debt: Equity 5: 1  Non-financial companies: Debt: Equity 2:1	China introduced thin capitalisation legislation for the first time late in 2008.  Two safe harbour ratios have been set, one for financial industry enterprises (and another) one for non-financial (industry enterprises).  If these ratios are breached, it appears that the taxpayer will still have the opportunity to try to demonstrate that the transaction is still consistent with the arm's length principle.
USA	Debt: Equity 1.5: 1	The US "earnings stripping rules" currently include a restriction on interest paid by a corporation to related persons, if the corporation has : A Debt: Equity ratio exceeding 1.5: 1, and A net interest expense exceeding 50% of the company's adjusted taxable income. This is likely to be tightened, probably to 25%.

Source: Sekar & Bhuson (2012)

From the above analysis, it can be noted that there are differences in practices across the different tax administrations in the world in the application of the thin capitalisation rules. However, there are still common areas which can be noted, these are particularly:

- Tax administrations use safe harbours
- Debt to equity or other similar ratios (such as those used in Australia and New Zealand) are commonly used to set safe harbours
- The safe harbour may be in the administrative practice rather than the legislation
- The South African safe harbour is generous compared to many other tax administrations
- Other tax administrations are considering reducing their safe harbour levels.

(Corrick, 2010:3.)

### **3.3.5 Comparables and databases used**

Paragraph 5.2 of the draft IN refers to third party provided commercial databases that can be used to assist taxpayers with the determination of the arm's length debt and interest. It is stated that these databases will incorporate elements such as the taxpayers credit risk and scorecard models.

According to the comments received from taxpayers, they require clarity on how they are expected to measure the "could have" requirement and what databases they should use in the event of an audit. They have also raised concerns regarding the cost to tax practitioners and taxpayers on acquiring the relevant licences to be able to use these databases.

### **3.3.6 Other considerations**

Industry realities need to be taken into account when it comes to the application of the new rules by SARS. For example, in the case of banks which already have strict compliance regulations, the thin capitalisation rules should not be applied in the exact same manner as with other companies. In countries like France and Denmark, thin capitalisation rules are not applicable to financial institutions, such as banks (Van der Westhuizen, 2013:2).

According to the new section 31, financial assistance includes loans, advances and guarantees. However, synthetic loans which are created using derivatives are not included in this definition. Consequently, SARS needs to ensure that this issue is addressed and the relevant TP expertise is there in order to deal with the structuring of these synthetic loans using complex securities, such as derivatives (Barnard, 2012:5).

## **3.4 NEW DISCLOSURE REQUIREMENTS**

With the aim of modernising their corporate income tax, SARS has recently changed the format of the annual income tax return to be submitted by corporates by replacing the IT14 form with the ITR14 form with effect from 4 May 2013. This form seems to place an increased emphasis on international tax aspects and transactions between connected parties requiring more attention and preparation (Reifarh, 2013). As opposed to the old

IT14 form, the new ITR14 form now requires taxpayers to disclose various financial ratios (Debt: Equity; debt: EBITDA; EBITDA: interest paid). However, as mentioned above, these ratios will only be used as risk indicators by SARS.

The new ITR14 provides SARS with useful information regarding the TP-related activities of companies which will allow them to select cases for audit more easily and efficiently (Spearman, 2013).

The disclosure requirements for companies relating to TP state that companies which do not comply with such requirements will face criminal charges. Chapter 15 of the Tax Administrative Act titled “administrative non-compliance penalties” is specifically dedicated to dealing with matters of non-compliance. This chapter also deals with relevant penalties to be charged by the SARS should a taxpayer not comply. Chapter 15 contains a provision under section 210 specifying that a penalty will be imposed by SARS should a taxpayer fail to comply with an obligation imposed under the tax Act. These requirements contain a provision stating that it is compulsory for all companies that enter into transactions with international connected parties to attach a TP policy document to the ITR14 form when submitting it to SARS, thereby implying that if a taxpayer does not do this they are non-compliant.

### **3.5 CONCLUSION**

Based on experience in Australia, Canada, New Zealand, and the Netherlands as well as experience from other jurisdictions, some of the main areas upon which tax authorities appear to be focusing when it comes to thin capitalisation are:

- related party financial assistance with high interest rates compared to local companies;
- relatively high guarantee fees being paid to offshore-related parties;
- companies with high debt to equity ratios compared to their related group companies;
- transactions lacking economic substance and having no documented or written agreements;



- companies not exercising their call options being included in intragroup financial assistance when the market shows that an independent party would; and
  - related party financial assistance which results in ongoing low levels of profits;
- (Rogers, van der Breggen, & Yohanna, 2009:52)

The main purpose of regulations on thin capitalisation is to address the tax avoidance of excessive debt funding through shareholders which consequently leads to excessive interest deductions resulting in the corresponding loss of tax revenue in the source countries (Knobbe-Keuk, Grotherr, Thommes, & Endres in Klostermann, 2007:8). This possibility causes concern not only to SARS but also to other revenue authorities worldwide looking into introducing new and effective ways of dealing with the concept of thin capitalisation.

Generally, it should be remembered that this IN is still in its draft form as the SARS is currently still addressing most of the concerns raised above from taxpayers. Furthermore, it is important that this new legislation strikes a careful balance in ensuring that the SARS collects the right amount of tax without discouraging foreign investment.

## CHAPTER 4

### CONCLUSION

#### 4.1 INTRODUCTION

The recently issued draft IN was intended to provide taxpayers with more clarity regarding the application of the new thin capitalisation rules. However, based on the comments received from taxpayers and their advisors it appears that it has had the opposite effect. As discussed above, reluctance from taxpayers are inevitable when it comes to new legislation being introduced. Taxpayers in the UK experienced the same lack of clarity when it amended its thin capitalisation legislation and British taxpayers are still grappling with this legislation today.

The fact that the RSA has now moved to a more commercially focused approach means that safe harbours will no longer be the main determinant to establish whether or not the company is thinly capitalised. This is, however, in contrast to the current feeling within certain TP circles that the increase in volume and sophistication of cross-border trade has made the arguments in favour of safe harbours more compelling (Young, 2012:2).

With separate country-specific safe harbor rules and expectations, the potential for disputes across country borders increases. It must be noted that the solicitation of non-binding quotes from the banks is not allowed in other countries. There are tax authorities who have started challenging the pricing of intragroup loans applying a combination of tax-related arguments and TP (Rogers, van der Breggen, M, & Yohanna, B, 2009:52).

This chapter aims to conclude on the analysis made above on the provisions of the new RSA thin capitalisation rules in comparison with the previous legislation. The chapter also concludes on the analysis made on the thin capitalisation guidelines issued in the UK by the HMRC, this is then followed by a conclusion of the comparison of the UK, RSA and the OECD MTC thin capitalisation rules.

## **4.2 A COMPARISON OF THE RSA, UK AND THE OECD MTC THIN CAPITALISATION RULES**

### **4.2.1 The new RSA thin capitalisation rules compared to the previous legislation**

It might appear that the RSA legislation is adequate with regard to addressing the issue of thin capitalisation, in that it is codified where necessary, and guidance dealing with the arm's length nature of related party transactions has now been issued. The major concern that is raised relates to the uncertainties with regard to the application of this new legislation. This concern is common among similar countries that have effected such amendments in the past. However, these countries have made deliberate attempts to address this issue.

Unlike the old RSA thin capitalisation rules, the new rules do not contain safe harbour ratios meaning that RSA taxpayers who fall foul of the ratio will need to rely of TP principles to justify their borrowing positions. The recently issued draft IN does not include specific provisions or guidelines on the work taxpayers need to do to prove that they have complied with the arm's length principle for thin capitalisation. "Deciding on what constitutes an arm's length amount of financial assistance and the related pricing is a very subjective matter" (Badenhorst, 2013). The draft IN states that the documentation required to support the arm's length nature of the financial assistance will vary according to the specific facts and circumstances of each case (SARS, 2013a:12).

A problem arises if taxpayers feel that their facts and circumstances are not complex enough to prepare detailed documentation to prove their compliance. However, SARS has a different point of view in this regard. Seligson (2010:8) points out that the wording of the new section 31 in regard to the manner in which its regulations should be applied lacks clarity and certainty of expression, and that the way in which it is drafted is somewhat opaque. Furthermore, the generality of the language used leaves too much to future extrinsic interpretation by SARS.

#### **4.2.2 The thin capitalisation guidelines issued in the UK by the HMRC**

It should be borne in mind that the primary function of the guidance issued by HMRC was to assist and advise HMRC officers, and therefore, taxpayers need to take cognizance of the fact that the views of HMRC might not be accepted by those with a different point of view. As is the case with SARS, HMRC also received comments from the relevant affected stakeholders. Most of the points raised were then incorporated into the current legislation (Tax Rates.cc, 2010).

The thin capitalisation legislation of HMRC is seen as one of the more complex pieces of legislation as far as thin capitalisation rules are concerned and it, therefore, raises greater scrutiny and uncertainty among taxpayers in the UK. In the past, this uncertainty has been increased by the time limitations set by the UK Corporate Tax Self-Assessment rules which provide for a window period of enquiry of up to 12 months. In practice this has resulted in companies dealing with thin capitalisation enquiries for some years after the financial assistance was introduced.

The guidance issued by the HMRC also included various points of view of which British taxpayers' struggled to reconcile with. Similarly, British taxpayers had problems with the subjective "would" argument relating to determining when a borrower "would borrow" rather than applying the objective test, which is whether a lender "would lend". There had also been comments received from taxpayers stating that this upward lending test was uncommercial (Gordon-Brown, Saul & Clarke, 2010:2).

With this being said, it is clear that the British thin capitalisation rules, as in the case of the RSA rules, also still have some way to go before everyone has a common view on how they should work.

#### **4.3 THE APPLICATION OF THE ARM'S LENGTH PRINCIPLE TO THIN CAPITALISATION AS PER THE OECD GUIDELINES**

The application of the arm's length principle to thin capitalisation transactions is increasingly becoming a contentious issue. This is mainly based on the fact that TP, in general, is inherently a very subjective matter and the values of the relevant transactions

are significant. Even if a structured approach can be applied, the selection of comparable companies and the credit analysis can require a subjective judgement and expertise. Furthermore, one might find that even if the parties setting these prices have the required knowledge to determine the TP for the interest and financial assistance precisely, the reviewer (ie the tax authority) might not have the required expertise. As stated above, the OECD guidelines does not address recommendations around the implementation or design of thin capitalisation legislation and nor provides guidance for the appropriate debt to equity ratios that should be applied (Miller, Liebenberg, Lalor & Louw, 2012:2).

The main purpose of regulations on thin capitalisation is to address the tax avoidance of excessive debt funding through shareholders which consequently leads to excessive interest deductions resulting in the corresponding loss of tax revenue in the source countries (Knobbe-Keuk, Grotherr, Thommes, & Endres in Klostermann, 2007:8). This possibility causes concern not only to SARS but also to other revenue authorities worldwide looking into introducing new and effective ways of dealing with the concept of thin capitalisation.

#### **4.4 RECOMMENDATION**

The idea behind the new RSA thin capitalisation rules is sound. However, its application could prove to be a challenge both for SARS and taxpayers. As discussed above, most countries prefer having safe harbour rules for the application of thin capitalisation rules, not only because of the compliance costs inherent in using the arm's length concept, but also because of the clarity it provides both taxpayer and the Revenue administrators. After 12 years of applying both the safe harbours ratio and arm's length test to their thin capitalisation cases, even the Australian Government announced this year that it will be reviewing the arm's length test by the Board of Taxation to consider ways in which they can improve the administration and the operation of this test. Prior to the Australian Budget speech this year, there were talks that the arm's length test would be completely eliminated from the Australian thin capitalisation legislation.

On 16 May 2013 the OECD issued a paper entitled "Revised section E on safe harbours in chapter IV of the transfer pricing guidelines". In this paper, the OECD discusses how resource-intensive it is to apply the arm's length principle, and how it can impose heavy

administrative burdens on tax administrators and taxpayers. This has, therefore, led OECD member countries to consider bringing back safe harbor rules into the TP area (OECD, 2013b:3).

Based on the above, it is strongly recommended that SARS re-examines the question of the use of safe harbours. Most countries appear to be using a mixture of a safe harbor fixed ratio with an arm's length test for any excess if it is to be tax deductible. This is something which SARS could also consider.

#### **4.5 FURTHER RESEARCH**

An empirical study on the compliance and administrative burden which will be faced by companies on the application of the new rules could be explored. This would assist in establishing whether RSA companies are adequately equipped to prepare the documentation required by SARS in proving their compliance with the arm's length principle. Furthermore, this research could focus on the adherence to the thin capitalisation legislation through the application of safe harbours versus the arm's length principle. This could also include a comparability study in the various countries on this concept.

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