

Thin capitalisation rules in South Africa

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Abstract

It is no wonder that in a globalised environment financial assistance transactions between related parties are examined more closely. Financial transactions should be reviewed when the capital of a company is made up of a much greater contribution of debt than equity, which is said to be “thinly capitalized”. The tax consequences that flow from these arrangements can affect a taxpayer’s taxable income in relation to determining the debt versus equity funding structure of that arrangement. The ripple effect of these financial arrangements is that they will impact the way in which a company is capitalised and therefore affect the level of profit the company would be taxable for. In essence, the higher the level of debt in a company, and thus the correlating amount of interest expense the company is liable to pay, the lower the tax base will be and thus its taxable profit.

There is still uncertainty regarding the practical application and interpretation of the guidelines in relation to thin capitalisation rules in South Africa. This study aims to review whether sufficient guidance in respect to thin capitalisation legislation in South Africa is provided, taking into consideration the legislation that has been amended, as contained in the revised section 31 of the Income Tax Act 58 of 1962 (‘section 31 of the Act’) and the guidance provided in the form of the Draft Interpretation Note on 22 March 2013 (‘the Draft IN’). The guidance provided is still in draft and refers to the old provisions of section 31 of the Act relating to the general ‘safe harbour’ ratio and the deemed loan provisions. The provisions do not provide any guidance relating to the new provisions of the legislation regarding deemed dividends and the treatment and application thereof.

There are challenges that many multinational companies face in relation to transfer pricing legislation, and specifically thin capitalisation rules for companies’ resident in South Africa that receive inbound financial assistance from their related parties. It has also become a major concern for tax authorities to reduce the amount of tax leakage in their country’s tax base as many multinationals fall short of adhering to the regulations that govern these financial arrangements.

KEY WORDS: Thin capitalisation, transfer pricing, financial assistance, tax base erosion, safe harbour, deemed loan, deemed dividend, arm’s length.

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Glossary

Abbreviation	Detailed description
AFR	Applicable Federal rate
APA	Advance Pricing Agreement
ATAF	Africa Tax Administration Forum
ATCA	Advance Thin Capitalisation Agreement
ATO	Australian Taxation Office
BEPS	Base Erosion and Profit Shifting
CFC	Controlled Foreign Companies
DTA	Double Tax Agreements
EBITDA	Earnings before interest, taxes, depreciation and amortisation
EDF	Expected Default Frequency
HMRC	Her Majesty's Revenue and Customs
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IRS	Internal Revenue Service
MAP	Mutual Agreement Procedure
MNEs	Multinational Enterprises
NGOs	Non-Government Organisations
OECD	Organisation for Economic Co-operation and Development
OECD Guidelines	Organisation for Economic Co-operation and Development's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations
PN2	Practice Note 2 dated 14 May 1996
PN7	Practice Note 7 dated 6 August 1999
SARB	South African Reserve Bank
SARS	South African Revenue Service
STC	Secondary Tax on Companies
the Act	The Income Tax Act 58 of 1962
the TAA	The Tax Administration Act 28 of 2011
the Draft IN	The Draft Interpretation Note for section 31 of the Income Tax Act 58 of 1962
TIOPA 2010	Taxation (International and other Provisions) Act 2010
UK	United Kingdom
UN	United Nations

UNCTAD

United Nations Conference on Trade and Development

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Chapter 1. Introduction to the research

1.1 Background

Globalisation and trade liberalisation, together with the advancement of technology have increased the freedom of trade between multinational enterprises¹ ('MNEs').² As a result, the focus on multinationals over the years has been on how cross-border transactions³ between them occur and the prices charged. These prices are known as transfer prices which influence the conditions of the transaction, as the prices set are not the same as the market conditions that would occur between independent parties.⁴ Arnold and McIntyre define 'transfer price' as – 'a price set by a taxpayer when selling to, buying from, or sharing resources with a related person. A transfer price is usually contrasted with a market price, which is the price set in the market place for transfers of goods and services between unrelated persons'.⁵ The term 'transfer pricing' entails the process through which related parties set prices where they can transfer goods or services between themselves.⁶ The

¹ The component parts of a multinational enterprise group, such as companies, are called "associated enterprises" in relation to transfer pricing. MNEs or associated enterprises are defined as any group of connected persons with members and business activities in more than one country. See OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) at 27. See also SARS *Draft Interpretation Note on section 31 of the Income Tax Act 58 of 1962* (2013) at 2.

² J Cooper, et al *Transfer pricing and developing economies: A handbook for policy makers and practitioners* (2016) at 1-2.

³ A cross-border transaction is an agreement between a resident and a non-resident. It includes an agreement between residents for the supply of goods or services outside the country or between non-residents for the supply of goods or services within the country. See RJ Vann *International Aspects of Income Tax: Tax Law Design and Drafting Volume 2* (ed Thuronyi) (1998) at 781. See also T Legwaila *Tax characteristics of an ideal holding company location* (2012) 45 Volume 1 *De Jure* at 41.

⁴ Cooper *Transfer pricing and developing economies* (2016) at 1-2.

⁵ Related parties or connected parties are used interchangeably as terms to refer to the same group of multinational companies in relation to transfer pricing. S1 of the Income Tax Act 58 of 1962 ('the Act') defines connected persons in relation to a company as — 'any other company that would be part of the same group of companies as that company if the expression 'at least 70 per cent of the equity shares in'. In paragraphs (a) and (b) of the definition of 'group of companies' were replaced by the expression 'more than 50 per cent of the equity shares or voting rights in.' See Arnold & McIntyre *International Tax Primer* (2002) at 55. L Olivier & M Honiball *International Tax: A South African perspective* (2011) at 620.

⁶ A Oguttu *Transfer Pricing and Tax Avoidance: Is the arm's length principle still relevant in the e-commerce era?* (2006) 18 *SA Merc LJ* at 139. SARS *Draft Interpretation Note* (2013) at 2

arm's length principle⁷ requires that transactions between related parties should be consistent with those that would have prevailed between two independent parties in a comparable transaction under similar circumstances.⁸ Transfer pricing rules are based on the arm's length principle, which is the international standard that should be used for determining transfer prices for tax purposes.⁹

Revenue authorities are taking more stringent measures to avoid the misuse of transfer pricing rules and the evident loss or 'tax leakage' of the fiscus to other jurisdictions.¹⁰ Hence revenue authorities may consider the misuse of transfer pricing or 'mis-pricing'¹¹ as any situation where the pricing of goods and services is not in line with the internationally applicable norms. This also includes the arm's length principle under domestic law, which may lead to issues of tax avoidance¹² and evasion.¹³ Mispricing leads to tax leakage which

also uses the same definition for transfer pricing as – 'The process by which connected persons set prices at which they transfer goods or services between themselves'. The Draft Interpretation Note was issued by SARS to provide guidance on the application of the arm's length basis in the context of determining whether a taxpayer is thinly capitalised under s 31 of the Income Tax Act. See also SARS issued Practice Note 7 dated 6 August 1999: Determination of taxable income of certain persons from international taxation (Section 31 of the Income Tax Act 58 of 1962) in par 2.1. See also Arnold & McIntyre (2002) at 55.

⁷ It is set forth in Article 9 of the OECD Model Tax Convention where conditions are imposed between the two related parties in their commercial or financial relations which differ from those which would be made between independent parties. Any profits which would have accrued to one of the parties, but by reason of those conditions, have not accrued, may be included in the profits of that party and taxed appropriately. See OECD *Transfer Pricing Guidelines* (2010) at 23. EY *Worldwide Transfer Pricing Reference Guide* (2014) at 8. Oguttu *Transfer Pricing and Tax Avoidance* (2006) at 140. See United Nations *Practical manual for transfer pricing for developing countries* (2013) at 25-26 on a discussion regarding domestic transfer pricing rules and tax treaties, specifically relating to the arm's length principle.

⁸ OECD *Transfer Pricing Guidelines* (2010) at 23.

⁹ Article 9 of the OECD Model Tax Convention.

¹⁰ PwC *International Transfer Pricing 2015/16* at 915.

¹¹ Associated parties may have reasons to engage in transfer mispricing when clear regulatory requirements are absent or where situations in which benefits of not complying with these regulations outweigh the potential disadvantages. See Cooper *Transfer pricing and developing economies* (2016) at 5-6.

¹² Olivier & Honiball *International Tax* (2011) at 509 refers to the distinction between tax avoidance and tax evasion as a legal and illegal transaction, determined by the courts. Oguttu *Transfer Pricing and Tax Avoidance* (2006) at 138 refers to tax avoidance as the use of legal methods by the taxpayer to avoid paying more taxes. Tax avoidance involves the use of certain loopholes in tax laws within the legal parameters of the law. See also Vern Krishna *Tax avoidance: The general anti-avoidance rule* (1990) at 9. Arnold & McIntyre (2002) at 83; Legwaila *Tax characteristics of an ideal holding company location* (2012) at 43.

¹³ Oguttu *Transfer Pricing and Tax Avoidance* (2006) at 138 refers to tax evasion as an illegal act which involves the non-disclosure of information and falsifying of documentation such as returns and unwarranted deductions. Olivier & Honiball *International Tax* (2011) at 509 refers to tax evasion as the wilful and conscious non-compliance with the domestic tax laws, whereby

occurs when a country does not adequately tax its sources of income and certain transactions are not included when determining its taxable income although these transactions are taxable.¹⁴ For instance, a company transacting in a high tax jurisdiction could structure its financial transactions in such a way to allow interest income to be received in a low tax jurisdiction or even a jurisdiction that does not tax interest income, thereby creating a revenue leakage in the high tax jurisdiction.¹⁵

As international trade between MNEs increases, with estimations ranging from one-third to as much as 60%,¹⁶ transfer pricing has become an important international tax issue that affects transactions such as intercompany services, financial transactions, intangibles, etc. between MNEs.¹⁷ This study will focus specifically on financial transactions and the thin capitalisation regulations that govern the relationship between MNEs and how they should set their prices, using legislation that is sufficient guidance for such financial arrangements.

Thin capitalisation refers to a situation where a company is financed by one or more of its connected parties through a combination of debt and equity.¹⁸ Olivier and Honiball define thin capitalisation, which is often regarded as a category of transfer pricing, as the funding of a company with an amount of debt that is disproportional in relation to equity so as to provide the investor or borrower with the benefit of having the interest expenditure deductible for tax purposes.¹⁹ An interest expense incurred in the production of income by

a taxpayer is able to avoid legal obligations by participating in illegal and fraudulent activities. See A Oguttu *Curbing Offshore Tax Avoidance: The case of South African companies and trusts* (LLDThesis Unisa) at 2-10 which distinguishes between tax avoidance and tax evasion. See also United Nations (2013) at 2.

¹⁴ United Nations (2013) at 2.

¹⁵ Oguttu *Transfer Pricing and Tax Avoidance* (2006) at 140. See also OECD *Thin capitalisation legislation* (Aug. 2012) at 3.

¹⁶ United Nations Conference on Trade and Development ('UNCTAD') Report (1999) at V-VII. M Forstater *Can stopping tax dodging by multinational enterprises close the gap in development finance?* (2015) at 24 clarified that common references to a share of up to 60% of global trade takes place between multinationals are based on a misunderstanding of UNCTAD's report from 1999. See also Cooper *Transfer pricing and developing economies* (2016) at 2.

¹⁷ Cooper *Transfer pricing and developing economies* (2016) at 1-2.

¹⁸ Olivier & Honiball *International Tax* (2011) at 217. See Vann (1987) at 785. Also see a paper prepared by the OECD Secretariat referred to as *Thin capitalisation legislation: A background paper for country tax administrations* (Pilot version for comments) (Aug. 2012). It is still in draft and aims to assist country tax administrations that are considering revising their existing thin capitalisation rules or introducing thin capitalisation rules for the first time.

¹⁹ Olivier & Honiball *International Tax* (2011) at 649. See De Koker, et al. *Silke: South African Income tax* (2002) at para 17.54. Olivier & Honiball *International Tax* (2011) at 224 states that interest expenditure is deductible when it falls within the requirements of section 11 (a) of the

a person carrying on a trade is deductible when determining taxable income, while distributions of dividends or returns of capital are not deductible as they are capital in nature for tax purposes.²⁰ Thin capitalisation rules are used to determine how much of the interest paid on a certain amount of debt is deductible for tax purposes, taking into consideration that capital (i.e. equity) is not deductible for tax purposes.²¹ Consequently, it is more beneficial for related parties to provide each other funding through the use of debt as opposed to equity, as debt will produce interest which is tax deductible as opposed to equity which derives a dividend which is non-deductible.²² Hence many countries implement thin capitalisation provisions that are favourable to debt funding rather than equity funding.²³ Consequently, thin capitalisation provisions are applied to restrict the deductibility of interest on any portion of excessive debt funding, thereby ensuring protection of the country's tax base against structures that allow heavily geared investments, and ultimately countering the cross-border shifting of profits through excessive debt.²⁴

The tax implications that flow from the classification of debt versus equity is that if a financial arrangement is funded mainly through debt, the jurisdiction in which the funding is made may have debt to equity ratios²⁵ that may limit the amount of debt which may be borrowed.²⁶

Act under the general deductions formula. However, the requirements state that the interest must be incurred in the production of income. Income or 'gross income' is defined in s 1 of the Act and states that any accruals or receipts of a capital nature are not subject to income tax rules. Therefore, it is only receipts or accruals of a non-capital nature, thereby referred to as 'income' or 'revenue', which are included in the taxpayer's 'gross income', and thus taxable in terms of the provisions of the Income Tax Act. Prohibited deductions are listed in section 23 of the Act.

²⁰ See the discussion relating to interest incurred on loans for general trading purposes which is deductible for tax purposes, and is illustrated in several cases, such as *Producer v COT* 15 SATC 405 and *Financier v COT* 17 SATC 34. See also the OECD *Thin capitalisation legislation* (Aug. 2012) at 7; SARS *Draft Interpretation Note* (2013) at 3.

²¹ OECD *Thin capitalisation legislation* (Aug. 2012) at 8. See also Olivier & Honiball *International Tax* (2011) at 219 for a discussion on several South Africa court cases which were mentioned to illustrate the test applied in our judiciary system to determine whether the proceeds for the disposal of an equity investment will be of a capital or revenue nature. See the discussion relating to *Barnato Holdings Ltd v SIR* 1987 (2) SA 440 (A) at 454; *African Life Investment Corporation (Pty) Ltd v SIR* 1969 (4) SA 259 (A) at 267B, *CIR v Middleman* 1991 (1) SA 200 (C) at 202A-B. See also *CIR v Nussbaum* 58 SATC 283 and *ITC 1746* 65 SATC 194.

²² Olivier & Honiball *International Tax* (2011) at 219. See De Koker (2002) at para 17.54.

²³ Olivier & Honiball *International Tax* (2011) at 219. See De Koker (2002) at para 17.54.

²⁴ Olivier & Honiball *International Tax* (2011) at 219. See De Koker (2002) at para 17.54; United Nations (2013) at 23-24.

²⁵ The maximum amount of debt on which interest may be deducted for tax purposes is established by a pre-determined ratio, such as the debt to equity ratio. See OECD *Thin capitalisation legislation* (Aug. 2012) at 8.

²⁶ Olivier & Honiball *International Tax* (2011) at 219.

If the consideration of debt is greater than the level of equity provided to the company, that company is regarded as being 'thinly capitalised' and the company will normally be referred to as being 'highly leveraged' or 'highly geared'.²⁷ The ripple effect of these financial arrangements is that they will impact the way in which these multinational entities are capitalised and therefore affect the level of profit an entity is taxable for. In essence, the higher the level of debt in a company and thus the correlating amount of interest the company is liable to pay, the lower the tax base will be and its overall taxable profit.²⁸

Some revenue authorities govern, through domestic legislation, how companies that are thinly capitalised are treated and may limit the interest deductible as a tax claim.²⁹ However, some revenue authorities simply disallow interest deductions if those deductions reach a certain threshold, by applying safe harbours³⁰ such as the debt to equity ratio (e.g. 3:1 debt to equity ratio). If the company reaches above the specified threshold then the company is considered to be too highly geared under applicable tax legislation.³¹

Thin capitalisation rules in South Africa were previously dealt with by a separate subsection of section 31, but are now governed by the general transfer pricing provisions of section 31(2) of the Income Tax Act 58 of 1962 ('the Act').³² The general transfer pricing provision allows for the South African Revenue Service ('SARS') to determine whether any term or condition imposed as part of any transaction, scheme, operation, arrangement or agreement differs to the terms and conditions that would have been entered into if the parties to the transaction were independent, which is the arm's length principle.³³ The same principle applies for thin capitalisation where SARS can determine whether any term or condition of a financial transaction differs from that which would have been entered into by third parties.³⁴

²⁷ United Nations (2013) at 23. OECD *Thin capitalisation legislation* (Aug. 2012) at 3.

²⁸ OECD *Thin capitalisation legislation* (Aug. 2012) at 3. See Oguttu *Transfer Pricing and Tax Avoidance* (2006) at 140.

²⁹ Olivier & Honiball *International Tax* (2011) at 224. See also OECD *Thin capitalisation legislation* (Aug. 2012) at 7.

³⁰ Safe harbours or 'fixed ratios' establish a set of rules under which tax authorities would automatically accept the transfer prices charged. Safe harbours reduce the compliance burden on taxpayers and provide a level of certainty both for taxpayers and tax authorities. See PwC *International Transfer Pricing 2015/16* at 38.

³¹ OECD *Thin capitalisation legislation* (Aug. 2012) at 7.

³² S 57 of the Taxation Laws Amendment Act No. 24 of 2011.

³³ S 31(2) of the Act.

³⁴ S 31(2) of the Act.

There are no specific regulations or rulings on the application of section 31 for all affected transactions;³⁵ guidance is currently contained in Practice Note 7 ('PN7'). SARS issued PN7 which provides guidance on transfer pricing rules and the provisions of section 31 of the Act.³⁶ Both PN7 and section 31 of the Act do not contain specific guidance with respect to intercompany financial assistance transactions.³⁷

The change in section 31 of the Act also meant that Practice Note 2 ('PN2'), which SARS issued to assist taxpayers in complying with the thin capitalisation legislation, ceased to be applicable. In its place, SARS issued specific guidance in the Draft Interpretation Note ('Draft IN') detailing SARS' approach to assessing the arm's length principle for financial assistance transactions between related parties.³⁸

The Draft IN only deals with providing guidance in relation to financial transactions mentioned in section 31. Furthermore, it only provides guidance on the old rules relating to deemed loans and therefore does not provide any guidance relating to the new provisions of section 31 which deals with deemed dividends and the treatment and application thereof.³⁹ Therefore, there are still uncertainties regarding the practical application and interpretation of the mentioned provisions, regardless of the Draft IN being published a few years ago.

On an international scale, the Organisation for Economic Co-operation and Development ('OECD')⁴⁰ has attempted to provide some guidance in respect to what thin capitalisation is and what measures are available to comply with these tax rules.⁴¹ The OECD and G20⁴²

³⁵ S 31 of the Act defines 'affected transaction' as "any transaction, operation, scheme, agreement or understanding where that transaction has been directly or indirectly entered into or effected between connected persons whereby any term or condition of that transaction is not the same as if it would have existed had those connected persons been independent persons dealing at arm's length."

³⁶ SARS *Practice Note 7* (1999) at 6-7.

³⁷ National Treasury *Draft Explanatory Memorandum on Taxation Laws Amendment Bill* (2014) at 67-68.

³⁸ SARS *Draft Interpretation Note* (2013) at 3.

³⁹ SARS *Draft Interpretation Note* (2013) at 10.

⁴⁰ The OECD provides a forum in which governments can work together to share experiences and seek solutions to common problems. The forum works with governments to understand what drives economic, social and environmental change. Furthermore, it measures productivity and global flows of trade and investment. The OECD also analyses and compares data to predict future trends. They set international standards on a wide range of things, from agriculture and tax to the safety of chemicals. Available from: <http://www.oecd.org/about/> [Accessed 24 Oct. 2015]. See United Nations (2013) at 7-10.

⁴¹ OECD *Thin capitalisation legislation* (Aug. 2012) at 2. Although South Africa is not a member

released reports addressing Base Erosion and Profit Shifting ('BEPS')⁴³ in February 2013 and adopted a 15-point action plan to address BEPS.⁴⁴ One of the final reports, specifically Action 4, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*, examines thin capitalisation and financial assistance transactions. The final report on Action 4 calls for the development and implementation of certain recommendations regarding best practices in legislation to prevent the erosion of the tax base through the inappropriate use of interest expense.⁴⁵

The South African government set up the Davis Tax Committee on 17 July 2013.⁴⁶ The Davis Tax Committee's main role in relation to the BEPS project is to address any transfer pricing and BEPS-related matters from a South African perspective, especially in the context of corporate income tax.⁴⁷ The Davis Tax Committee set up a BEPS sub-committee⁴⁸ and has provided its recommendations on some of the action points in the 15-point action plan in a report called the Davis Tax Committee Interim Report, *Addressing Base Erosion and Profit*

of the OECD, it does recognise and follow the OECD guidelines when applying transfer pricing rules and the arms' length principle. Considering that the OECD guidelines are a globally accepted standard, it has become common practice for South Africa to address transfer pricing and BEPS issues together with the OECD and other countries worldwide. See Davis Tax Committee *Interim Report* (Dec. 2014) at 18.

⁴² The G20 is the group of finance ministers and central bank governors from 20 economies, namely, Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, México, Russia, Saudi Arabia, South Africa, Korea, Turkey, the United Kingdom, United States and European Union. See Wikipedia 'The G-20 Major Economies'. Available at http://en.wikipedia.org/wiki/G-20_major_economies [Accessed 24 Oct. 2015].

⁴³ A programme introduced by the OECD in July 2013 that established 15 actions related to harmonising and coordinating international tax and transfer pricing rules across jurisdictions. See <http://www.oecd.org/tax/beps.htm> [Accessed 25 April 2015]. See also PwC *International Transfer Pricing 2015/16* at 8.

⁴⁴ See <http://www.oecd.org/tax/beps.htm> [Accessed 25 April 2015]. See also PwC *International Transfer Pricing 2015/16* at 915.

⁴⁵ OECD/ G20 Base Erosion and Profit Shifting Project, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 -2015 Final Report* (2015) at 15. Available from: <http://dx.doi.org/10.1787/9789264241176-en> [Accessed 05 Oct. 2015]. This report also provides recommendations, which are discussed in more detail in Chapter 3.

⁴⁶ Davis Tax Committee *Interim Report* (Dec. 2014) at 18.

⁴⁷ Davis Tax Committee *Interim Report* (Dec. 2014) at 18.

⁴⁸ The [DavidDavis](#) Tax Committee BEPS sub-committee consulted with various stakeholders on how BEPS issues should be addressed from a South African perspective. These include: business representatives, trade unions, civil society organisations, tax practitioners, SARS, National Treasury, the South African Reserve Bank ('SARB'), members of international bodies and academics, who have been involved through meetings where they presented their views and through submissions of technical reports on various BEPS actions plans. See Davis Tax Committee *Interim Report* (Dec. 2014) at 1.

*Shifting in South Africa.*⁴⁹ These recommendations provide some guidance on the interpretation of this new legislation and give taxpayers the South African perspective on how these action points could be customised for South Africa.⁵⁰

Many countries have their own domestic rules to govern thin capitalisation and do not have to comply with the OECD's arm's length principle in respect of financial assistance transactions because OECD publications and recommendations are merely persuasive in international law and countries are not legally bound to adhere to them.⁵¹ The legislation is constantly changing and the lack of guidance in terms of the interpretation of that legislation keeps taxpayers in an uncertain position when it comes to compliance with thin capitalisation rules. It has become increasingly difficult for taxpayers to apply and implement their transfer pricing policies when they are unsure of how to treat the nature of these transactions.

1.2 Research objectives

In respect of this study, the main aim is to evaluate whether the guidance provided is clear in relation to thin capitalisation legislation in South Africa, where the Draft IN and revisions to section 31 of the Act have been made, for taxpayers when interpreting and applying these thin capitalisation rules.

In order to achieve this aim, the objectives of this study are:

- to analyse the former and new thin capitalisation and financial assistance rules in South Africa and assess the manner and extent to which these guidelines were previously implemented and currently how they are interpreted;
- to analyse and interpret the thin capitalisation position of a taxpayer by using practical examples to demonstrate the interpretation of the new provisions and determine the taxpayer's taxable income. These examples will help to identify the practical issues around the implementation of these new rules; and
- to determine the efficiency and practicality to which these guidelines have been adopted

⁴⁹ Davis Tax Committee *Interim Report* (Dec. 2014) at 1.

⁵⁰ Davis Tax Committee *Interim Report* (Dec. 2014) at 19.

⁵¹ Davis Tax Committee *Interim Report* (Dec. 2014) at 18.

by comparing the thin capitalisation legislation effected by South Africa with other countries, specifically Australia and the United Kingdom ('UK'), which can provide alternative solutions, if necessary, for South Africa's improvement in implementing its legislation.

1.3 Limitations

The aim of this study is to analyse section 31 of the Act in relation to the financial assistance provisions for related parties and other related guidelines, such as the Draft IN and international guidance from the OECD for transfer pricing purposes. This study aims to review the practical implications of these sections relating to thin capitalisation from a transfer pricing perspective.

This study does not evaluate any other provisions, such as limitation of interest deductions under section 23M or 23N of the Act, controlled foreign companies ('CFCs') under section 9D, or equity loans related to financial assistance. The study also does not examine in great detail Double Tax Agreements ('DTA'), withholding taxes, or several other aspects of international tax law.

1.4 Research methods and design

The research design entails a qualitative review of the literature on thin capitalisation. This involves an examination of various journal articles and publications on thin capitalisation rules. This review also includes an analysis of the thin capitalisation rules of Australia and the UK. These countries have more developed and advanced transfer pricing rules with extensive knowledge and staff resources devoted to transfer pricing since these rules have been in place for several decades. Hence, this study focuses on how they apply their thin capitalisation rules.

The study also includes analysing legislation and the OECD Guidelines, together with supporting guidance such as explanatory memoranda and interpretation notes in relation to thin capitalisation provisions.

1.5 Structure and outline of chapters

Chapter One provides an introduction to thin capitalisation rules in South Africa. It discusses the research design and methodology as well as the research objectives of this study.

Chapter Two evaluates the interpretation of the previous legislation regarding financial assistance and how that compares to the new legislation, using practical examples of how these significant changes affect taxpayers.

Chapter Three demonstrates the interpretation of the guidance provided in the Draft IN and how taxpayers can test the arm's length nature of their financial transactions by providing a practical step-by-step analysis of the risk assessment of a taxpayers' thin capitalisation position.

Chapter Four discusses the international developments on thin capitalisation in Australia and the UK. BEPS developments regarding financial assistance are also discussed as they relate to the implementation of some of the expected recommendations of the OECD BEPS project into domestic law provisions.

Lastly, Chapter Five summarises the findings of this study and provides proposed recommendations and an overall conclusion of this study.

Chapter 2. Former and new thin capitalisation rules

2.1 Introduction

Tax certainty is an integral part of the legislative framework of South Africa.¹ The degree of certainty necessary to achieve uniformity is made through formulating rules which are clear and indicate the methods and manner in which tax should be collected by SARS as the revenue authority.² However, when uncertainties and disputes occur between the taxpayer and SARS, SARS may respond by issuing a specific ruling, or formulating interpretation notes, guidelines and brochures on the matter.³ SARS has formulated various interpretation notes such as PN7 and PN2 for transfer pricing and thin capitalisation rules that are aimed at assisting the taxpayer in interpreting and resolving uncertainties. However, these practice notes are not law and therefore limits their application as authority in a legal context.⁴ Consequently, SARS' views are not binding on either SARS or the taxpayer, as they do not have any statutory basis.⁵

This chapter provides a comparative analysis of the current and prior legislation relating to thin capitalisation in South Africa as well as providing practical examples of how this legislation would impact a taxpayer's taxable income when implementing these provisions.

2.2 Former provisions of section 31

South Africa introduced thin capitalisation rules following the introduction of transfer pricing rules in 1995. With effect from 19 July 1995, the revised section 31 was introduced into the Act.⁶

¹ A Oguttu *Resolving transfer pricing disputes: Are 'Advance Pricing Agreements' the way forward for South Africa?* (2006) 18 SA Merc LJ at 392-393.

² Oguttu *Resolving transfer pricing disputes* (2006) at 392-393. See also Haase, Grimm & Versfeld *International Commercial Law from a South African Perspective* (2003) at 68.

³ Oguttu *Resolving transfer pricing disputes* (2006) at 392-393. See SARS *Discussion paper on a proposed system for advance tax rulings* (2003) at 4.

⁴ Oguttu *Resolving transfer pricing disputes* (2006) at 392-393.

⁵ Oguttu *Resolving transfer pricing disputes* (2006) at 392-393.

⁶ S 31 of the Act. These provisions will be referred to as the old section 31 in order to distinguish them from the new section 31 provisions.

The old provisions of section 31(2) provided powers to the Commissioner of SARS to make adjustments for excessive interest deductions, while the old provisions of section 31(3) provided the Commissioner with the rights to make adjustments for excessive debt to equity ratios.⁷ Section 31(3) dealt specifically with thin capitalisation where financial assistance was granted in respect of international transactions between related parties.⁸

The Commissioner was allowed to review the financial assistance transactions rendered between related parties.⁹ If the Commissioner considered the debt excessive in proportion to the borrower's fixed capital, the interest, finance charges, or other consideration relating to the excessive financial assistance, any interest deduction on that debt was disallowed.¹⁰ The Commissioner's assessment on what constituted excessive financial assistance was detailed in PN2 which SARS issued as guidance on 14 May 1996.¹¹

PN2 stated that excessive financial assistance was determined by applying the safe harbour rule of 3:1 debt to equity ratio to the fixed capital.¹² If the portion of the financial assistance fell outside the 3:1 guideline, then it was deemed to be excessive, the thin capitalisation rules would apply and the interest charged in respect to the excessive portion of the loan would be disallowed as a deduction.¹³ Excessive financial assistance was determined using the following formula contained in para 4.1 of PN2:¹⁴

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

In which formula:

- "A" represents the disallowable interest, limited to interest incurred during such year in respect of financial assistance granted on or after 19 July 1995;

⁷ S 31 of the Act. See also Olivier & Honiball *International Tax* (2011) at 650.

⁸ S 31 of the Act; SARS PN 2 (1996) at 1.

⁹ SARS PN 2 (1996) at 1-4.

¹⁰ S 31 of the Act; SARS PN 2 (1996) at 1-4.

¹¹ SARS PN 2 (1996) at 1-4. See also Olivier & Honiball *International Tax* (2011) at 650.

¹² SARS PN 2 (1996) at 3-4. See also PwC *International Transfer Pricing 2015/16* at 38.

¹³ SARS PN 2 (1996) at 1.

¹⁴ SARS PN 2 (1996) at 3-4.

- "B" represents the total interest incurred during such year in respect of all financial assistance, contemplated in section 31(3), in existence during such year (whether or not such financial assistance was granted before, on or after 19 July 1995);

- "C" represents the weighted average of all interest-bearing financial assistance which was in existence during such year (whether or not such financial assistance was granted before, on or after 19 July 1995); and

- "D" represents the greater of - * three times the fixed capital of the resident or recipient as at the end of the relevant year of assessment; and * the weighted average of all interest-bearing financial assistance granted prior to 19 July 1995, which existed during such year.

PN2 stated that the concept of financial assistance only included interest-bearing financial assistance for thin capitalisation adjustment purpose, hence interest free loans were not added to the definition of fixed capital.¹⁵ Therefore, in terms of the old section 31(2), the interest free loan was disregarded for the portion of the thin capitalisation calculation. However, in terms of the old section 31(2) with the calculation of excessive interest, the interest free loan was accounted for on a weighted average basis. This benefitted the taxpayer substantially as it resulted in bringing down the overall effective tax rate of the interest incurred.¹⁶

Any interest rate that exceeded the weighted average of the South African prime rate plus 2%, if the loan was a Rand denominated loan or was denominated in a foreign currency, would not be acceptable.¹⁷ Any interest rate that exceeded the weighted average of the relevant interbank rate plus 4% would not be accepted as a nominal annual interest rate.¹⁸ Any interest rate exceeding the prescribed rates was regarded as excessive and therefore was not allowed as a deduction for income tax purposes.¹⁹

¹⁵ Fixed capital was defined in PN2 in the following regard as determining the amount of fixed capital by including the following items: share capital, share premium, accumulated profits of a capital and revenue nature and permanent owners' capital (excluding any financial assistance). SARS *PN 2* (1996) at 4.

¹⁶ Olivier & Honiball *International Tax* (2011) at 652.

¹⁷ SARS *PN 2* (1996) at 3. See also Olivier & Honiball *International Tax* (2011) at 653.

¹⁸ SARS *PN 2* (1996) at 3. See also Olivier & Honiball *International Tax* (2011) at 653.

¹⁹ SARS *PN 2* (1996). Olivier & Honiball *International Tax* (2011) at 653.

Not only was the excessive interest not deductible for tax purposes, it was also deemed to be a dividend under section 64C (2)(e)²⁰ of the Act and Secondary Tax on Companies²¹ ('STC') was payable on the excessive amount.²² The regulations and PN2 have been repealed and are only applicable for years of assessment that commenced prior to 1 April 2012.²³

2.3 New provisions of section 31

Most countries, including South Africa, use the arm's length principle to curb the depletion of their tax bases and prevent tax leakage because of transfer pricing transactions.

For years of assessment commencing on or after 1 April 2012, the transfer pricing rules have been amended to include any transaction, operation, scheme, agreement or understanding entered into between connected persons. These would include terms and conditions that would have been applied between independent persons interacting at an arm's length basis.²⁴ Therefore when analysing any inbound²⁵ financial assistance transactions, the taxpayer must be able to justify that the amount of the loan is at arm's length.

In order to prove that the transaction is at arm's length, the terms and conditions under which the funds are advanced should not exceed what the South African borrower would be capable of sustaining if the same terms and conditions had been applied by a third party in determining the funding to be advanced.²⁶ Therefore the taxpayer should assess and determine its lending capacity by taking into account the terms and conditions which would

²⁰ Section 64C(2)(e) provides that any amount which is deemed to have been distributed by a company to a recipient will be deemed to be a dividend declared by the company. See Olivier & Honiball *International Tax* (2011) at 659.

²¹ Secondary tax on companies was levied at a rate of 10% and is of relevance to both thin capitalisation and transfer pricing. See Olivier & Honiball *International Tax* (2011) at 658 on their discussion relating to secondary tax on companies.

²² PwC *International Transfer Pricing* (2011) at 180.

²³ See S 31 of the Act. See also SARS *Draft Interpretation Note* (2013) at 3.

²⁴ S 31(2) as amended by the Taxation Laws Amendment Act 24 of 2011. See also Oguttu *International Tax Law* (2015) at 246-250; EY *Worldwide Transfer Pricing Reference Guide* (2014) at 272.

²⁵ An inbound loan relates to when a South African subsidiary borrows funding from its foreign holding company. See examples in SARS *Draft Interpretation Note* (2013) at 5-9.

²⁶ SARS *Draft Interpretation Note* (2013) at 4.

have occurred between third parties. If the Commissioner concludes that the financial assistance is not at arm's length, he has the authority to make a primary adjustment²⁷ to ensure that the transaction is arm's length.²⁸

In addition, the amended section 31 now places the onus on the taxpayer to transact and make an adjustment on an arm's length basis, whereas under the old provisions only the Commissioner had the discretion to make the adjustment. This shift in the burden of proof results in the introduction of a self-assessment provision.²⁹

The 2011 legislative amendments in terms of the Taxation Laws Amendment Bill introduced secondary adjustment³⁰ rules.³¹ Many tax systems have secondary adjustments in various forms such as deemed dividends, deemed equity contributions, or deemed loans which are a well-established practice adopted by tax authorities.³² According to the OECD Guidelines, secondary adjustments take the form of constructive³³ dividends, constructive equity contributions, or constructive loans.³⁴ Secondary adjustments; however, have been known to be an administrative burden both for the taxpayer and the tax authorities.³⁵

These adjustments introduced in the Taxation Laws Amendment Bill³⁶ are in the form of a deemed loan which was construed as an affected transaction which meant that the deemed loan needed to have a corresponding arm's length interest to be calculated on the loan

²⁷ A primary adjustment is the adjustment made when a company has entered into an affected transaction, and the actual terms and conditions of the debt are not those that would have been agreed to. The taxpayer is then requested to calculate that difference between the non-arm's length portion and the arm's length portion of the debt. The excessive interest on the excessive debt portion must be disallowed in computing the taxable income. SARS *Draft Interpretation Note* (2013) at 9-16.

²⁸ Oguttu *International Tax Law* (2015) at 249.

²⁹ EY *Worldwide Transfer Pricing Reference Guide* (2014) at 272.

³⁰ The disallowed interest portion shall be a deemed loan and this will require the taxpayer to calculate the secondary adjustment to account for interest income at an arm's length amount. SARS *Draft Interpretation Note* (2013) at 16.

³¹ Taxation Laws Amendment Bill No. 19 of 2011.

³² National Treasury *Draft Explanatory Memorandum* (2014) at 67-68.

³³ The word 'constructive' is interchangeable with the word 'deemed'.

³⁴ OECD *Transfer Pricing Guidelines* (2010) at 29. See also National Treasury *Draft Explanatory Memorandum* (2014) at 67-68.

³⁵ National Treasury *Draft Explanatory Memorandum* (2014) at 67-68.

³⁶ No. 19 of 2011.

amount.³⁷ The accrued interest on the deemed loan meant that calculating the balance of the deemed loan was capitalised annually. The deemed loan and the interest accrued on it was deemed to be payable until the loan was repaid by the taxpayer.³⁸ The taxpayer was required to calculate and take into consideration the calculation of the interest income at an arm's length rate on the deemed loan.³⁹ For example, a subsidiary making a primary adjustment when calculating its taxable income may treat the excess profits that are entitled to the foreign parent as a dividend, and thereby are subject to withholding tax. It is possible that a subsidiary pays an excessive amount of dividends to the foreign parent as a way of avoiding a liability of withholding tax.⁴⁰

The Davis Tax Committee Interim Report has given some guidance with regards to how SARS may implement and interpret these changes in legislation; however, it is not binding in law.⁴¹ In practice, for a foreign company to repay the deemed loan and the deemed interest, is difficult because there is no contractual legal obligation for the deemed loan supporting the settlement of the loan. In terms of the accounting treatment of the deemed loan, it is difficult to record a deemed loan and deemed interest in the financial statements of the taxpayer and the relevant currency of the deemed loan and deemed interest.⁴² Further, due to exchange control restrictions in the residence of the connected person, the repatriation of funds may be difficult. The South African Reserve Bank ('SARB') has strict regulations surrounding the repatriation of funds. The SARB has made it a requirement to transfer the funds for any loan repayments, thus resulting in a continuous interest charge which will be required for the loan repayments of the deemed loan for tax purposes.⁴³

Even with these regulations from the SARB regarding the repatriation of funds, there is a lack of guidance pertaining to the exchange control treatment of a deemed loan created in terms of section 31 of the Act. The creation of a deemed loan would most likely also result in a deemed or fictional interest charge which should adhere to the arm's length rate from

³⁷ National Treasury *Draft Explanatory Memorandum* (2014) at 67-68. See also Oguttu *International Tax Law* (2015) at 248.

³⁸ National Treasury *Draft Explanatory Memorandum* (2014) at 67-68.

³⁹ National Treasury *Draft Explanatory Memorandum* (2014) at 67-68.

⁴⁰ National Treasury *Draft Explanatory Memorandum* (2014) at 67-68.

⁴¹ Davis Tax Committee *Interim Report* (Dec. 2014) at 16-19. See also EY Global Tax Alert *South Africa amends law on transfer pricing secondary adjustments* (3 March 2015) at 1-3.

⁴² National Treasury *Draft Explanatory Memorandum* (2014) at 67-68.

⁴³ South African Reserve Bank *Exchange Control Manual* (July 2014) at section I. See also National Treasury *Draft Explanatory Memorandum* (2014) at 67-68.

the South African entity to its offshore related party. As a general rule, any outbound loans from South African companies to their offshore related group companies should be approved by the SARB in the form of a loan schedule or loan agreement in place between the parties.⁴⁴

This deemed loan provision has created several problems where an arm's length charge would remain in force, resulting in an increase each year should that deemed loan not be repaid and an interest charge to be imputed each year. The adjustment made was deemed to be a loan until the point in time where the difference in pricing between the two related parties is settled through the repatriation of funds or through a possible mutual agreement procedure ('MAP').⁴⁵

The former South African Minister of Finance, Gordon, has not made any reference in his budget speech⁴⁶ to the practical application of the deemed loan provision which replaced the STC liability. This, together with the lack of guidance provided by SARS, has brought little or no comfort to the taxpayer on the application of adjustments made under the transfer pricing rules contained in section 31 of the Act. This, coupled with the new arm's length test for thin capitalisation, has led to an inordinate amount of uncertainty in applying transfer pricing rules in South Africa.⁴⁷

The new section 31 of the Act as of 1 January 2015 deems a transfer pricing adjustment to be a dividend.⁴⁸ The amount of the loan, including the interest accrued, under this current provision, that is still outstanding is deemed to be a dividend and is also subject to dividend withholding tax at a rate of 15%.⁴⁹ Normally there are no other specific penalties for transfer pricing, but general penalty rules do apply, which could amount to up to 200% of the additional tax resulting from such an adjustment (in the event of default, omission, incorrect

⁴⁴ South African Reserve Bank *Exchange Control Manual* (July 2014) at section I. See also J Kruger *South African Transfer Pricing: A paradigm shift in the dark* TaxTalk Magazine (May/June 2012) at 16-17.

⁴⁵ J Kruger *South African Transfer Pricing: A paradigm shift in the dark* TaxTalk Magazine (May/June 2012) at 16-17.

⁴⁶ National Budget Speech (February 2011) at 30. Available at <http://www.treasury.gov.za/documents/national%20budget/2011/speech/speech2011.pdf> [Accessed 28 April 2016].

⁴⁷ National Budget Speech (February 2011) at 30.

⁴⁸ S 31(3) of the Act.

⁴⁹ S 64G and s 64FA of the Act. See also Deloitte *Global Transfer Pricing Country Guide* (2015) at 198-202.

disclosure or misrepresentation).⁵⁰

In terms of section 31(3) of the Act, the resident company is deemed to have a dividend that consists of a distribution of an asset *in specie*⁵¹ that is declared and paid by that resident company to the connected person on the last day of the period of six months following the end of the year of assessment in respect of which that adjustment was made. Where the amount of the difference was provided prior to 1 January 2015, that amount is deemed to be a loan, and therefore any amount of the loan which has not been paid before that period must be deemed to be a dividend *in specie*.⁵²

This transition as of 1 January 2015 from deemed loans to deemed dividends, has timing implications. Payment for the withholding tax is due six months after the deemed date of payment, but for any secondary adjustments that are deemed as dividends, payment is due by the end of the following month (i.e. February 2015).⁵³ Any dividend tax payable by a taxpayer, i.e. a company in South Africa, arising from a deemed dividend *in specie* would be payable to SARS by the last day of the month following the month during which the dividend is deemed to have been made.⁵⁴ Thus, any initial payments of the dividends tax as a result of the conversion of deemed loans to deemed dividends *in specie*, would have been payable on or before 28 February 2015. Moreover, the transition has an impact on the level of debt which would be taxable.⁵⁵ The 'dividends' or loan amount that is created from the deemed loan prior to 1 January 2015 does not have a six month rule, unlike the deemed dividends that arise from any adjustments made after 1 January 2015. These deemed dividends are dealt with under the general dividends tax provisions date for payment rules, which is due by the close of the month following the month of the dividend (i.e. between one and two

⁵⁰ S 210 and s 211 of the Tax Administration Act 28 of 2011.

⁵¹ A dividend *in specie* refers to distribution to shareholders in a form other than cash. Available from: <http://www.sars.gov.za/FAQs/Pages/833.aspx> [Accessed 25 Oct. 2015].

⁵² S 31(3) of the Act.

⁵³ S 64G and s 64FA of the Act. See Deloitte *Global Transfer Pricing Country Guide* (2015) at 198-202.

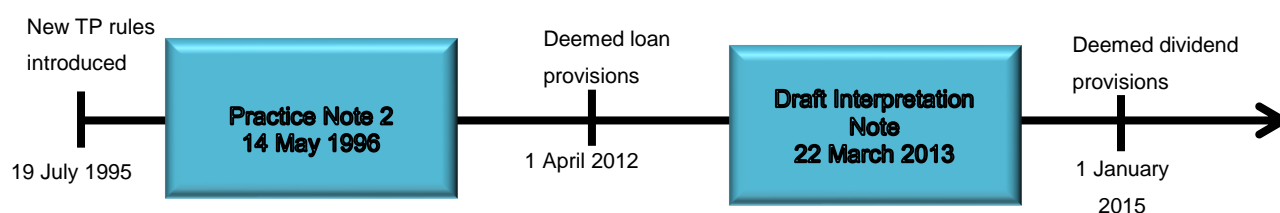
⁵⁴ See discussion regarding secondary adjustments in National Treasury *Draft Explanatory Memorandum* (2014) at 67-68. See also EY Global Tax Alert *South Africa amends law on transfer pricing secondary adjustments* (3 March 2015) at 1-3.

⁵⁵ Chapter Four provides a practical step-by-step analysis of the risk assessment of a taxpayers' thin capitalisation position and provide examples to demonstrate how financial transactions can be calculated with South Africa's rules on transfer pricing and thin capitalisation.

months).⁵⁶

However, for various technical issues, there have been some misunderstandings regarding the payment date with regard to the dividend *in specie* and National Treasury has not concluded any discussions regarding this confusion.⁵⁷ Hopefully this matter will be clarified in future for that year of assessment and the misalignment dealt with by National Treasury.⁵⁸

Figure 2-1: Timeline of old and new provisions



Source: Author

2.4 Examples

Below are examples of the thin capitalisation provisions that apply from 1 April 2012 as well as 1 January 2015 due to various legislative changes. The examples below are a comparison between the deemed loan and deemed dividend legislative provisions and are based on the following facts:

- Company A, a foreign entity, and Company B, a South African entity, are related parties and form part of the same group of companies.
- Both these entities have a 31 December year end.
- On 1 July 2013, Company A provided Company B with an intercompany loan to the value of R5 000 000. The loan bears interest at 5% per annum, which resulted in interest of R250 000 being payable to Company A at year end.

⁵⁶ S 64K of the Act.

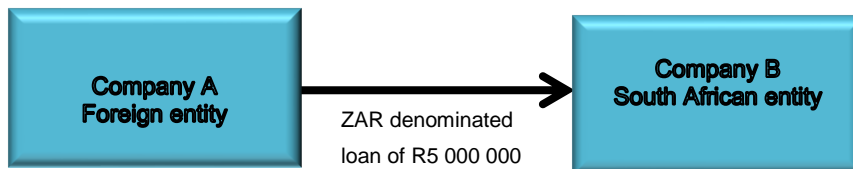
⁵⁷ National Treasury *Draft Explanatory Memorandum* (2014) at 67-68. See EY Global Tax Alert *South Africa amends law on transfer pricing secondary adjustments* (3 March 2015) at 1-3.

⁵⁸ Deloitte *Global Transfer Pricing Country Guide* (2015) at 198-202.

Upon examination, it was discovered that the arm's length interest rate that should have been charged was 2.5%.

Therefore, Company B paid excessive interest to the value of R125 000 to its related party.

Figure 2-2: Illustration of example



Source: Author

Example 1: Secondary adjustment - Deemed loan (as of 1 April 2012)

Implications:

As per section 31 of the Act, a primary and secondary adjustment will apply to the excessive amount of interest paid by Company B.

The additional tax payable by Company B is likely to be as follows:

- Primary adjustment: Company B will need to make a transfer pricing adjustment to account for excessive interest deduction, on which income tax rate of 28% will be levied. $R125\,000 \times 28\% = R\,35\,000$.
- Secondary adjustment: The primary adjustment will result in a secondary adjustment in the form of a deemed loan owed by Company A to Company B. The deemed loan bears deemed interest on which company B will be taxed.

Example 2: Secondary adjustment - Deemed dividend (as of 1 January 2015)

Implications:

The additional tax payable by Company B is as follows:

- Primary adjustment: Company B will need to make a transfer pricing adjustment to account for the excessive interest deduction, on which income tax of 28% will be levied. $R125\ 000 \times 28\% = R35\ 000$.
- Secondary adjustment: The primary adjustment will also result in a secondary adjustment. However, the adjustment is in the form of a deemed dividend in specie on which dividend tax of 15% is payable. $R125\ 000 \times 15\% = R18\ 750$.

2.5 The practical implications of these new provisions

The above changes have been incorporated into legislation but relatively little guidance is provided. It is therefore crucial that practical guidance should be provided on this matter by issuing an updated practice note or Draft IN on the new transfer pricing provisions.

Kruger states that while there was concern regarding the previous legislation which had a negative cash implication for the taxpayer, the new regime has not provided comprehensive guidance to the taxpayer.⁵⁹

SARS indicates in the Draft IN that it will apply a risk-based audit approach to identify potential thin capitalisation for multinational companies on a case-by-case basis.⁶⁰ In the Draft IN SARS states that it considers financial assistance transactions in which the Debt: EBITDA⁶¹ ratio is greater than 3:1 to be of a higher risk and these transactions may be selected for audit. It is accepted by SARS that the ratio may vary from industry to industry.⁶²

Furthermore, the Draft IN mentions that from an audit perspective, SARS considers an intercompany debt denominated in Rand to be of greater risk if it has an interest rate exceeding the weighted average of the South African Johannesburg Interbank Agreed Rate⁶³ plus 2%. The Draft IN states that an intercompany debt denominated in a foreign

⁵⁹ J Kruger *South African Transfer Pricing: A paradigm shift in the dark*, TaxTalk Magazine (May/June 2012) at 16-17.

⁶⁰ SARS *Draft Interpretation Note* (2013) at 11-12.

⁶¹ EBITDA is defined as earnings before interest, taxation, depreciation, amortization and any exceptional items. See SARS *Draft Interpretation Note* (2013) at 2.

⁶² SARS *Draft Interpretation Note* (2013) at 11-12.

⁶³ The Johannesburg Interbank Agreed Rate (JIBAR) is defined as - 'the money market rate, used in South Africa. It is calculated as the average interest rate at which banks buy and sell money.

currency will be considered to be of greater risk if it has an interest rate exceeding the weighted average of the base rate of the country of denomination plus 2%. These rates are not safe harbours, but indicators of the level of risk set by SARS.⁶⁴

2.6 Conclusion

The examples provided above give the taxpayer a sense of how SARS may interpret the Draft IN and the provisions of section 31 of the Act. However, it is merely an illustration and cannot be determinative of how the revenue authority would compute the arm's length calculation on the affected transaction in a practical situation. The legislation is constantly changing and the current position is that any transfer pricing adjustment will be treated as a deemed dividend. This could cause many uncertainties for various taxpayers on the treatment and implementation thereof into their financial statements should such an adjustment be made.

Overall, the arm's length principle used to arrive at the arm's length price is found to work effectively in most instances, although using the arm's length principle has proven to be more difficult to apply than a safe harbour rule, both for the taxpayer and the revenue authority. The arm's length principle is not always as straightforward to apply in practice.⁶⁵

This rate is calculated daily by the South African Futures Exchange as the average prime lending rate quoted independently by a number of different banks. The rate is available in one-month, three-month, six-month and twelve-month discount terms. In particular, the 3 month JIBAR rate is used as a benchmark of short-term interest rate movements.' See SARB *A review of the rate-setting process of the Johannesburg Interbank Agreed Rate as an interest rate benchmark report* (2012) at 6-7. Available at <https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/5292/JibarReview.pdf>.

⁶⁴ SARS *Draft Interpretation Note* (2013) at 11-12.

⁶⁵ A Oguttu *Transfer Pricing Disputes: Advance Pricing Agreements* (2006) 18 *SA Merc LJ* at 399-400.

Chapter 3. The arm's length risk assessment of the taxpayer's thin capitalisation position

3.1 Introduction

Section 31 of the Act requires that intercompany transactions between related parties, i.e. taxpayers and foreign connected parties, are conducted on an arm's length basis.¹ The OECD has stated that countries often make use of the fixed approach or the arm's length approach or a combination of the two, in efforts to minimise the benefits of thin capitalisation.²

This chapter discusses the OECD approach in relation to thin capitalisation, either through the use of the fixed ratio approach or through the arm's length principle. Furthermore, the chapter also considers the arm's length risk position of the taxpayer as provided for in the guidance of the Draft IN. Moreover, the various steps outlined in the Draft IN that a taxpayer needs to determine to assess whether they are in an arm's length position when transacting with their related parties in financial assistance arrangements will be analysed.

3.2 The OECD approach on restricting thin capitalisation

3.2.1 *The fixed ratio approach*

The fixed ratio approach is used by some countries as a restrictive measure to limit or exclude the excess amount of the loan provided, whereby other countries use the fixed ratio as a 'safe harbour', allowing the taxpayer to demonstrate that portion of the loan (i.e. through the use of the debt to equity ratio) is at arm's length.³

Financial ratios determine the amount of deductible interest expense in relation to a specified ratio, such as the debt to equity ratio mentioned above. If these fixed ratios are

¹ S 31 of the Act.

² OECD *Issues in International Taxation No.2 Thin Capitalisation: Taxation of entertainers, artists and sportsmen* (1987) at para 25. See Oguttu *International Tax Law* (2015) at 235.

³ Oguttu *International Tax Law* (2015) at 236.

applied, any additional interest on the amount of debt would not be deductible.⁴ Financial ratios differ among countries, either using for example, a debt to equity ratio of 3:1 or 2:1. Some countries only use intercompany debt in the calculation, whereby other countries use the total debt (including any third-party debt) in the equation. Some countries generally treat the fixed ratios which are used according to the arm's length criteria as an equivalent to using a safe harbour, providing numerous advantages and disadvantages.⁵

The OECD does not necessarily support the use of the fixed ratio approach, in spite of the fact that many countries using it are able to get the certainty that it provides to revenue authorities and group entities in determining the excess debt. The OECD has noted that the use of fixed ratios can be restrictive and the strict adherence to this approach may not take into account the commercial rationale of a certain business which could be detrimental to the entity.⁶

3.2.2 The advantages and disadvantages of using safe harbours for financial transactions

Safe harbours, such as the debt to equity ratio, can be used as thresholds or restrictions provided by a tax authority for certain taxpayers covered by transfer pricing legislation. Therefore, if the taxpayer meets certain requirements and falls within the prescribed intracompany transaction, and within the prescribed thresholds, then SARS will consider and accept the transaction without further assessment of the transaction.⁷ A safe harbour can either be in the form of a complete exemption or partial exemption based on satisfying certain requirements. Safe harbours allow taxpayers to achieve a certain level of compliance when used, as a means to meet a threshold of prescribed qualifications to reduce or eliminate the taxpayer's tax liability.⁸ The thresholds provided are usually

⁴ OECD *Thin capitalisation legislation* (Aug 2012) at 3.

⁵ OECD *Thin capitalisation legislation* (Aug 2012) at 3. See safe harbours as discussed in par. 2.6 for a further discussion on 'fixed ratios' or safe harbours.

⁶ OECD/ G20 Base Erosion and Profit Shifting Project, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 -2015 Final Report* (2015) at 47-48 and 82. See also Oguttu *International Tax Law* (2015) at 236- 237.

⁷ J Sweidan *Why SARS should consider transfer pricing safe harbours*, TaxTalk Magazine (Sept/Oct 2014) at 48-50.

⁸ J Sweidan *Why SARS should consider transfer pricing safe harbours*, TaxTalk Magazine (Sept/Oct 2014) at 48-50.

determined by performing a benchmarking study⁹ but are normally higher than the margins provided within the arm's length margins of that benchmarking study to accommodate a range of taxpayers.¹⁰

According to Honiball and Delahaye, a particular area of concern is the change to the thin capitalisation rules and the absence of a safe-harbour rule. They state that abolishing the safe harbour rule may hinder investment into Africa, as group companies offering financial assistance to their subsidiaries is a common *modus operandi*. It is important for SARS to issue an updated interpretation note. The updated guidance should, hopefully, contain a new safe harbour rule, which is in line with international best practice.¹¹

Sweidan states that in the past the OECD guidelines were inclined to have a negative position when it came to the use of safe harbours and ultimately recommended against the adoption of this rule.¹² Sweidan contends that the issues with the safe harbour approach outweigh its envisaged benefits. The negative considerations include:¹³

- The safe harbour may shift using a more appropriate method such as a comparable uncontrolled price (CUP)¹⁴ or transactional net margin method (TNMM),¹⁵ which may be inaccurate, and therefore be inconsistent with the arm's-length principle;

⁹ The use of comparable data or a benchmarking study is important when determining an arm's length debt assessment because when all the relevant facts and circumstances are considered it should support the position the taxpayer has reached in testing the transaction. Accordingly, taxpayers must obtain comparable independent data and conduct a benchmarking study, taking into account the quantitative and qualitative factors that third party lenders would typically consider when making lending decisions. This is to test the appropriateness of their arm's length debt assessment. For example, financial ratios for comparable taxpayers using third party databases or potentially a competitor's position (based on comparable or similar positions). See SARS *Draft Interpretation Note* (2013) at 8.

¹⁰ J Sweidan *Why SARS should consider transfer pricing safe harbours*, TaxTalk Magazine (Sept/Oct 2014) at 48-50.

¹¹ M Honiball & L Delahaye *Transfer Pricing - Uncertainty prevails*, Tax Professional (2013) at 16-17.

¹² J Sweidan *Why SARS should consider transfer pricing safe harbours*, TaxTalk Magazine (Sept/Oct 2014) at 48-50.

¹³ J Sweidan *Why SARS should consider transfer pricing safe harbours*, TaxTalk Magazine (Sept/Oct 2014) at 48-50.

¹⁴ A method of pricing based on the price charged between unrelated entities in respect of a comparable transaction in comparable circumstances. See PwC *International Transfer Pricing 2015/16* at 8.

¹⁵ A transfer pricing method based on an analysis of the operating profit derived by a business from a particular related party transaction or group of transactions. See PwC *International Transfer Pricing 2015/16* at 9.

- Safe harbours are likely to be restrictive and arbitrary to satisfy the arm's-length standard and would impute certain administrative burdens on SARS;
- Profit shifting to countries or jurisdictions that accept safe harbour in order to satisfy the safe harbour notion could undermine compliance in foreign jurisdictions and also result in double taxation;
- Competent authorities should not support countries that accept the safe harbour so that relief can be acquired only by the taxpayer convincing the other jurisdiction that its results were at an arm's-length basis;
- Foreign tax authorities may find it necessary to audit more widely in situations where a safe harbour was elected in a foreign country to avoid income depletion, thus shifting the administrative burden to such countries;
- Tax planning opportunities might be created, for example, for companies that are fairly profitable and moving from a high to a low-tax jurisdiction or tax havens; and
- Equity and uniformity issues relating to the concern that a common standard will not be applied to all countries using the same principle.

The advantages that a safe harbour system can offer SARS and taxpayers include:¹⁶

- Simplifying compliance and reducing the costs of compliance for qualified taxpayers in determining and documenting appropriate terms for eligible controlled transactions;
- Providing certainty to taxpayers that the price charged or paid on certain transactions between related parties will be accepted by the tax administrations that have adopted the safe harbour. This can be achieved with a limited audit, or without an audit, ensuring the taxpayer has met the qualifying conditions of and complying with the safe harbour provisions;
- Allowing tax administrations to redirect their administrative resources from the scrutiny of

¹⁶ J Sweidan *Why SARS should consider transfer pricing safe harbours*, TaxTalk Magazine (Sept/Oct 2014) at 48-50.

lower risk transactions to evaluations of more complex or higher risk transactions and taxpayers;

- Reducing or eliminating the possibility of certain disputes in court; and
- Improving foreign direct investment.

SARS also considers the use of various financial ratios such as the debt to equity and debt to EBITDA ratio to assess the arm's length nature of financial transactions considering these ratios have previously been used as safe harbours.¹⁷ However, SARS has mentioned in the Draft IN that the ratios should not be used as a safe harbour but rather as a risk-based approach to their audits against taxpayers.¹⁸ Taxpayers should rather use the arm's length basis as a measure for acceptability of financial assistance transactions. There is no safe harbour amount of debt and SARS is well within its ambit to audit taxpayers who are within the range of the ratio; i.e. the debt to equity ratio.¹⁹

Sweidan is of the opinion that the suggestions mentioned above for safe harbour approaches recognise that the use of ratios as safe harbours should be used to accomplish an appropriate fiscal balance.²⁰

3.2.3 The arm's length approach

The arm's length principle is provided for under Article 9(1) of the OECD Model Tax Convention²¹ and states that:

"Where:

- a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

¹⁷ SARS *Draft Interpretation Note* (2013) at 11-12.

¹⁸ SARS *Draft Interpretation Note* (2013) at 11-12.

¹⁹ SARS *Draft Interpretation Note* (2013) at 11-12.

²⁰ J Sweidan *Why SARS should consider transfer pricing safe harbours*, TaxTalk Magazine (Sept/Oct 2014) at 48-50.

²¹ OECD Model Tax Convention on Income and on Capital, July 2010.

b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State.

In either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.”

Article 9(1) observes that the financial assistance provided should be on an arm’s length basis i.e. the quantum of the loan should be arm’s length and the interest rate applied should be at an arm’s length rate.

In applying the arm’s length principle to thin capitalisation, what needs to be analysed is all the particular facts and circumstances of each transaction in the provision of the loan, in order to determine whether a third party in a similar circumstance would have granted the loan and therefore transacted at an arm’s length position.²²

The OECD’s view is that the decision to use the arm’s length approach to thin capitalisation should be substantiated on whether the quantum of the loan would have been provided in an arm’s length situation.²³

The arm’s length approach and the detailed risk assessment of the taxpayer’s thin capitalisation position, which is in line with the OECD’s views, is discussed in greater detail below.

3.3 The arm’s length risk assessment

The guidelines provided in the Draft IN essentially have three tests to conduct a risk assessment; namely, determining the arm’s length amount of debt, the classification of debt and equity for purposes of arm’s length testing, and the determination of an arm’s length

²² Oguttu *International Tax Law* (2015) at 236.

²³ OECD *Issues in International Taxation No.2* at para 25. See also Oguttu *International Tax Law* (2015) at 236-237.

interest rate.²⁴ Assessing the arm's length nature of the amount of the loan and the interest rate charged is more clear and precise as it is based on a quantitative²⁵ analysis which involves performing a comparability analysis using independent third party data, credit risk and scorecard models.²⁶ However, what is not as clear and straightforward is determining whether the substantive nature of the funding arrangement will be categorised as a loan or equity instrument, considering that it is a qualitative²⁷ analysis which is subjective and involves a number of factors to consider.²⁸ Taking all of these steps into consideration, the taxpayer will be in a position to determine whether or not the financial arrangements are arm's length and therefore whether the interest expense of that funding is deductible.

The analysis below refers to the use of the arm's length approach for South African taxpayers, in assessing their thin capitalisation position. The analysis is based on the guidance provided by the Draft IN, which SARS has provided to taxpayers as a means of determining whether they are compliant with the thin capitalisation rules in South Africa.

3.3.1 Determining an arm's length amount of debt

In order to determine an arm's length amount of debt, the quantitative and qualitative factors that third party lenders would typically consider when making lending decisions need to be taken into consideration.²⁹ When taking all the relevant facts and circumstances of each transaction into account, the arm's length amount of debt may be zero in certain circumstances. For example, a taxpayer with a generous balance sheet, cash reserves in excess and enough borrowing capacity loaned from an offshore parent company, can show that there was no business rationale or commercial benefit for the additional finance (assuming the return was less than the cost involved).³⁰

²⁴ SARS *Draft Interpretation Note* (2013) at 6-9.

²⁵ Quantitative analysis involves generating numerical data or data that can be transformed into useable statistics. See C.R Kothari *Research Methodology: Methods and Techniques* (2004) at 3-4.

²⁶ SARS *Draft Interpretation Note* (2013) at 6-9.

²⁷ Qualitative analysis involves gaining insight into understanding reasons, opinions, and motivations. See Kothari *Research Methodology* (2004) at 3-4.

²⁸ SARS *Draft Interpretation Note* (2013) at 6-9.

²⁹ SARS *Draft Interpretation Note* (2013) at 7-8. See Oguttu *International Tax Law* (2015) at 267-272.

³⁰ SARS *Draft Interpretation Note* (2013) at 7-8. See Oguttu *International Tax Law* (2015) at 267-

In this example, third party lenders would be willing to lend to an entity in the same or similar position as the taxpayer but an entity in the taxpayer's position may not have been willing to borrow from a third party based on these arm's length conditions. However, the facts and circumstances specific to the taxpayer are unique and will be considered on a case-by-case basis.³¹

As mentioned in the Draft IN, taxpayers are required to determine what amount of debt could be borrowed, based on an arm's length analysis from an independent third party. They are also required to take that consideration into account when preparing their annual income tax return and assessing what portion of the related interest expense is not deductible under section 31 of the Act. This requires a taxpayer to perform a functional analysis and a comparability analysis as part of their transfer pricing analysis. The analysis would determine the appropriateness of their debt assessment and whether such borrowings are concluded at an arm's length basis.³²

3.3.1.1 Functional analysis

The first step in determining the arm's length amount of debt of the taxpayer would be to perform a functional analysis. When conducting a functional analysis of the financial assistance transaction the following factors would be of relevance:³³

- a) The funding structure in place or in the process of being put in place. This should include the reasoning behind getting the funds, the dates of transactions, and where the funds originate from. It may also include reasons for obtaining the funds, the purpose of the funding and how they will be applied and the repayment terms.
- b) A high-level understanding of the business. This should include the relevant industry, the business structure, and details regarding the management team. The external market conditions, as well as the plans or business strategy of the company may also be

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³¹ SARS *Draft Interpretation Note* (2013) at 7-8. See Oguttu *International Tax Law* (2015) at 267-272.

³² SARS *Draft Interpretation Note* (2013) at 7-8. See Oguttu *International Tax Law* (2015) at 267-272.

³³ SARS *Draft Interpretation Note* (2013) at 7-8. See Oguttu *International Tax Law* (2015) at 267-272.

included.

- c) The financial strategy of the business, including how capital is allocated, the interaction between cash flows from operations and capital. This should also include any significant adjustments relating to the funding transactions, details regarding the principal cash flows and the sources of repayment of debt.
- d) The group structure including other subsidiaries which are affected by or involved in the funding transactions and any significant changes to the structure taking place over the duration of the funding transactions.
- e) The current and projected financial position of the taxpayer during the course of the financial transaction, including the assumptions underlying the projections and cash flows.
- f) Other indicators of the creditworthiness of the taxpayer, including any ratings by independent ratings agencies, if they are available.
- g) The accessibility and value of security.
- h) The subordination to the claims of other creditors must be determined, if applicable.
- i) The terms and conditions of the funding transaction including the repayment terms, the period of funding, and the cost of funding.

3.3.1.2 Comparability analysis

Once the functional analysis is completed, the next step in determining the arm's length amount of debt of the taxpayer would be to conduct a comparability analysis, which would use the functionality employed in the analysis to ensure that a valid comparison is made with third party comparables. When conducting a comparability analysis of the financial assistance transaction, the following financial ratios may be used in order to determine arm's length borrowings of independent third parties and comparing these to the ratios achieved by

the taxpayer, using comparable data.³⁴

a) Debt: EBITDA ratio (leverage ratio)

The Debt: EBITDA ratio provides a measure of a company's ability to pay off its incurred debt. This ratio gives the investor the approximate amount of time that would be needed to pay off all debt, ignoring the factors of interest, taxes, depreciation and amortisation.³⁵

b) EBIT: Interest expense (interest cover ratio)

A ratio used to determine how easily a company can pay interest on outstanding debt. The interest coverage ratio is calculated by dividing a company's earnings before interest and taxes (EBIT) of one period by the company's interest expenses of the same period.³⁶

c) Debt: Equity ratio (gearing ratio)

A measure of a company's financial leverage is calculated by dividing its total liabilities by stockholders' equity. It indicates what proportion of equity and debt the company is using to finance its assets.³⁷

In general, the acceptable level for these ratios depends on the industry in question, the size of the company, and on borrower-specific facts and circumstances (e.g. track record, business forecasts, and quality of information available to the lender).³⁸ Therefore, the availability and quality of comparability data has to be taken into account, as well as the quantitative and qualitative factors that independent lenders would typically consider when making lending decisions.³⁹ The table below provides an indication of the rule of thumb with respect to the levels to be achieved for these ratios.

³⁴ SARS *Draft Interpretation Note* (2013) at 7-8. See Oguttu *International Tax Law* (2015) at 267-272.

³⁵ OECD *Thin capitalisation legislation* (Aug. 2012) at 15-16.

³⁶ SARS *Draft Interpretation Note* (2013) at 2.

³⁷ OECD *Thin capitalisation legislation* (Aug. 2012) at 12-13.

³⁸ SARS *Draft Interpretation Note* (2013) at 12.

³⁹ SARS *Draft Interpretation Note* (2013) at 8.

Table 3-1: Indicative ratios

Ratio	Investopedia⁴⁰	Readyratios⁴¹	SARS Draft IN⁴²
Debt: EBITDA	No indication provided.	<3 but industry dependent.	<3. If greater than 3, it means greater risk of being selected for audit.
EBIT: Interest expense	>1.5	>1.5	No indication provided.
Debt: Equity	Industry dependent.	<1.5 – 2 but dependent on industry and size of company.	No indication provided.

Source: Adjusted Investopedia, Readyratios and SARS Draft Interpretation Note.

The use of comparable data, i.e. benchmarking studies, is important in the context of an arm's length debt assessment. When considered together with all the relevant information, the comparable data should test whether the taxpayer has reached an arm's length position. Accordingly, financial ratios for comparable taxpayers using third party databases or independently available information should be used.⁴³

SARS can, in the event of an audit, consider the suitability of using comparable data obtained from the taxpayer.⁴⁴ In addition, SARS is currently examining the use of comparable data regarding South African companies; however, these are generally not available or limited. This is because only public listed companies have to file and report their financial accounts which are mandatory requirements and often these entities have extensive intercompany transactions and therefore lack independence.⁴⁵

SARS' view is that the databases being considered are used in conjunction with credit risk models from a quantitative perspective and scorecard models from a qualitative perspective.⁴⁶ The databases, model, and scorecard would ultimately provide a range of

⁴⁰ See <http://www.investopedia.com/terms/> [Accessed 10 Nov. 2015].

⁴¹ See <http://www.readyratios.com/> [Accessed 10 Nov. 2015].

⁴² SARS *Draft Interpretation Note* (2013) at 11.

⁴³ SARS *Draft Interpretation Note* (2013) at 8.

⁴⁴ SARS *Draft Interpretation Note* (2013) at 8

⁴⁵ Deloitte *Global Transfer Pricing Country Guide* (2015) at 198-202.

⁴⁶ SARS *Draft Interpretation Note* (2013) at 11.

industry sector norm ratios (like Debt: EBITDA) based on credit ratings. This in conjunction with other relevant information provided by the taxpayer, can be used to assess the appropriateness of comparable data provided and ultimately the taxpayer's assessment of the amount it could and would have borrowed at arm's length'.⁴⁷

3.3.1.3 The classification of debt and equity for purposes of arm's length testing

Once the functional and comparative analysis is performed, the subjective factors or substantive nature of the arm's length amount of debt needs to be performed. One of the most important factors of the arm's length debt test is the correct identification of what constitutes debt versus equity and ensuring that all financial arrangements are taken into consideration.

Debt, for purposes of arm's length testing, includes straightforward loans, advances and debts.⁴⁸ In addition, economic equivalents of debt, such as finance leases, certain structured derivative financial instruments, and components of hybrid instruments, would be included as debt.⁴⁹ Most countries consider equity as share capital, retained profits, interest free loans, capital contributions, or revaluation reserves.⁵⁰

The Draft IN states that independent parties dealing at arm's length would look at the economic substance of a financial arrangement when assessing whether it is of a debt or equity nature or a hybrid of both.⁵¹ In determining the nature of a particular financial arrangement, the International Financial Reporting Standards⁵² ('IFRS') principles and application are adopted in financial statement of accounts as an acceptable guideline.⁵³

⁴⁷ SARS *Draft Interpretation Note* (2013) at 11.

⁴⁸ For purposes of thin capitalisation, debt is not limited to financial instruments classified under financial accounting standards such as International Financial Reporting Standards ('IFRS') but can be illustrated differently in various domestic legislations across different countries.

⁴⁹ SARS *Draft Interpretation Note* (2013) at 8-9.

⁵⁰ OECD *Thin capitalisation legislation* (Aug. 2012) at 14.

⁵¹ SARS *Draft Interpretation Note* (2013) at 8-9.

⁵² IFRS are a set of international accounting standards stating how particular types of transactions and other events should be reported in financial statements. See <http://www.ifrs.org/Pages/default.aspx>.

⁵³ SARS *Draft Interpretation Note* (2013) at 8-9.

Considering that SARS does not have any views, rulings or pending case law in court regarding thin capitalisation that is legally binding on the taxpayer, as mentioned above, this study has looked to foreign legislation for guidance.⁵⁴ Based on the guidance provided in the draft IN, together with the case of *Estate of Travis Mixon v United States of America*⁵⁵ and the ATO Taxation Ruling 92/11⁵⁶, an analysis should be performed of the substantive nature of the funding arrangements. The court ruled that the factors taken into consideration for the funding arrangements are not all inclusive. There are various factors which have been used at various times by the courts in determining specific substantive factors regarding funding arrangements.⁵⁷ An overview of the key characteristics of the funding arrangements and the key considerations as mentioned in the Mixon case⁵⁸ and the ATO ruling⁵⁹ has been summarised in the table below.

Table 3-2: Characteristics of funding arrangements

Characteristic	Consideration
IFRS	The exact features of the loans are contained in the respective loan agreements. The loans are treated as loans for IFRS purposes. This provides an indication that the loan funding is more akin to a debt arrangement.
Creditor / debtor relationship	The loan agreements set out the features of a typical creditor / debtor relationship. This includes, among others, the obligation to repay the principal amount and the obligation to pay interest. In this respect, it will also be relevant to assess whether the quantum of the loans can be considered reasonable, as an excessive loan amount could lead to

⁵⁴ See para. 2.1.

⁵⁵ 464F.2d 394 (1972).

⁵⁶ Australian Taxation Office, Taxation ruling TR92/11.

⁵⁷ 464F.2d 394 (1972) at 19.

⁵⁸ 464F.2d 394 (1972).

⁵⁹ Australian Taxation Office, Taxation ruling TR92/11 at 20.

	<p>a credit risk for the taxpayer that would not be observed in a typical creditor / debtor relationship. From the loan agreements, it can be determined that a typical creditor / debtor relationship has been established and provides an indication that the loan funding is more akin to a debt arrangement.</p>
<p>Presence of a legal arrangement</p>	<p>There are separate loan agreements for each loan under review. Specific loan vocabulary is used consistently throughout these agreements and provides an indication that the funding arrangements are more akin to debt arrangements.</p>
<p>Maturity date and repayment conditions</p>	<p>The funding arrangements between related parties have a fixed maturity date and have a tenor of one year (with the option to roll forward). This does not seem unreasonable, as it gives related entity the ability to regularly reassess its decision to provide funding. This provides an indication that the funding arrangements are more akin to a debt arrangement.</p>
<p>Ability to borrow</p>	<p>One of the aspects to consider in determining a taxpayer's ability to borrow is its ability to generate sufficient income to fulfil its financial obligations in respect of the funding arrangements. The credit rating of taxpayer would be an important factor to consider. If the entity is unable to generate sufficient levels of cash flow and income to fulfil its obligations towards its parent entity and/or if there are reasonable doubts as to the taxpayer's ability to repay the loan, this might be an indication that the parent entity has taken on a non-arm's length credit risk. If this is the case, this is an indication that the loan funding is more akin to an equity arrangement.</p>
<p>Debt ranking</p>	<p>If the ranking of the loan funding provided by the parent entity is not lower than other creditors (if any), this provides an indication that the loan funding is more akin to a debt arrangement. One might take the</p>

	view that if the loan funding provided by the parent entity is subordinated to external creditors (if any), this might be seen as an indication that the loan funding is more akin to an equity arrangement.
Interest obligations and payment	Where payment of interest is ad-hoc, based on corporate earnings or dependent on profitability, the arrangement may be considered economically similar to equity. If interest is payable by the taxpayer on a regular basis, regardless of its earnings, and if regular interest payments can in fact be made by the taxpayer, this provides an indication that the loan funding is more akin to a debt arrangement.
Purpose of borrowing	Where the funds are used for capital acquisitions they are more likely to be viewed as equity in nature as the funds will inherently be less liquid. Funds used to finance working capital or operational costs suggest an arrangement more akin to a debt arrangement.

Source: Compiled by author

With reference to the table above, it appears that a number of features of the funding arrangements indicate that a taxpayers' borrowing could either be more akin to equity or akin to debt arrangements.

3.3.2 Determining whether the interest rate is at arm's length

Although the Draft IN focuses on providing guidance in relation to the determination of an arm's length amount of debt, it is also important that taxpayers focus on determining whether the interest rate applied is at arm's length.⁶⁰ The Draft IN stipulates that a taxpayer may have an amount of debt that is arm's length but the interest rate may not be at arm's length.

⁶⁰ SARS *Draft Interpretation Note* (2013) at 9.

Therefore, both the amount of debt and the interest rate may or may not be at arm's length.⁶¹

3.3.2.1 Credit rating

In order to evaluate the interest rates applied for financial transactions, a taxpayer must assess the stand-alone credit rating using databases such as Moody's, Standard & Poor's or Fitch, based on the taxpayers current and projected financials. In essence, a credit rating is a formal determination of a company's ability to repay its debt obligations; i.e. in principle its creditworthiness. Credit ratings are publicly available for many companies with a history of previous participation in the capital markets. In this context, 'credit ratings' refer to ratings that are assigned by internationally recognised credit rating agencies.⁶²

There are different ways to investigate, analyse, and maintain records on the creditworthiness of multinational companies. In general, credit ratings are assigned on the basis of a company's key financial data, as well as the qualitative and quantitative factors reflecting the credit history of the company and overall financial performance of the company. Simultaneously, these considerations are examined while taking into account the various country and sector specific risk factors. A poor credit rating indicates a high risk of the taxpayer defaulting on payment of a loan, and this could inevitably result in a higher interest rate or the refusal of a loan by the lender.⁶³

Alternatively, a credit rating may be applied to a specific debt security, thereby presenting the obligor of the security with an opinion of the creditworthiness of the borrower. In essence, a credit rating for a specific financial obligation is not only based on the general creditworthiness of an obligor, but also takes into account relevant risk factors of the obligation, including different forms of credit enhancement, and may reflect the credit wealth of guarantors or insurers.⁶⁴

If an entity does not have an independent credit rating published by a reputable rating agency, then that entity can use one of the credit rating tools offered by these agencies to approximate their creditworthiness. These credit models are mainly based on financial

⁶¹ SARS *Draft Interpretation Note* (2013) at 9.

⁶² See <http://www.investopedia.com/terms/c/creditrating.asp>. [Accessed 28 April 2016].

⁶³ SARS *Draft Interpretation Note* (2013) at 9.

⁶⁴ SARS *Draft Interpretation Note* (2013) at 9.

statement information and usually do not consider the company's qualitative factors, but still incorporate the country and sector specific information into a credit risk assessment process. Particularly, credit risk benchmarks utilise large sets of financial statements and credit event data.

3.3.2.2 Determining the arm's length interest rate

In order to establish an interest rate for the loan funding that is consistent with the arm's length principle, a benchmarking analysis must be performed. Based on the above credit rating, a benchmarking study can be performed.

Once the benchmarking search has been performed, the database will generate the results of comparable government and corporate bonds that take into account the quantitative and qualitative factors that third party lenders would normally consider when deciding whether to lend to a taxpayer.

The comparable data, based on the benchmarking study performed on the database should support the position of the taxpayer in the context of an arm's length interest rate assessment and provide the taxpayer with a range of interest rates that are considered at arm's length, in conjunction with all the relevant facts and circumstances of the financial arrangement.

3.4 Conclusion

The OECD has advocated for the use of the arm's length principle to restrict the abuse of thin capitalisation practices because the approach offers flexibility and affords the revenue authorities the ability to determine the specific facts and circumstances of each case. However, this approach has also been scrutinised due to it being subjective as it may not offer a high level of certainty to multinational companies.⁶⁵ A fixed ratio approach to restrict to a specified proportion of earning, assets or equity of a company is already widely used by a number of countries. Although there is difficulty in benchmarking an appropriate ratio that considers significant BEPS risks, the OECD seems to believe that certain ratios can be too

⁶⁵ Oguttu *International Tax Law* (2015) at 260.

high to effectively deal with BEPS risks.⁶⁶

As stated above, there are different opinions with regards to the advantages and disadvantages of using safe harbour rules, and in most cases, there are different approaches that countries use when applying safe harbour provisions. Therefore, whether SARS should apply a safe harbour system is not the main concern, but rather how SARS should implement it.⁶⁷ The method used should be considered carefully, profit level indicators evaluated, arm's length ranges updated regularly, proper competent authority assistance provided, as well as anti-abusive rules considered.⁶⁸

The other challenge is with regards to the comparability factors, where the conditions of a controlled transaction are compared to the conditions in transactions between independent parties. In order for this comparison to be effective, the economically relevant characteristics of the conditions being compared must be sufficiently comparable.⁶⁹ However, applying these comparability factors have proven to be difficult since various factors, as discussed above, can affect the comparisons. For financial assistance transaction, a banker or other independent party would take various factors into account, where certain difference such as the financial agreements and risk factors of the taxpayer would also apply.⁷⁰

Determining the arm's length interest rate is also a challenge considering that it is based on a number of assumptions. With varying interest rates, it becomes very difficult to accurately delineate how much a company can borrow. The variables could distort the debt modelling of a taxpayer, especially if there are high arm's length borrowings, compared to the assets with correlating high interest rates.⁷¹

The taxpayer is also considered on a stand-alone basis as opposed to reviewing the

⁶⁶ OECD Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 -2015 Final Report at 11. See PwC *International Transfer Pricing 2015/16* at 165. Further discussion on OECD approach to fixed ratio is discussed below in para 4.2.2.2.

⁶⁷ J Sweidan *Why SARS should consider transfer pricing safe harbours*, TaxTalk Magazine (Sept/Oct 2014) at 48-50.

⁶⁸ J Sweidan *Why SARS should consider transfer pricing safe harbours*, TaxTalk Magazine (Sept/Oct 2014) at 48-50.

⁶⁹ OECD *Transfer Pricing Guidelines* (2010) in para D1.33. See Oguttu *International Tax Law* (2015) at 260.

⁷⁰ Oguttu *International Tax Law* (2015) at 260.

⁷¹ Oguttu *International Tax Law* (2015) at 260-261.

creditworthiness of the group as a whole.⁷² Considering that the credit rating of the group will be higher than the subsidiary, this significantly reduces the interest rates determined, under the arms' length analysis.⁷³

The application of the transfer pricing methods has also not been explained effectively by the OECD. It is still unclear whether the same methods used for transfer pricing will have the same effect for thin capitalisation transactions. For instances, it is not certain whether a taxpayer would be able to rely on the use of transactional methods in this instance.⁷⁴

From some of the factors discussed above, it is evident that applying the arm's length principle is more challenging than simply applying a fixed ratio or safe harbour and will require a more detailed evaluation of the lending and borrowing factors on a case by case basis. This approach will pose a significant administrative burden on taxpayers as well as revenue authorities to apply the arm's length principle in the context of thin capitalisation transactions.⁷⁵

⁷² SARS *Draft Interpretation Note* (2013) at 9.

⁷³ Oguttu *International Tax Law* (2015) at 260-261.

⁷⁴ Oguttu *International Tax Law* (2015) at 262.

⁷⁵ Oguttu *International Tax Law* (2015) at 262.

Chapter 4. International developments on thin capitalisation

4.1 Introduction

There have been certain international developments on thin capitalisation. These developments include the BEPS project which has since been finalised and provides guidance in several reports addressing base erosion and profit shifting. The OECD and G20 countries have since September 2013 adopted a 15-point action plan to address BEPS.¹

The issues surrounding thin capitalisation and financial assistance involve high levels of debt, particularly in a cross-border context between related parties, which may lead to an erosion of the tax base.² The higher the level of debt in a company and consequently the greater the amount of interest paid, the lower the taxable profit of that company will be. In most instances, debt can be seen as more tax efficient than equity considering that debt has various tax exemptions and deductions whereas equity does not.³

With the introduction of the new transfer pricing rules, thin capitalisation rules have become part of the transfer pricing mandate. Therefore, thin capitalisation in a broader context is part of the BEPS mandate and will globally affect the way multinationals interact with each other.⁴

This chapter evaluates the recent developments in light of the OECD BEPS project, specifically focusing on financial assistance arrangements and the deductibility of interest according to the new guidance provided in the OECD BEPS action plan reports. Specifically, Action 4 which aims to produce best practice rules to address BEPS through the

¹ See the 15-point action plan on the OECD BEPS initiative, ~~Available at~~ <http://www.oecd.org/> [Accessed 11 September 2017].

² P Dachs South Africa: Base erosion and profit shifting – Debt: Equity, International Tax Review (Feb 2015), ~~Available at~~ <http://www.internationaltaxreview.com> [Accessed 25 June 2015].

³ See P Dachs South Africa: Base erosion and profit shifting – Debt: Equity, International Tax Review (Feb 2015), ~~Available at~~ <http://www.internationaltaxreview.com> [Accessed 25 June 2015].

⁴ P Dachs South Africa: Base erosion and profit shifting – Debt: Equity, International Tax Review (Feb 2015), ~~Available at~~ <http://www.internationaltaxreview.com> [Accessed 25 June 2015].

use of 'excessive' interest expense. This chapter also analyses thin capitalisation legislation implemented in Australia and the UK, in comparison to South Africa, that can provide alternative solutions, if necessary, for South Africa's improvement in implementing their legislation.

4.2 BEPS developments in thin capitalisation and financial assistance

4.2.1 Background

The concept of BEPS has been discussed at various international forums. The G20 and OECD countries have worked together to finalise these reports and the European Commission also provided its views throughout the BEPS project.⁵ Developing countries such as South Africa and other OECD observing countries have been involved extensively through direct participation in the Committee on Fiscal Affairs.⁶ In addition, regional tax organisations such as the African Tax Administration Forum ('ATAF'), the *Centre de rencontre des administrations fiscales* and the *Centro Interamericano de Administraciones Tributarias* joined international organisations such as the International Monetary Fund ('IMF'), the World Bank and the United Nations ('UN') in contributing to the BEPS project. The BEPS project received more than 1 400 submissions, including comments and suggestions on the work from advisers, industry, academics and various Non-Government Organisations ('NGOs').⁷ There have been several public consultations, including live streaming of these consultations and webcasts where the OECD Secretariat periodically updated the public and further answered any questions the public might have had.⁸

These final reports include recommendations for substantial changes in tax issues concerning multinational enterprises. Furthermore, these recommendations are incorporated in revisions to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ('OECD Guidelines'), the OECD Model Tax

⁵ OECD Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 -2015 Final Report at 3.

⁶ OECD Action 4 -2015 Final Report at 3.

⁷ OECD Action 4 -2015 Final Report at 3.

⁸ OECD Action 4 -2015 Final Report at 3.

Convention,⁹ and are recommended to be incorporated into domestic law provisions for various countries.¹⁰ Since the release of these OECD final reports, the main focus is on countries in developed and developing markets to determine whether, when, and how to implement the various recommendations. Countries have started implementing these OECD recommendations, and there is substantial activity around BEPS-driven legislative and tax administration in various countries across the globe.¹¹

Action 4 of the OECD final report discusses financial instruments which have payments that are equal or similar to interest but have a different legal form. These forms of financial instruments therefore create a route to escape any tax liability based on whether interest is deductible. Dividends or other forms of equity are not deductible and are therefore subject to some form of tax relief (an exemption, exclusion, credit, etc.) for the payee.¹² The OECD and G20 state that the use of third party and related party interest is one of the easiest ways for multinationals to affect profit-shifting techniques in international tax planning. The fluidity and flexibility of income makes it easy to adjust the combination of debt and equity in a connected party.¹³ This creates various risks from a BEPS perspective in that many multinational groups will use intergroup or third-party debt to either: (1) generate interest deductions in excess of the multinational group's actual third party interest expense, (2) generate tax exempt income, or (3) place higher levels of third party debt in high tax jurisdiction countries.¹⁴

These three scenarios are discussed in the report and the risks thereof are addressed in Action 4 of the *Action Plan on Base Erosion and Profit Shifting*¹⁵ which relates to financial assistance transactions. The report provides recommendations regarding best practices in the development of certain rules to prevent base erosion and profit shifting through the use of interest expense. There are various approaches discussed in the report which could be

⁹ Model Tax Convention on Income and on Capital.

¹⁰ PwC *International Transfer Pricing 2015/16* at 165.

¹¹ EY Global Tax Alert *OECD releases final reports on BEPS action plan* (6 Oct. 2015). ~~Available at~~ <http://www.ey.com/GL/en/Services/Tax/International-Tax/Alert--OECD-releases-final-reports-on-BEPS-Action-Plan>. [Accessed 05 March 2016].

¹² OECD Action 4 -2015 Final Report at 15.

¹³ OECD Action 4 -2015 Final Report at 3.

¹⁴ OECD Action 4 -2015 Final Report at 3.

¹⁵ OECD Action 4 -2015 Final Report at 3.

used as guidance for thin capitalisation legislation in South Africa.¹⁶

4.2.2 OECD recommendations regarding best practices

The aim of Action 4 is to target the misuse of what it considers as ‘excessive interest’ and to outline the best practice rules in respect to addressing the BEPS issues relating to the use of interest expense. The report reviews a number of different approaches including group wide rules, fixed financial ratios, targeted rules, and a combination of the approaches. The most common approaches are discussed in further detail below.¹⁷

4.2.2.1 Group-wide interest allocation or ratio approach (group-wide tests)

The ratio approach would either limit an entity’s net interest deductions to a proportion of the group’s actual net third party interest expense.¹⁸ Under the group rule, a company with net interest more than a country’s fixed ratio could be deductible for that interest expense for countries to level up to 10% to the group’s net third party interest expense to avoid double taxation. Using another group ratio could be considered as an ‘equity escape’ rule, which allows interest expense as long as a company’s debt to equity ratio does not exceed its worldwide group.¹⁹

4.2.2.2 Fixed ratio approach

The fixed ratio approach acts to restrict interest expense to a specified proportion of earnings, equity or assets of an entity.²⁰ The fixed ratio approach limits an entity’s net deductions for interest and payments economically equivalent to interest to a percentage of its EBITDA. In order to make sure that various countries are able to use a fixed ratio that is

¹⁶ OECD Action 4 -2015 Final Report at 3.

¹⁷ PwC *International Transfer Pricing 2015/16* at 170.

¹⁸ PwC *International Transfer Pricing 2015/16* at 170.

¹⁹ EY Global Tax Alert *OECD releases final reports on BEPS action plan* (Oct. 2015) at 4-5. The worldwide leverage ratio or group ratio rule entails that an entity would use its worldwide group (including all its subsidiaries) level of debt versus its net interest expense/EBITDA ratio to determine how highly leveraged they are, rather than using a fixed ratio which only looks at the entity on a stand-alone basis. See OECD Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 -2015 Final Report at 11. Also see chapter 7 at 57 for a detailed discussion on the group ratio rule.

²⁰ PwC *International Transfer Pricing 2015/16* at 170.

low enough to address BEPS issues, the recommended approach includes a range of possible ratios of between 10% and 30%.²¹ The fixed ratio approach can be used together with the worldwide group ratio, but does not exclude the worldwide group ratio rule being used on its own as it allows an entity to exceed the range of between 10% and 30% in certain circumstances.²²

4.3 Various jurisdictions and their thin capitalisation rules

4.3.1 Australia

The thin capitalisation rules enforced by the Australian Taxation Office ('ATO') disallow a proportion of deductible debt-related expenses when the debt allocated to a multinational company's Australian operations exceeds certain limits.²³ The thin capitalisation threshold requires businesses to claim deductions on tax based on their global debt to equity ratio, as opposed to the debt to equity ratios of only Australian operations.²⁴

Generally, Australian subsidiaries with non-Australian tax resident entities have thin capitalisation thresholds for the Australian operations, should the greater of either of the below apply:²⁵

- A debt level of 75% of adjusted Australian assets (the 'safe harbour debt test'); or
- A debt level that a third-party lender generally would find acceptable (the arm's length debt test).

A third test may be applied for Australian tax-resident entities with foreign subsidiaries. This

²¹ OECD Action 4 Final Report (2015) at 11.

²² OECD Action 4 Final Report (2015) at 11.

²³ Income Tax Assessment Act 1997 (ITAA 1997) sub-division 820. Australian Taxation Office, Taxation ruling TR92/11 at 3-4. See also PwC Tax Alert *Australia releases draft reform to thin capitalisation and dividends exemptions tax*. Tax insights from International Tax Services (May 2014) at 1-2.

²⁴ ITAA 1997 sub-div 820. Australian Taxation Office, Taxation ruling TR92/11 at 3-4 and 14. See also M McBride *Australian taxpayers balk at labor party's challenge to thin capitalisation* (March 2015) - <http://www.internationaltaxreview.com> [Accessed 25 June 2015].

²⁵ ITAA 1997 sub-div 820. See also M McBride *Australian taxpayers balk at labor party's challenge to thin capitalisation* (March 2015) - <http://www.internationaltaxreview.com> [Accessed 25 June 2015].

additional test limits deductible debt in the Australian operations to the greater of the results under the above two tests, or 120% of the level of the worldwide leverage ratio; i.e. the worldwide group's leverage.²⁶ The recent thin capitalisation amendments in relation to the legislation mentioned above have:²⁷

- Reduced the safe harbour debt limit to 60% of adjusted Australian assets for 'general' entities²⁸ (effectively reducing the maximum safe harbour debt-to-equity ratio to 1.5:1) and to 15:1 for certain 'financial' entities²⁹;
- Increased the *de minimis* threshold³⁰ exemption for application of the thin capitalisation rules to \$A2 million of debt deductions;
- Extended the worldwide leverage test to foreign controlled Australian companies of

²⁶ ITAA 1997 sub-div 820. See also M McBride *Australian taxpayers baulk at labor party's challenge to thin capitalisation* (March 2015) - <http://www.internationaltaxreview.com> [Accessed 25 June 2015].

²⁷ ITAA 1997 sub-div 820. See also M McBride *Australian taxpayers baulk at labor party's challenge to thin capitalisation* (March 2015) - <http://www.internationaltaxreview.com> [Accessed 25 June 2015].

²⁸ A general entity is "an entity that is neither a financial entity nor an ADI entity. An ADI entity is a body corporate that is an authorised deposit taking institution for the purposes of the Banking Act 1959." See sub-div 820 of the ITAA 1997.

²⁹ A financial entity is "an entity, other than an ADI, that is any of the following:

- a registered corporation under the Financial Sector (Collection of Data) Act 2001;
- a securitisation vehicle;
- an entity that is either:
 - a financial services licensee, within the meaning of the Corporations Act 2001, whose licence covers dealings in at least one of the financial products mentioned in paragraphs 764A(1)(a), (b) and (j) of that Act or dealings in derivatives; or
 - both of the following
 - exempt under paragraph 911A(2)(h) or (l) of the Corporations Act 2001 from the requirement to hold an Australian financial services licence for dealings in at least one of those financial products or dealings in such derivatives
 - carrying on a business of dealings in securities or such derivatives, but not predominantly for the purposes of dealing in securities or such derivatives with, or on behalf of, the entity's associates." See sub-div 820 of the ITAA 1997.

³⁰ The *de minimis* threshold differentiates between entities which have a low level of net interest expense. Where a group has more than one entity in a country, it is recommended that the threshold be applied to the total net interest expense of the local group. See OECD Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 *Final Report* at 12.

multinational groups;

- Reduced the worldwide leverage ratio to 100%; and
- Increased the safe harbour capital limit for authorised deposit-taking institutions (e.g. certain financial institutions) to 6% of their risk-weighted Australian assets.

The amendments apply to income tax years commencing on or after 1 July 2014. There are no transition provisions. These newly enacted legislative provisions have equipped the Australian government to deal with any multinational companies that use tax avoidance practices. The rules have been changed to enable the authorities to pursue any anti-avoidance measures and create an environment that has more certainty and consistency in applying tax laws in Australia. This will enable companies to remain as an attractive place to invest and conduct business.³¹

It is important that tax policies move towards treating multinational companies as one entity for tax purposes, rather than subsidiaries that operate as a stand-alone corporation that each requires the application of tax rules separately. It would alleviate the burden that domestic businesses face as their multinational competitors might use artificial debt assistance as a way of avoiding tax compliance in order to have an unfair advantage in the open market.³²

4.3.2 United Kingdom

The United Kingdom ('UK') is one of the many countries that participated in and endorsed the BEPS project when it started in July 2013.³³ Her Majesty's Revenue and Customs ('HMRC'), the UK tax authority and Her Majesty's Treasury are involved in the OECD's 15-point action plan. HMRC has aspirations that the BEPS actions mentioned in its report on tackling aggressive tax planning in the global economy will 'succeed in fundamentally

³¹ M McBride Australian taxpayers balk at labor party's challenge to thin capitalisation (March 2015)- Available at <http://www.internationaltaxreview.com> [Accessed 25 June 2015].

³² M McBride Australian taxpayers balk at labor party's challenge to thin capitalisation (March 2015)- Available at <http://www.internationaltaxreview.com> [Accessed 25 June 2015].

³³ W Nicholls & L Hughes; Grant Thornton UK LLP How BEPS will affect the UK transfer pricing legislation. International Tax review (June 2014). Available at <http://www.internationaltaxreview.com> [Accessed 25 June 2015].

changing the international tax landscape, and shift the balance of the rules in favour of tax authorities...³⁴ The UK government hopes to introduce new tax rules which deal with this issue on a worldwide basis. HMRC is increasing efforts to protect the tax base locally and has been provided with additional funding for transfer pricing enquiries which it estimates will bring approximately £2 billion in receipts by the end of 2018.³⁵

The current transfer pricing legislation in the UK under the Taxation (International and other Provisions) Act 2010 ('TIOPA 2010') expressly refers to the OECD transfer pricing guidelines in terms of interpretation and guidance.³⁶ Therefore, any additions or updates to the provisions in the OECD guidelines will automatically be included as provisions into the UK tax legislation and the BEPS changes will take effect in the UK earlier than they may be enacted in other countries.³⁷

The arm's length principle is used as the method to establish whether the amount of debt or the interest rate is excessive. The test is whether a third party would have borrowed from the company, specifically the consideration of financial assistance and the specified interest rate. The aim of the legislation is to align the UK provisions with Article 9 of the OECD Model Tax Convention.³⁸

The thin capitalisation rules stipulated in the UK's transfer pricing legislation under TIOPA 2010 are aimed at limiting a tax deduction for interest payments that are payable on borrowings between related entities. These thin capitalisation rules apply to financing transactions between UK-related parties and in some instances, lending from a third party.

³⁴ HM Treasury & HMRC discussion paper on *Tackling aggressive tax planning in the global economy: UK priorities for the G20-OECD project for countering Base Erosion and Profit Shifting* (March 2014) at 3-4. W Nicholls & L Hughes; Grant Thornton UK LLP How BEPS will affect the UK transfer pricing legislation *International Tax review* (June 2014).

³⁵ HM Treasury & HMRC *Tackling aggressive tax planning in the global economy* (March 2014) at 3-4. W Nicholls & L Hughes; Grant Thornton UK LLP How BEPS will affect the UK transfer pricing legislation *International Tax review* (June 2014).

³⁶ Taxation (International and other Provisions) Act 2010 (TIOPA 2010) Part 4. See also the Her Majesty's Revenue and Customs (HMRC) International Manual (July 2016). ~~Available at~~ <https://www.gov.uk/hmrc-internal-manuals/international-manual/intm510000> [Accessed: 18 July 2017].

³⁷ W Nicholls & L Hughes; Grant Thornton UK LLP How BEPS will affect the UK transfer pricing legislation *International Tax review* (June 2014).

³⁸ TIOPA 2010, Part 4 ~~which~~ includes provisions that incorporate financial transactions. See also PwC *International Transfer Pricing 2015/16* at 1033-1034. Arbitrage is defined as the practice of profiting from differences between the way transactions are treated for tax purposes. Read more: <http://www.investopedia.com/terms/t/tax-arbitrage.asp#ixzz4QkFgUiT0>

These provisions, acting together, extend the UK thin capitalisation rules to bring borrowing between non-connected entities for the purposes of UK tax within the ambit of the legislation.³⁹ There are various ways in which HMRC may limit interest deductions for resident companies in the UK, including anti-arbitrage⁴⁰ and worldwide group ratio rules.⁴¹

These rules have certain implications, including the refusal or denial of tax deductions or exemptions for interest expense. These could also include the accrual of interest income for loans between related UK entities or where a party has a guaranteed lending by another party. However, it may be possible for parties to claim compensating adjustments to their taxable profits in some situations.⁴²

There is no formal UK safe harbour specifically relating to the debt-to-equity ratio or interest cover ratio.⁴³ However, it has been suggested in the past that a debt-to-equity ratio of 1:1 and interest cover ratio of 3:1 could exempt companies from tax liability and therefore be considered to be 'safe'.⁴⁴ HMRC has mentioned that these situations would be dealt with on a case-by-case basis and would accept these ratios individually on the foundation that they demonstrate historical averages. The HMRC would use its employees and resources in a more efficient way and only review cases that displayed more extreme ratios.⁴⁵

These averages could also be influenced by a particular industry sector, and may be different when compared against each industry. Other ratios are also considered, including the ratio of debt to earnings and other forms of interest cover. There are various other factors that the HMRC takes into consideration; i.e. what a third party would also consider,

³⁹ TIOPA 2010, Part 4. HMRC International Manual (July 2016). See also PwC *International Transfer Pricing 2015/16* at 1033-1034.

⁴⁰ TIOPA 2010, Part 4. HMRC International Manual (July 2016). See also PwC *International Transfer Pricing 2015/16* at 1033-1034.

⁴¹ TIOPA 2010, Part 4. HMRC International Manual (July 2016). See also PwC *International Transfer Pricing 2015/16* at 1033-1034.

⁴² TIOPA 2010, Part 4. HMRC International Manual (July 2016). See also PwC *International Transfer Pricing 2015/16* at 1033-1034.

⁴³ TIOPA 2010, Part 4. HMRC International Manual (July 2016). See also PwC *International Transfer Pricing 2015/16* at 1033-1034. The interest coverage ratio is calculated by dividing a company's earnings before interest and taxes (EBIT) of one period by the company's interest expenses of the same period.

⁴⁴ HMRC International Manual (July 2016). See also PwC *International Transfer Pricing 2015/16* at 1033-1034.

⁴⁵ TIOPA 2010, Part 4. HMRC International Manual (July 2016). See also PwC *International Transfer Pricing 2015/16* at 1033-1034.

including a consolidated debt to equity ratio of the borrower's worldwide group (including all of its subsidiaries), and the ability of the group of companies to pay interest and repay capital.⁴⁶

HMRC enters into unilateral Advance Pricing Agreements ('APA')⁴⁷ with taxpayers, known as an advance thin capitalisation agreement ('ATCA'),⁴⁸ to determine the arm's length amount of interest that should be deductible in the UK taxpayer's tax return. ATCAs are fairly popular in the UK and approximately 144 agreements were entered into with HMRC and UK taxpayers in year ended 2012 and 2013.⁴⁹ Therefore, acceptable ratios can be discussed and agreed upon in advance.

4.4 Comparison of legislation between different countries

The measures used by the ATO and HMRC for thin capitalisation and financial assistance transactions can be used by SARS as guidance on the application of the arm's length test. Below is a table illustrating the difference and similarities of the legislation in place between the countries when applying their thin capitalisation regulations.

The table below provides a summarised version of the discussion in the aforementioned paragraphs:

⁴⁶ TIOPA 2010, Part 4. HMRC International Manual (July 2016). See also PwC *International Transfer Pricing 2015/16* at 1033-1034.

⁴⁷ TIOPA 2010, Part 4. HMRC International Manual (July 2016). See also PwC *International Transfer Pricing 2015/16* at 8. APAs are binding advance agreements between the tax authorities and the taxpayer, which set out the method for determining transfer pricing for inter-company transactions.

⁴⁸ ATCA are the same as APAs mentioned above; however, ATCAs deal with thin capitalisation agreements. See also PwC *International Transfer Pricing 2015/16* at 1033-1034.

⁴⁹ W Nicholls & L Hughes; Grant Thornton UK LLP How BEPS will affect the UK transfer pricing legislation *International Tax review* (June 2014).

Table 4-1: Comparison of legislation between different countries

Indicators	Australia	United Kingdom	South Africa
Existence of safe harbours	A safe harbour tests is applied using a debt to equity ratio of 1.5:1	There is no formal UK safe harbour, however a debt-to-equity ratio of 1:1 and interest cover ratio of 3:1 is used and determined on a case-by-case basis	The Draft IN mentions a debt to EBIDTA ratio of 3:1 which is used as an indicator for risk- based approach in audits, however it is not considered a safe harbour
Application of interest thresholds	Uses the <i>de minimis</i> threshold exemption i.e. interest expense threshold		
Application of ratios	Application of the worldwide leverage ratio up to 100%	HMRC may limit interest deductions for resident companies in the UK using anti-arbitrage and worldwide group ratio rules	
Existence of APA process	A formal APA process is available in Australia	HMRC enter into unilateral APAs with taxpayers, specifically known as ATCA	An APA process is not currently available in South Africa

Source: Compiled by author

4.5 Conclusion

The ATO and HMRC, unlike SARS, have had transfer pricing legislation for several decades and have more sophisticated and advanced processes to deal with thin capitalisation transactions. The ATO and HMRC are more vigilant in ensuring tax compliance and have better resources and knowledge to deal with any audit matters that may arise.⁵⁰

It is quite evident that the Draft IN does not discuss the measures analysed by the ATO and HMRC in respect of other measures that could support the arm's length test for financial transactions. What is also evident is that the Draft IN may not necessarily apply the debt to EBIDTA ratio appropriately as they measure a 3:1 ratio whereas other countries would rather use a debt to equity ratio and debt to EBITDA ratio of between 10% and 30%. SARS has

⁵⁰ PwC *International Transfer Pricing 2015/16* at 204 and 1033-1034.

expressed an interest in considering using the APA process but has still not introduced the APA process in South Africa.⁵¹

Taking into consideration the thin capitalisation regulations applied by other jurisdictions, it would be beneficial for SARS to evaluate how it can implement some of the approaches adopted by these countries.

⁵¹ PwC *International Transfer Pricing 2015/16* at 924.

Chapter 5. Conclusion

5.1 Final remarks

One of the objectives of this study was to analyse the former and new provisions of thin capitalisation regulations. The transition from old to new legislation can be challenging for tax authorities, and even more difficult to interpret for taxpayers. It is evident that over the years transfer pricing rules, and specifically thin capitalisation legislation in South Africa, has had various legislative changes; however, extensive guidance on this area has been lacking.

The difficulties with the provisions of the old section 31 of the Act is that the provisions did not incorporate the OECD guidelines in respect of the arm's length principle, which is the underlying basis when dealing with transfer pricing and thin capitalisation transactions. Despite the new provisions of section 31 of the Act being more aligned with the OECD guidelines by applying an arm's length test for the amount of debt and interest rate charged for any financial transactions between connected parties, the guidance provided in the Draft IN does not give certainty and uniformity with the application of this principle.

This study also analysed and interpreted the new provisions of section 31 of the Act and the Draft IN by using practical examples to determine the taxpayer's taxable income. The Draft IN needs to be finalised in order to provide taxpayers with the guidance on the application and compliance of assessing the risk position in thin capitalisation transactions. Finalisation of the Draft IN would also require SARS to conduct a more detailed assessment into a taxpayer's positions, requiring extensive knowledge and due diligence from their staff. The implications are that related foreign entities that provide funding to each other, specifically to South African subsidiaries, have to be more proactive in ensuring that their financial transactions are arm's length.²⁴³ Taxpayers and their related parties should also be aware of the pitfalls of implementing the new provisions of the secondary adjustment.²⁴⁴

Different tax authorities across the world, such as Australia and the UK, implement various thin capitalisation legislation. There are common practices and recommendations that are applied and that have proven to be effective for those countries, as discussed in this study.

²⁴³ Oguttu *International Tax Law* (2015) at 271.

²⁴⁴ Oguttu *International Tax Law* (2015) at 271.

5.2 Recommendations

The application of the arms' length basis is fundamentally of a detailed factual nature, containing various steps as discussed in this study, and should take into account various factors particular to the specific taxpayer concerned.

It is therefore essential that sufficient guidance is provided to ensure compliance by taxpayers and efficient administration for tax authorities.

Ultimately, the aim with the revision of section 31 and any applicable guidance, such as the Draft IN, should be to align South Africa's legislation with the OECD's arm's length principle, adopted in the BEPS action plan and provided for in the BEPS final reports. The revised legislation and guidance will give taxpayers the incentive to restructure their financial arrangements, which should inevitably assist taxpayers to comply with the regulations. This should place less of an administrative burden on taxpayers if the guidance on this matter is clear and concise. Therefore, it would be beneficial to SARS and taxpayers for guidance on thin capitalisation transactions to be updated and finalised as soon as possible.

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