

REPUBLIC OF SOUTH AFRICA

SOUTH AFRICAN REVENUE SERVICE: INLAND REVENUE

PRACTICE NOTE: NO.2 DATE: 14 MAY 1996

INCOME TAX : DETERMINATION OF TAXABLE INCOME WHERE FINANCIAL ASSISTANCE HAS BEEN GRANTED BY A NON-RESIDENT OF THE REPUBLIC TO A RESIDENT OF THE REPUBLIC

1. INTRODUCTION

1.1. In anticipation of a possible relaxation in exchange controls, the Commission of Inquiry into certain aspects of the Tax structure of South Africa (under the Chairmanship of Prof. M M Katz) recommended in its first and second interim reports that transfer pricing provisions be introduced into the Income Tax Act, 1962 (the Act), inter alia to counter thin capitalisation practices which may have adverse tax implications for the South African fiscus.

Transfer pricing provisions are normally applied to adjust the prices of goods and services in terms of certain transactions concluded between related parties to reflect an arm's length price which would have applied had the transaction been concluded on normal commercial grounds between unrelated parties. The effect of the application of transfer pricing provisions is to neutralise the tax benefit arising from such transactions. On the other hand, thin capitalisation provisions are applied to limit the deductibility of interest where there is a disproportionate ratio between the loan capital and equity employed in, for example, a company.

In order to counter such practices, section 23 of the Income Tax Act, 1995 (Act No. 21 of 1995), substituted section 31 of the Act. Such section consists of a combination of transfer pricing and thin capitalisation provisions, which may, for instance, be applied where financial assistance is granted in respect of international transactions.

1.2 Measures to counter transfer pricing schemes are in essence contained in section 31(1) and (2). Although these provisions may also, in certain circumstances, be applied to combat thin capitalisation, the provisions of subsection (3) are more specifically aimed at countering thin capitalisation schemes.

Once the excessive portion of financial assistance has been determined in accordance with the guidelines as set out in paragraph 4 of this Practice Note, the provisions of section 31(2) must be applied to determine whether the interest calculated on that portion of the financial assistance falling within the 3:1 guideline provided in the aforementioned paragraph, is based on an arm's length price (interest rate). In this regard consideration should be given to the guidelines provided in paragraph 2.2.

On a literal interpretation of section 31 the concept of financial assistance would include not only interest-bearing financial assistance, but also interest-free financial assistance. As the purpose of subsection (3) is in essence to enable the Commissioner for Inland Revenue to determine an acceptable debt/equity ratio in order to disallow a deduction in respect of interest relating to the excessive portion of loan capital, the application of subsection (3) will be limited to interest-bearing

financial assistance. This will, however, not have the effect that financial assistance which is not interest bearing, will be regarded as permanent owners' capital.

On the same basis only, interest-bearing financial assistance will be taken into account in the application of the transfer pricing provisions of subsection (2) in cases where it is applied in conjunction with the provisions of subsection (3) in order to determine whether the interest calculated on that portion of the financial assistance falling within the 3 : 1 guideline, is based on an arm's length price (interest rate). However, where the application of the thin capitalisation provisions is not necessary because the financial assistance granted falls within the prescribed guidelines, financial assistance may include financial assistance, which is not interest-bearing in the application of the provisions of subsection (2).

1.3 EXAMPLE

A profitable South African company, TPS (Pty) Ltd, was capitalised in Rand by its shareholder who is a non-resident. The company's financial year ends on 31 August. The RSA prime rate was 18.5% throughout the 1995/6 year of assessment. The following further information is relevant for the application of section 31:

Fixed capital

Shareholder R1 000 000

Loans R4 000 000

- Shareholder granted loan # 1 on 1/9/95 @ 24% pa - R2000 000
- Shareholder granted loan # 2 on 26/1/96 @ 0% pa - R2000 000

Interest

- Loan # 1: R2 000 000 at 24% R480 000
- Section 31(3) is not applicable as the interest-bearing financial assistance granted falls within the 3 : 1 guideline.

Calculation of excessive interest in terms of section 31(2)

- Interest falling within the 3 : 1 guideline = R480 000
- Weighted average of financial assistance:
 - R2 000 000 for 147 days 294 000 000
 - R4 000 000 for 219 days 876 000 000
 - 1 170 000 000 , 366 = R3 196 721

Effective interest rate of acceptable financial assistance = $\frac{R480\,000 + R196\,721}{R2\,000\,000 + R4\,000\,000} = 15\%$

Excessive interest relating to the 1995/6 year of assessment is Rnil as the 20.5% (18.5% + 2% (see 2.2 below)) limit has not been exceeded.

2. SECTION 31(1) AND (2)

2.1 The scope of subsections (1) and (2) is limited to an "international agreement" as defined. A transaction, operation or scheme qualifies as an international agreement where such agreement has been entered into between – * a natural person ordinarily

resident in the Republic or a person other than a natural person managed or controlled in the Republic (hereinafter referred to as a resident); and * a natural person not ordinarily resident in the Republic or a person other than a natural person managed or controlled outside the Republic (hereinafter referred to as a non-resident). Furthermore, paragraph (c) of the definition of "services" in section 31(1) encompasses the granting of financial assistance, including a loan, advance or debt and the provision of any security or guarantee.

2.2 Where in terms of section 31(2) a service, specifically the granting of financial assistance, is provided by a non-resident to a resident who is a connected person in relation to the non-resident and the consideration relating to the financial assistance is excessive in the sense that the consideration does not reflect an arm's length price, the Commissioner may, in the determination of the taxable income of the resident, adjust the consideration in the hands of the resident to reflect an arm's length consideration in relation to the financial assistance granted. Consideration, in the context of financial assistance, will be interpreted to include not only interest or related finance charges, but also a discount or premium. Where the loan, advance or debt is denominated in rand, a rate not exceeding the weighted average of the South African prime rate plus 2 percentage points will be an acceptable nominal annual interest rate. Where the loan, advance or debt is denominated in a foreign currency, a rate not exceeding the weighted average of the relevant inter bank rate plus 4 percentage points will be an acceptable nominal annual interest rate. Any interest exceeding the above mentioned prescribed rates will be regarded as excessive interest and will consequently not be allowed as a deduction for income tax purposes.

3. SECTION 31(3)

Section 31(3) was introduced specifically to address thin capitalisation transactions between certain related parties. The provisions of this section will apply where financial assistance is granted directly or indirectly by a non-resident of the Republic (the investor) to - (a) a resident (the resident) of the Republic who is a connected person in relation to the investor; or (b) a person other than a natural person who is managed or controlled in the Republic (the recipient) in whom the investor has a direct or indirect interest by virtue of which the investor is entitled to participate in 25% or more of the dividends, profits or capital of the recipient or is entitled to exercise, directly or indirectly, 25% or more of the voting rights of the recipient.

Where in terms of such an arrangement the Commissioner is satisfied that the financial assistance granted by the investor to the resident or the recipient is excessive in relation to the fixed capital of the resident or recipient, any interest relating to the excessive portion of the financial assistance shall be disallowed as a deduction in the hands of the resident or recipient.

4. DETERMINATION OF "DISALLOWABLE INTEREST" RELATING TO EXCESSIVE FINANCIAL ASSISTANCE

4.1 As a general guideline, the Commissioner will not apply the thin capitalisation provisions contained in section 31(3) where the financial assistance/fixed capital ratio does not exceed 3:1. The excessive portion of financial assistance granted by an investor will, therefore, be that portion of the financial assistance which exceeds an amount equal to three times the fixed capital of the resident or recipient of the financial assistance. This approach will ensure a degree of continuity as it will, to some extent, correspond with the current practice of the Exchange Control

Authorities. The interest (interest, finance charge or other consideration including inter alia a discount or premium) in relation to or in respect of financial assistance shall be apportioned between the amount of financial assistance which is considered to be acceptable and the amount of financial assistance which is regarded as excessive. In order to determine which portion of interest relates to excessive financial assistance in relation to an investor in respect of a year of assessment, the following formula will be applied: $A = B \times \frac{C}{D}$ 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; "B" represents the total interest incurred during such year in respect of all financial assistance, contemplated in subsection (3), in existence during such year (whether or not such financial assistance was granted before, on or after 19 July 1995); "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.

4.2 The financial assistance contemplated in section 31 to be used in symbol C is a amount equal to the weighted average of the financial assistance in existence during the relevant year of assessment and includes interest-bearing financial assistance only. where no significant variation occurred in the level of financial assistance during the year of assessment, the amount of financial assistance as it exists at the end of the relevant year of assessment may be used. Trade credit which is interest-bearing must be included in the amount of financial assistance granted as contemplated in section 31(1). Furthermore, where a South African company is partially owned by an investor (e.g. 50%) and such investor is jointly and severally, together with all other shareholders, liable in terms of a security provided in respect of - * a foreign bank overdraft of the South African company; or * any other independent third party foreign loan to the South Africa company, a portion of the overdraft or loan, pro rata to the investor's interest in the company, will be regarded as financial assistance granted by such investor.

4.3 In determining the amount of fixed capital of the resident or recipient in the Republic, the following items are to be taken into account on a pro rata basis in accordance with the investors' interest in the South African entity:

- share capital;
- share premium;
- accumulated profits of a capital and revenue nature; and
- permanent owners' capital (excluding any financial assistance) in circumstances where there is no share capital.

Fixed capital will be reduced by any reserves and increased by any losses, resulting from the revaluation of assets. The amount of fixed capital to be used when calculating symbol "D" of the formula is an amount equal to the fixed capital at the end of the relevant year of assessment. However, the annual net trading losses sustained during the current and immediately preceding two years of assessment, limited to losses sustained for years of assessment during which the investor has granted financial assistance to the resident or recipient, may be added back to fixed capital to be used in symbol "D" of the formula.

4.4 In determining the fixed capital relating to investors, the calculation should not be done on the basis of what the investors invested, but rather on such investors' pro rata share of the total fixed capital. Furthermore, fixed capital will exclude deferred tax as determined for accounting purposes.

4.5 Where financial assistance is granted to a resident of the Republic by more than one investor as contemplated in subsection (3), the rules of section 31 will be applied to such investors, without reference to any person other than an investor having an interest in the fixed capital of the resident or recipient.

5. EXAMPLE

A profitable South African company, TCS (Pty) Ltd, was capitalised in rand by its shareholders, all of them being non-residents. Only X is an investor. The company's financial year ends on 31 August. The RSA prime rate was 18.5% throughout the 1995/96 year of assessment. The following further information is relevant for the application of section 31:

Fixed capital R15 000 000

Shareholder X - (2/3) R10 000 000

Various other shareholders - (1/3) R 5 000 000

Loans R40 000 000

Shareholder X granted loan # 1 on 1/9/95 @ 24% pa R30 000 000

Shareholder X granted loan # 2 on 26/1/96 @ 18% pa R10 000 000

Interest R 8 277 049

Loan # 1: R30 000 000 at 24% for 366 days R 7 200 000

Loan # 2: R10 000 000 at 18% for 219 days R 1 077 049

Calculation of disallowable interest in respect of shareholder X in terms of section 31(3)

$B = R8277049$

$C = R30\,000\,000 \text{ for } 147 \text{ days } 4\,410\,000\,000$

$R40\,000\,000 \text{ for } 219 \text{ days } 8\,760\,000\,000$

$R13\,170\,000\,000 \div 366 = R35\,983\,606$

$D = \text{The greater of } (R10\,000\,000 \times 3) \text{ or } R_{nil} = R30\,000\,000$

$A = 8\,277\,049 \times (35\,983\,606 - 30\,000\,000)$

$1\,359\,836\,06$

= R1 376 365 (disallowable interest for the 1995/6 year of assessment)

Calculation of excessive interest in respect of shareholder X in terms of section 31(2)

Interest falling within the 3:1 guideline = R8 277 049 – R1 376 365 = R6 900 684

Effective interest rate of acceptable financial assistance = $\frac{R6\,900\,684}{R30\,000\,000} = 23\%$

Excessive interest relating to the 1995/6 year of assessment = $R6\,900\,684 \times (23 - 20.5) + 23 = R750\,074$

6. COMMISSIONER'S DISCRETION

6.1 Notwithstanding the guideline of the 3:1 ratio and the interest rates referred to in paragraph 2.2, with regard to the application of section 31, it is acknowledged that a higher level of financial assistance in contrast with the guideline ratio of financial assistance to fixed capital or a higher interest rate may be applicable as a result of transactions and agreements entered into for commercial and economic reasons rather than to obtain tax advantages.

6.2 where a taxpayer, therefore, can justify a higher level of financial assistance in contrast with the guideline ratio of financial assistance to fixed capital or a higher interest rate under particular or special circumstances, he may approach the

Commissioner, to exercise his discretion in terms of section 31. This will, generally be of a temporary nature and a period may be specified within which the 3:1 ratio should be restored or the interest rate be reduced.

6.3 Taxpayers falling within the 3:1 ratio will not be required to justify their ratio. They must, however, submit the information requested in the annual income tax return.

7. FINANCIAL ASSISTANCE IN CURRENCY OTHER THAN RAND

Where financial assistance is denominated in a currency other than the currency of the Republic, the equivalent currency value of the Republic must be determined by applying the spot or relevant forward rate, as the case may be, on the date the amount of financial assistance is to be determined. However, where there is an increase in the rand value of the financial assistance as a result of a weakening of the rand against the relevant foreign currency, the rand value of the financial assistance may be determined with reference to the spot or relevant forward rate, as the case may be, on the following dates: In the case of a loan owing by a person, the date on which the amount payable in respect of the loan was received by such person and in the case of a debt owing by a person, the date on which the debt was actually incurred.

8. BACK-TO-BACK ARRANGEMENTS

In the application of section 31(3), the term `financial assistance granted includes back-to-back arrangements through independent parties or co-investors. where a foreign parent company, therefore, makes a loan to a South African bank, a foreign bank or any other person on condition that the bank or other person on-lends the funds to the South African subsidiary of the parent company, the loan will be treated

as financial assistance. where the foreign parent company provides a guarantee to a foreign bank or any other non-resident as security for a loan to the local subsidiary, the bank debt will be treated as financial assistance. where, however, the foreign parent company provides a guarantee to a South African bank as security for a loan to the local subsidiary, the bank loan will not be treated as financial assistance as the foreign company will not receive any interest and the recipient of the interest will be taxed thereon.

9. EXCESSIVE (see par.2.2) AND DISALLOWABLE (see par.4) INTEREST SUBJECT TO SECONDARY TAX ON COMPANIES (STC)

In the case of companies the total amount of the excessive and disallowable interest will be deemed to be a dividend declared in terms of section 64C(3)(e) of the Act and STC will be payable on the excessive and disallowable interest. As the determination of the excessive and disallowable portions of interest and the exercising of the Commissioner's discretion are to be made at the time the relevant assessment is raised, the dividend cycle in respect of such deemed dividend will, for purposes of the definition of "dividend cycle" in section 64B(1), be regarded to end on the date of assessment in respect of the year of assessment to which the excessive and disallowable interest relates. Where, however the taxpayer has been notified in writing by the Commissioner of the amount of the excessive and disallowable interest prior to such date of assessment, the dividend cycle will be regarded to end one month after the date of such notification.

10. APPLICATION

The provisions of section 31 shall inter alia only apply to any services supplied on or after 19 July 1995. As already mentioned, the supply of services includes the granting of financial assistance. Interest incurred after that date on a loan or advance received or debt incurred before that date will, therefore, not be subject to the provisions of section 31.

COMMISSIONER FOR INLAND REVENUE
PRETORIA