

**DRAFT INTERPRETATION NOTE**

DATE:

**ACT : INCOME TAX ACT NO. 58 OF 1962 (the Act)**  
**SECTION : SECTION 31**  
**SUBJECT : DETERMINATION OF THE TAXABLE INCOME OF CERTAIN PERSONS FROM INTERNATIONAL TRANSACTIONS: THIN CAPITALISATION**

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### ***Preamble***

In this Note unless the context indicates otherwise –

- **“affected transaction”** means a transaction as defined in the **Annexure**;
- **“EBITDA”** is defined as earnings before interest, taxation, depreciation, amortization and any exceptional items;
- **“interest cover ratio”** means the ratio determined by calculating EBITDA to gross interest paid;
- **“members”** means the constituent parts (including natural persons) of an MNE, each having a separate legal existence;
- **“MNE”** means a multinational enterprise;
- **“multinational enterprise”** means any group of connected persons with members and business activities in more than one country;
- **“OECD”** means the Organisation for Economic Co-operation and Development;
- **“OECD Guidelines”** means the OECD Report on Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, published in July 2010, and supplemented from time to time with additional chapters and revisions to the contents thereof;
- **“OECD Model Tax Convention”** means the OECD Model Tax Convention on Income and on Capital;
- **“section”** means a section of the Act;
- **“tax benefit”** includes any avoidance, postponement or reduction of any liability for tax imposed in terms of the Act;
- **“transfer pricing”** means the process by which connected persons set the prices at which they transfer goods or services between themselves; and
- any word or expression bears the meaning ascribed to it in the Act.

## 1. Purpose

This Note provides taxpayers with guidance on the application of the arm's length basis in the context of determining whether a taxpayer is thinly capitalised under section 31 and, if so, calculating taxable income without claiming a deduction for the expenditure incurred on the excessive portion of finance.

The guidance and examples provided are not an exhaustive discussion of every thin capitalisation issue that might arise. Each case will be decided on its own merits taking into account its specific facts and circumstances.

The application of the arms' length basis is inherently of a detailed factual nature and takes into account a wide range of factors particular to the specific taxpayer concerned. SARS has provided what it considers to be indicators of risk (see 7), acknowledging that the risk indicator may not constitute an arm's length position for a particular taxpayer or industry. SARS welcomes comments regarding this aspect as well as suggestions of areas for further guidance (including views on what that guidance may be) and indeed any aspect of this Note. Comments should be submitted by 30 June 2013.

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

## 2. Background

Taxpayers are broadly financed in two ways, namely through the use of equity and debt. The returns on equity capital and debt capital are treated differently for tax purposes. Interest payments incurred in the production of income by a person carrying on a trade are, subject to certain conditions and restrictions, deductible in determining taxable income while distributions of profits (whether in the form of dividends or returns of capital) are not deductible.

The way in which a taxpayer is financed has an impact on the calculation of the taxpayer's taxable income. This raises tax concerns regarding the balance between the amount of equity capital and debt capital. A taxpayer which is considered to have too little equity when considered against the amount of its debt is said to be thinly capitalised for tax purposes.

Thin capitalisation typically becomes an issue in cases where a South African taxpayer is funded either directly or indirectly by non-resident connected persons. The funding of a South African taxpayer with excessive intra-group, back-to-back or intra-group-guaranteed debt may result in excessive interest deductions thereby depleting the South African tax base.

South Africa introduced thin capitalisation rules in 1995. Under these rules, which were contained in section 31(3), the Commissioner was empowered to have regard to the international financial assistance rendered and if it was considered excessive in proportion to the particular lender's fixed capital in the borrower, the interest, finance charges or other consideration relating to the excessive financial assistance was disallowed. The Commissioner's views on what constituted excessive

international financial assistance were documented in Practice Note No. 2 of 14 May 1996. These rules and Practice Note No. 2 have been repealed and are only applicable to years of assessment commencing before 1 April 2012.

For years of assessment commencing on or after 1 April 2012, thin capitalisation is no longer dealt with by a separate subsection of section 31 and is instead governed by the general transfer pricing provisions of subsection 31(2).<sup>1</sup>

One of the most significant changes is that taxpayers must determine the acceptable amount of debt on an arm's length basis. The arm's length basis will be discussed further in this Note.

This Note deals with the provisions of section 31 which, as noted above, are applicable for years of assessment commencing on or after 1 April 2012. For example, in the case of a year of assessment ending on 31 December, the first year of assessment to which the new legislation will apply is the year of assessment commencing on 1 January 2013 and ending on 31 December 2013.

### 3. The law

For ease of reference, the relevant sections of the Act are quoted in the **Annexure**.

### 4. Application of the law

Section 31 requires taxpayers to –

- determine whether the actual terms and conditions of any transaction, operation, scheme, agreement or understanding meeting part (a) of the definition of an “affected transaction”<sup>2</sup> differ from the terms and conditions that would have existed if the parties had been independent persons dealing at arm's length; and
- if there is a difference which results or will result in a tax benefit for one of the parties to the affected transaction, to calculate their taxable income based on the arm's length terms and conditions of the affected transaction.

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

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

Taxpayers are required to file a return which has been prepared on an arm's length basis. Accordingly, taxpayers must be able to demonstrate that debt which meets the definition of an affected transaction is at arm's length or that a tax deduction has not

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<sup>1</sup> Section 57 of the Taxation Laws Amendment Act No. 24 of 2011.

<sup>2</sup> See the **Annexure** – section 31(1) “affected transaction”.

been claimed for the expenditure incurred on the portion of the debt that is not arm's length.

#### 4.1. Part (a) of the definition of an "affected transaction"

The wording of part (a) of the definition of an "affected transaction" has been included in the **Annexure**.

It is impractical to give a detailed list of all the transactions which constitute affected transactions. Taxpayers must consider their particular facts and circumstances and identify transactions which may potentially constitute an affected transaction per the definition referred to above.

##### 4.1.1 Direct and indirect funding

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

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

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

#### **Example 1 – Connected party credit protection**

*Facts:*

Foreign Co is a multinational company which wishes to recapitalise its 100%-held South African subsidiary (SA Subco) by an additional R2 million.

There are two proposals on the table. Under the first proposal (Proposal 1), SA Subco will issue R0,5 million in equity to Foreign Co and borrow the remaining R1,5 million from SA Bank A at 8.5%. Under the second proposal (Proposal 2), SA Bank B is willing to lend SA Subco R2 million at 9%, provided that Foreign Co provides SA Bank B with credit protection in the event that SA Subco defaults on its loan obligations. Foreign Co will however charge SA Bank B an annual fee of 2,5 % of the loan value for providing such credit support.

It is assumed for purposes of this example that the maximum amount SA Subco could borrow in an arm's length transaction would be R1,5 million and that the applicable arm's length interest rate would be 8,5% on the basis that there is a further equity injection of R0,5 million.

Proposal 2 is accepted.

*Result:*

Two adjustments will be required. First, R0,5 million of the loan will be treated as a direct loan by Foreign Co to SA Subco and the interest expense attributable to that portion of the loan will be denied in full. Second, SA Subco will be denied a deduction for 0,5% interest on the remaining R1,5 million of the loan.

This will result in the interest deduction enjoyed by SA Subco being reduced by R52 500 [(R500 000 x 9%) + (R1 500 000 x 0.5%)].

#### **4.1.2 Parties specified in part (a) of the definition of an “affected transaction”**

The parties specified in the definition are detailed in the **Annexure**.

Taxpayers should note that the parties potentially falling within the ambit of thin capitalisation under section 31 have increased under the new legislation. Section 31 includes, amongst others, certain situations where the transaction, operation, scheme, agreement or understanding is between a non-resident and another non-resident's permanent establishment in the Republic or alternatively between a resident and another resident's permanent establishment which is located outside the Republic.

This means, for example, that if a non-resident subsidiary of an MNE provides a loan to another non-resident subsidiary of that MNE and that subsidiary channels the funds through to its South African permanent establishment, the transaction potentially falls within the ambit of an affected transaction.

#### **4.1.3 Connected persons**

The term “connected person” is defined in section 1(1) of the Act. Guidance on the definition of a “connected person” is provided in Interpretation Note: No. 67 “Connected Persons” (1 November 2012) which is available on the SARS website [www.sars.gov.za](http://www.sars.gov.za).

In addition, section 31(4) amends the section 1(1) definition where the transaction, operation, scheme, agreement or understanding relates to the granting of any financial assistance. Section 31(4) provides that section 1(1) definition applies “(p)rovided that the expression ‘and no shareholder holds the majority voting rights in the company’ in paragraph (d)(v) of that definition must be disregarded”.

### **5. Application of the arm's length basis**

#### **5.1 General**

Guidance on the application of and adherence to the arm's length basis can be found in the OECD guidelines. For the purposes of thin capitalisation it is not intended that the OECD guidelines be ignored, however SARS will also consider the additional points discussed in **5.2** below.

## 5.2 Determining an arm's length amount of debt

In applying the arm's length basis, SARS requires taxpayers to consider the transaction from both the lender's perspective and the borrower's perspective. That is, from the lender's perspective, whether the amount borrowed **could** have been borrowed at arm's length (that is, what a lender would have been prepared to lend and therefore what a borrower could have borrowed) and from the borrower's perspective, whether the amount **would** have been borrowed at arm's length (that is, what a borrower acting in the best interests of its business would have borrowed). The arm's length amount of the debt is the lesser of the amount that could have been borrowed and the amount that would have been borrowed in a transaction between parties dealing at arm's length.

For example, taking all the relevant facts and circumstances into account, the arm's length amount of debt may be nil in circumstances where a taxpayer with a very healthy balance sheet, excess cash reserves and spare borrowing capacity borrowed from an offshore parent company when all the relevant facts indicate that there was no business need or reason or commercial benefit for the additional finance (assume the return was not greater than the cost involved). In this example independent lenders may have been prepared to lend to a person in the taxpayer's position but a person in the taxpayer's position would not have borrowed from an independent person on an arm's length basis. As with all thin capitalisation cases, the circumstances specific to the taxpayer will be considered on a case-by-case basis.

As noted in 4 and 5.2, taxpayers are required to determine the amount of debt that could have been borrowed and would have been borrowed at arm's length from an independent party and to take that amount into account when preparing their tax return and assessing what portion of the related expenditure, if any, is not deductible under section 31. This requires taxpayers to perform a functional analysis and a comparability analysis to support the appropriateness of their arm's length debt assessment.

In performing a functional analysis of the transaction, the items listed below are the types of factors or information which may be relevant and accordingly which taxpayers should take into account:

- The funding structure which has been or is in the process of being put in place, including the dates of transactions, the source of the funds (immediate and ultimate), reasons for obtaining the funds, how the funds were or will be applied (the purpose of the funding) and the repayment terms.
- The business (a high level understanding covering the relevant industry, the business itself, details regarding the management team and external market conditions) and the plans of the principal trading operations (including the business strategy).
- The financial strategy of the business, including how capital is allocated, the relationship between capital and cash flows from operations and any changes relating to the funding transactions; and details regarding the principal cash flows and the sources of repayment of debt.
- The companies in the group structure which are affected by or involved in the funding transactions and any changes to the structure taking place over the course of the funding transactions.

- The taxpayer's current and projected financial position for an appropriate period of time, including the assumptions underlying the projections and cash flows (for example, the appropriateness of the intended repayment through sale of the asset (if applicable) or increased profits).
- Appropriate financial ratios for the abovementioned periods (current and projected), for example:
  - Debt: EBITDA ratio
  - Interest cover ratio
  - Debt: Equity ratio
- Other indicators of the creditworthiness of the taxpayer, including, if available, any ratings by independent ratings agencies.
- The availability and quality of security.
- Whether or not the financial assistance is subordinate to the claims of other creditors.
- Terms and conditions of the funding arrangement such as the repayment terms, the period of funding and the cost of funding.

The use of comparable data is important in the context of an arm's length debt assessment because when considered in conjunction with all the relevant facts and circumstances it should support the position the taxpayer has reached. Accordingly, taxpayers must obtain comparable data, taking into account the quantitative and qualitative factors that third party lenders would typically consider when making lending decisions, to support the appropriateness of their arm's length debt assessment. For example, financial ratios for comparable taxpayers using third party provided commercial databases or potentially a competitor's position (if truly comparable).

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

### **5.3 The classification of debt and equity for purposes of arms length testing**

A critical element of the arm's length debt test is the appropriate identification of what constitutes debt and equity and ensuring that all debt arrangements are taken into account.

SARS's view is that independent parties dealing at arm's length would look to the economic substance of an item when assessing whether it is of a debt or equity nature or perhaps partly of a debt and partly of an equity nature. Accordingly, in determining the nature of a particular item the principles and treatment which would



be adopted in financial statements prepared in terms of International Financial Reporting Standards (IFRS) are a good guideline,<sup>3</sup> bearing in mind that the facts and circumstances of the particular case must always be taken into account in assessing whether any adjustments are required. Debt for purposes of arm's length testing will therefore include, for example, straightforward loans, advances and debts. In addition, it will include things that are economically equivalent to debt such as finance leases, certain structured derivative financial instruments and components of hybrid instruments.

#### 5.4 Determining whether the interest rate is arm's length

This Note focuses on providing guidance in relation to the determination of an arm's length amount of debt, however it is important that taxpayers do not lose sight of the fact that in addition to the amount of debt, the interest rate must also be arm's length.

Again, the facts and circumstances of each case are critical. A taxpayer may have an arm's length amount of debt but the interest rate may not be arm's length or *vice versa*. Alternatively, both the amount of debt and the interest rate may or may not be arm's length.

##### **Example 2 – Thin capitalisation and interest**

*Facts:*

A South African subsidiary borrows R60 million bearing interest at 15% from its foreign holding company. In an arm's length arrangement between independent parties, a lender would have been prepared to lend and a borrower would have been prepared to borrow R40 million bearing interest at 10%.

*Result:*

Two adjustments must be made under section 31. First, no deduction must be claimed for the interest on the excessive debt of R20 million. Second, no deduction must be claimed for the excessive interest (that is 5%) on the arm's length portion of the debt (that is, on the R40 million).

A taxpayer's credit rating, an approximation of which would be available from the use of the third party provided database, credit risk and scorecard models which SARS is investigating (see 5.2), may be used as a basis to determine the arm's length interest rate in conjunction with relevant external third party data.

#### 5.5 Timing

In order to determine whether an adjustment will be required under section 31 in the case of a term loan,<sup>4</sup> which falls within the definition of an affected transaction, it is necessary for taxpayers to specifically consider whether at the time of obtaining that debt they are thinly capitalised. In addition, subsequent to obtaining the debt a taxpayer must reassess the appropriateness of the level of debt and interest from time to time. It is not possible to give a standardised frequency of time at which a taxpayer must reassess whether the amount of debt is arm's length. The frequency and timing will depend on the nature of the particular taxpayer's business and the

<sup>3</sup> This would be the case even if the taxpayer does not prepare its account and financial records in terms of IFRS.

<sup>4</sup> A term loan is usually a loan which is granted for a fixed period of time and must be repaid as agreed between the parties within that period.

amount of change and variability it experiences. For example, some taxpayers may need to reassess quarterly but others may only need to test annually. The on-going assessment is in line with the principle of arm's length testing.

For debt *akin to an overdraft*<sup>5</sup> the testing must also be performed from time to time at appropriate intervals. Similarly, some taxpayers may need to test quarterly but others may only need to test annually.

## **6. Effect of a taxpayer being thinly capitalised**

### **6.1 Primary transfer pricing adjustment**

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

### **6.2 Secondary adjustments**

Section 31 provides for a secondary tax adjustment which arises from a primary transfer pricing adjustment (see **6.1**). The OECD Guidelines<sup>6</sup> explain that –

“these adjustments serve to make the actual allocation of profits consistent with the primary transfer pricing adjustment, some countries ... assert under their domestic legislation a constructive transaction (a secondary transaction), whereby the excess profits resulting from a primary adjustment are treated as having been transferred in some other form and taxed accordingly”.

This means that in addition to the primary adjustment, the amount of the disallowed deduction is deemed to be a loan by the taxpayer that constitutes an affected transaction.<sup>7</sup> As a result the taxpayer will have to calculate and account for interest income at an arm's length rate on the deemed loan. The accrued interest on the deemed loan will be capitalised annually for the purposes of calculating the deemed loan outstanding.

The deemed loan and the interest calculated on it will be deemed to be payable until the amount is regarded as having been repaid to the taxpayer. An amount will be regarded as having been repaid if, for example, the taxpayer is refunded the excessive interest or the other party pays the interest raised on the deemed loan.

To the extent that the deemed loan is regarded as having been repaid to the taxpayer by the end of the year of assessment in which the primary adjustment was made, the section 31 primary adjustment will not be treated as a loan for the purposes of section 31.

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<sup>5</sup> That is, debt where the amount is drawn down as required and does not have a fixed period of repayment.

<sup>6</sup> Paragraph 4.66.

<sup>7</sup> Section 31(3).

**Example 3 – Deemed loan***Facts:*

Foreign Parent lends its South African subsidiary R1,2 million on 30 June. Interest is payable at 6% per year. The subsidiary has a 31 December financial year-end.

The South African subsidiary determines that an arm's length amount of debt is R1 million and an arm's length interest rate is 6% per year.

*Result:*

The subsidiary must effect a primary adjustment in its tax return by not claiming a tax deduction for interest of R6 050 (R0,2 million x 6% x 184/365). This will increase the South African subsidiary's taxable income by R6 050.

The differential of R6 050 will constitute a deemed loan by the South African subsidiary to its Foreign Parent for the purposes of section 31. A secondary adjustment will not be required if the deemed loan is regarded as having been repaid by the end of the year of assessment in which the primary adjustment under section 31 is made. The deemed loan will be regarded as having been repaid if the subsidiary can demonstrate that it has received a refund from the Foreign Parent for the excessive interest of R6 050.

Assuming the deemed loan is not regarded as having been repaid by the end of the year of assessment, interest on the deemed loan must be calculated at the arm's length rate of 6% per year and included in taxable income. The calculation will need to take into consideration that the primary adjustment arose over a six-month period (that is, the interest which has been denied a tax deduction accrued over a six-month period from 30 June to 31 December). For every subsequent year of assessment deemed interest on the outstanding balance of the deemed loan will continue to be calculated and included in the subsidiary's income until the deemed loan is regarded as having been repaid. The interest on the deemed loan will be capitalised annually for the purposes of calculating the outstanding balance of the deemed loan.

**7. Risk assessment and selection of cases for audit****7.1 Thin capitalisation – arm's length debt**

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

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

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

The ratio is not a safe harbour and does not preclude SARS from auditing a taxpayer who is within the range of the abovementioned ratio. The ratio is merely indicative of the level of risk set by SARS for the purpose of selecting cases for audit. It is accepted that the ratio may vary in different industries and according to the creditworthiness of the particular taxpayer. Accordingly, the ratio may not be indicative of what constitutes an arm's length position for a particular taxpayer or industry; the ratio is merely used as a potential risk identifier.

SARS's risk assessment calculations will be based on the values stated in the audited financial statements relevant to the year of assessment under review. In the event of an audit, taxpayers may need to submit additional or more detailed data relevant to the transaction in order to substantiate the arm's length nature of the borrowed amount.

## 7.2 Arm's length rate of interest on inbound loans

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

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

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

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

These interest rates are not a safe harbour and do not preclude SARS from auditing a taxpayer where the interest rate does not exceed the rates mentioned above. The interest is merely indicative of the level of risk set by SARS for the purpose of selecting cases for audit.

## 8. Documentation guidelines

The documentation a taxpayer will need to support its arm's length amount of debt and, if applicable, thin capitalisation adjustment, will vary depending upon the facts and circumstances of the particular case including its' size and complexity. However, as a guideline SARS considers that, as appropriate to the particular facts and circumstances, taxpayers should retain the following documentation on their capitalisation position:

- A description of the funding structure which has been or is in the process of being put in place, including the dates of transactions, a clear statement of the source of the funds (immediate and ultimate), reasons for obtaining the funds, how the funds were or will be applied (the purpose of the funding) and the repayment terms.
- A description of the business (including the type of business, details of the specific business, details regarding the management team and external market conditions) and the plans of the principal trading operations (including the business strategy).

- Copies of relevant funding agreements and other relevant documents, for example, board minutes relevant to the funding, South African Reserve Bank applications and approvals, copies of related funding applications (for example, where part of the funding is received from an offshore bank).
- An analysis of the financial strategy of the business, including how capital is allocated and the relationship between capital and cash flows from operations and any changes relating to the funding transactions; and details regarding principal cash flows and the sources of repayment of debt.
- A group structure covering all relevant companies and clearly setting out any changes to the structure taking place over the course of the funding transactions.
- Copies of the financial statements or management accounts just before the point in time the funding is obtained and after the funding transactions.
- A summary of financial forecasts which are contemporaneous with the funding transactions in question, projected as far as is meaningful in relation to the period of the funding transactions, including a clear picture of the expected levels of interest cover, gearing or other relevant measures over the forecast period.
- An analysis supporting the borrower's view of the extent to which the connected party (or supported) debt is considered to be arm's length.

## **9. Tax treaties and permanent establishments**

South Africa has reserved the right to use the version 7 of the OECD Model Tax Convention, immediately prior to the July 2010 update. Paragraph 2 of Article 7 of this Model requires that the profits to be attributed to a permanent establishment are those which that permanent establishment would be expected to make if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar market conditions. As South Africa interprets Article 7 in accordance with the Commentary as it stood before the 2010 Update, SARS will apply the arm's length basis when attributing profits to a permanent establishment, but will not accept notional charges or expenses in calculating the profits to be attributed to the permanent establishment.

In applying the arm's length basis to potential thin capitalisation situations involving permanent establishments (see **4.1.2**), SARS will apply principles consistent with this principle. The permanent establishment will be viewed as a separate enterprise which is subject to the application of the arm's length basis but notional charges will not be permitted as a deduction. All criteria, including the risk assessment parameters, applied by SARS for thin capitalisation purposes to other entities will apply equally to the permanent establishments falling within the ambit of an affected transaction (see **4.1.2**).

The portion of debt which is provided to a non-resident (or a resident) and that is attributable to its South African (or foreign) permanent establishment, is a question of fact. SARS will consider all the relevant facts and circumstances of each case when considering this issue. SARS may therefore, for example, refer to the interest and other finance charges claimed by the permanent establishment as a deduction in the determination of its taxable income, as a factor in establishing what portion of the debt relates to the permanent establishment.

## 10. Headquarter companies

### 10.1 Relaxation of transfer pricing provisions

In principle, a headquarter company must comply with the transfer pricing provisions of section 31. However, there are two exceptions in circumstances involving the provision of financial assistance where the provisions of section 31 will not apply to a headquarter company.

The Act provides that where any transaction, operation, scheme, agreement or understanding has been entered into and in terms of which financial assistance is provided by –

- a non-resident person to a headquarter company, the provisions of section 31 will not apply to so much of that financial assistance which is directly applied to any foreign company in which the headquarter company directly or indirectly holds at least 10% of the equity shares and voting rights;<sup>8</sup> or
- a headquarter company to a foreign company in which the headquarter company directly or indirectly holds at least 10% of the equity shares and voting rights, the provisions of section 31 will not apply to that financial assistance.<sup>9</sup>

#### **Example 4 – Headquarter company**

*Facts:*

A non-resident connected person lends R50 million to a headquarter company. The headquarter company directly on-lends R20 million to a foreign company in which the headquarter company directly holds 30% of the equity shares and voting rights.

*Result:*

The provisions of section 31 will only apply to R30 million of the loan which was used for unspecified purposes. The provisions of section 31 will not apply to the loan advanced by the headquarter company of R20 million.

### 10.2 Ring-fencing of interest expenditure incurred on financial assistance granted by a non-resident

Section 20C(2) limits the deduction for interest payable by a headquarter company on financial assistance granted to it by a non-resident person (if a company it must hold at least 10%<sup>10</sup> of the equity shares and voting rights in the headquarter company) to the amount of interest received by or accruing to the headquarter company from any portion of that financial assistance that was directly applied as financial assistance to specified foreign companies. The specified foreign companies are foreign companies in which the headquarter company directly or indirectly, alone or together with any other company forming part of the same group of companies, held 10% of the equity shares and voting rights of that foreign company.

<sup>8</sup> The headquarter company may hold that interest alone or together with any other company forming part of the same group of companies.

<sup>9</sup> The headquarter company may hold that interest alone or together with any other company forming part of the same group of companies.

<sup>10</sup> It may hold that interest alone or together with any other company forming part of the same group of companies as that person.

Under section 20C(3), the amount disallowed under section 20C(2) must be –

- carried forward to the immediately succeeding year of assessment of the headquarter company; and
- deemed an amount of interest actually incurred by the headquarter company during that succeeding year of assessment on the financial assistance previously granted to the headquarter company by a person that is not a resident.

## **11. High-taxed controlled foreign companies**

Section 31(6)<sup>11</sup> provides that the provisions of section 31 will not apply to the calculation of taxable income or tax payable of a resident (other than a headquarter company) in respect of any amount received or accrued to a resident from any transaction, operation, scheme, agreement or understanding that comprises, amongst others, the granting of financial assistance to a controlled foreign company (CFC) in relation to the resident if:

- the resident (alone or together with a company in the same group of companies) owns at least 10% of the equity shares and voting rights in the CFC;
- that CFC has a foreign business establishment as defined in section 9D(1); and
- the aggregate amount of tax payable by the CFC to all spheres of government of a foreign country in respect of a particular tax year is at least 75% of the amount of tax that would have been payable in respect of the CFC's taxable income had the CFC been resident in South Africa in that year.

In calculating the aggregate amount of tax payable any applicable tax treaties and credits, rebate or right of recovery of tax from any sphere of government of a foreign country must be taken into account. In addition, any loss in respect of any year other than the particular foreign tax year or from a company other than the CFC must be disregarded.

## **12. Advance pricing agreements**

In relation to thin capitalisation, advance pricing agreements are the result of a process whereby taxpayers and tax administrations agree on the amount of debt which will and will not be considered arm's length. The process is conducted in advance of the transactions being undertaken or in advance of filing a tax return.

An advance agreement process is not currently available in South Africa.

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<sup>11</sup> With effect from years of assessment commencing on or after 1 January 2013.

### 13. Conclusion

In summary:

- Section 31 applies to affected transactions which are broadly cross border<sup>12</sup> transactions between connected persons that have been concluded on terms and conditions that would not have existed if the parties had been independent persons dealing at arm's length and those terms and conditions result or will result in a tax benefit.
- For years of assessment commencing on or after 1 April 2012, taxpayers must determine the acceptable amount of debt from affected transactions on an arm's length basis. There is no safe harbour amount of debt.
- Taxpayers are required to calculate taxable income based on the arm's length terms and conditions that should have applied to the affected transaction. This means that the interest and other charges relating to any excessive portion of affected transaction debt must be disallowed as a deduction in computing taxable income.
- In addition to a disallowed deduction for the interest and other charges, the amount of the disallowed deduction is deemed to be a loan by the taxpayer that constitutes an affected transaction. As a result the taxpayer will have to calculate and account for interest income at an arm's length rate of interest on the deemed loan.
- Taxpayers must also ensure that the amount of the interest rate is arm's length.
- SARS adopts a risk-based audit approach in selecting potential thin capitalisation cases for audit. SARS has detailed a ratio in the Note which is used as a risk identifier. The ratio is not a safe harbour and does not preclude SARS from auditing a taxpayer who is within the range of the ratio.
- Taxpayers must be able to substantiate their view of the extent to which the connected party (or supported) debt is considered to be arm's length and accordingly must retain appropriate documentation.
- The transfer pricing provisions have been relaxed in relation to certain transactions involving financial assistance and headquarter companies, with a corresponding limitation on the amount of the related interest deductions.
- The transfer pricing provisions will not apply to certain financial assistance transactions with CFC's that are taxed at a high rate in the foreign jurisdiction.
- South Africa does not currently have advance pricing agreements.

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<sup>12</sup> Cross border is used widely here; it includes transactions between two non-residents and transactions between two residents where the transaction involves a South African permanent establishment or a foreign permanent establishment respectively.



**Annexure – The law****Section 31**

**31. Tax payable in respect of international transactions to be based on arm's length principle.**—(1) For the purposes of this section—

**“affected transaction”** means any transaction, operation, scheme, agreement or understanding where—

- (a) that transaction, operation, scheme, agreement or understanding has been directly or indirectly entered into or effected between or for the benefit of either or both—
  - (i) (aa) a person that is a resident; and  
(bb) any other person that is not a resident;
  - (ii) (aa) a person that is not a resident; and  
(bb) any other person that is not a resident that has a permanent establishment in the Republic to which the transaction, operation, scheme, agreement or understanding relates;
  - (iii) (aa) a person that is a resident; and  
(bb) any other person that is a resident that has a permanent establishment outside the Republic to which the transaction, operation, scheme, agreement or understanding relates; or
  - (iv) (aa) a person that is not a resident; and  
(bb) any other person that is a controlled foreign company in relation to any resident,  
and those persons are connected persons in relation to one another; and
- (b) any term or condition of that transaction, operation, scheme, agreement or understanding is different from any term or condition that would have existed had those persons been independent persons dealing at arm's length;

**“financial assistance”** includes the provision of any—

- (a) debt; or
- (b) security or guarantee.

(2) Where—

- (a) any transaction, operation, scheme, agreement or understanding constitutes an affected transaction; and
- (b) any term or condition of that transaction, operation, scheme, agreement or understanding—
  - (i) is a term or condition contemplated in paragraph (b) of the definition of 'affected transaction'; and
  - (ii) results or will result in any tax benefit being derived by a person that is a party to that transaction, operation, scheme, agreement or understanding,

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

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

- (a) any amount that is, after taking subsection (2) into account, applied in the calculation of the taxable income of any resident that is a party to an affected transaction; and
- (b) any amount that would, but for subsection (2), have been applied in the calculation of the taxable income of the resident contemplated in paragraph (a),

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

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

- (a) the granting of any financial assistance; or
- (b) intellectual property as contemplated in the definition of ‘intellectual property’ in section 23I(1) or knowledge,

“**connected person**” means a connected person as defined in section 1: Provided that the expression ‘and no shareholder holds the majority voting rights in the company’ in paragraph (d)(v) of that definition must be disregarded.

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

- (a) any other person that is not a resident and that transaction, operation, scheme, agreement or understanding is in respect of the granting of financial assistance by that other person to that headquarter company, this section does not apply to so much of that financial assistance that is directly applied as financial assistance to any foreign company in which the headquarter company directly or indirectly (whether alone or together with any other company forming part of the same group of companies as that headquarter company) holds at least 10 per cent of the equity shares and voting rights;
- (b) any foreign company in which the headquarter company directly or indirectly (whether alone or together with any other company forming part of the same group of companies as that headquarter company) holds at least 10 per cent of the equity shares and voting rights and that transaction, operation, scheme, agreement or understanding comprises the granting of financial assistance by that headquarter company to that foreign company, this section does not apply to that financial assistance;
- (c) any other person that is not a resident and that transaction, operation, scheme, agreement or understanding is in respect of the granting of the use, right of use or permission to use any intellectual property as defined in section 23I (1) by that other person to that headquarter company, this section does not apply to the extent that the headquarter company—
  - (i) grants that use, right of use or permission to use that intellectual property to any foreign company in which the headquarter company directly or indirectly (whether alone or together with any other company forming part of the same group of companies as that headquarter company) holds at least 10 per cent of the equity shares and voting rights; and
  - (ii) does not make use of that intellectual property otherwise than as contemplated in subparagraph (i); or
- (d) any foreign company in which the headquarter company directly or indirectly (whether alone or together with any other company forming part of the same group of companies as that headquarter company) holds at least 10 per cent of the equity shares and voting rights and that transaction, operation, scheme, agreement or understanding comprises the granting of the use, right of use or permission to use any intellectual property as defined in section 23I (1) by that headquarter company to that foreign company, this section does not apply to that granting to that foreign company.

(6) Where any transaction, operation, scheme, agreement or understanding that comprises the granting of—

- (a) financial assistance; or
- (b) the use, right of use or permission to use any intellectual property as defined in section 23I,

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

- (i) that resident (whether alone or together with any other company forming part of the same group of companies as that resident) owns at least 10 per cent of the equity shares and voting rights in that controlled foreign company;
- (ii) that controlled foreign company has a foreign business establishment as defined in section 9D (1); and
- (iii) the aggregate amount of tax payable to all spheres of government of any country other than the Republic by that controlled foreign company in respect of any foreign tax year of that controlled foreign company during which that transaction, operation, scheme, agreement or understanding exists is at least 75 per cent of the amount of normal tax that would have been payable in respect of any taxable income of that controlled foreign company had that controlled foreign company been a resident for that foreign tax year: Provided that the aggregate amount of tax so payable must be determined—
  - (aa) after taking into account any applicable agreement for the prevention of double taxation and any credit, rebate or other right of recovery of tax from any sphere of government of any country other than the Republic; and
  - (bb) after disregarding any loss in respect of a year other than that foreign tax year or from a company other than that controlled foreign company.

## Section 20C

**20C. Ring-fencing of interest and royalties incurred by headquarter companies.**—(1) For the purposes of this section—

“**financial assistance**” means financial assistance contemplated in section 31 (1); and

“**royalty**” means any amount that is, before taking into account section 49D (b), subject to the withholding tax on royalties in terms of Part IVA.

(2) Where a headquarter company has during any year of assessment incurred any interest in respect of any financial assistance granted to that headquarter company by a person—

- (a) that is not a resident; and
- (b) if that person is a company, that directly or indirectly (and whether alone or together with any other company forming part of the same group of companies as that person) holds at least 10 per cent of the equity shares and voting rights in that headquarter company,

the amount of that interest in respect of which a deduction is allowable to that headquarter company in that year of assessment is limited to so much of the amount of interest received by or accrued to the headquarter company as relates to any portion of that financial assistance that is directly applied as financial assistance to any foreign company in which the headquarter company directly or indirectly (whether alone or together with any other company forming part of the same group of companies as that headquarter company) holds at least 10 per cent of the equity shares and voting rights.

(2A) Where a headquarter company has during any year of assessment incurred any amount that constitutes a royalty payable to a person—

- (a) that is not a resident; and
- (b) if that person is a company, that directly or indirectly (and whether alone or together with any other company forming part of the same group of companies as that person) holds at least 10 per cent of the equity shares and voting rights in that headquarter company,

the amount of that royalty in respect of which a deduction is allowable to that headquarter company in that year of assessment is limited to so much of any amounts received by or accrued to the headquarter company in respect of—

- (i) the use or right of use of or permission to use any intellectual property as defined in section 23I; or
- (ii) the imparting of or the undertaking to impart any scientific, technical, industrial or commercial knowledge or information, or the rendering of or the undertaking to render, any assistance or service in connection with the application or utilisation of such knowledge or information,

from any foreign company in which the headquarter company directly or indirectly (whether alone or together with any other company forming part of the same group of companies as that headquarter company) holds at least 10 per cent of the equity shares and voting rights.

(3) Any amount that is disallowed as a deduction in any year of assessment of a headquarter company in terms of subsection (2) or (2A) must—

- (a) be carried forward to the immediately succeeding year of assessment of the headquarter company; and
- (b) where that amount is disallowed as a deduction—
  - (i) in terms of subsection (2), be deemed to be an amount of interest actually incurred by the headquarter company during that succeeding year in respect of financial assistance granted to that headquarter company by a person that is not a resident; or
  - (ii) in terms of subsection (2A), be deemed to be an amount actually incurred by the headquarter company during that succeeding year that constitutes a royalty payable to a person that is not a resident.