New Section 31 rules
(thin capitalisation)

Introduction

The changes to South Africa's thin capitalization rules, contained in section 31 of the Income Tax Act (the Act), were legislated in 2010 and updated in the 2011 Taxation Laws Amendment Act. The new rules are effective from 1 April 2012 in respect of years of assessment commencing on or after this date. In making these changes the South African Revenue Service (SARS) felt that there was a need to align the wording of section 31 of the Act more closely with the wording in Article 9 of the Organization for Economic Cooperation and Development (OECD) Model Tax Convention (MTC). Ernst & Young agrees with this sentiment.

South Africa is a signatory to the OECD's MTC. In making these changes SARS wish to shift the focus of the legislation to the application of the arm's length principle such that fiscal adjustments made by SARS may be effected more efficiently. This is because Article 9(2) makes reference to the OECD Transfer Pricing Guidelines (the OECD Guidelines), which provides relief from economic double taxation caused by non-arm's length pricing.

The new legislation applies to transactions entered into between a South African resident who is a connected person, which is defined by section 1 of the Act, to their offshore investor. The new legislation is also applicable through indirect or common control. The new rules have been widened considerably to include transactions between Controlled Foreign Companies (CFCs) of South African tax residents.

By widening the new rules the legislation will be more closely aligned to that of section 9D, the CFC legislation, which provides for transfer pricing adjustments on transactions between a CFC and its connected persons. The legislation will also apply to transactions entered into with third parties, where the transaction is related to other transactions entered into between the South African tax resident and their offshore connected persons.
2. Background

South Africa introduced its current thin capitalization and transfer pricing rules in 1995 to combat financial leakage due to the anticipated relaxation of its exchange controls.

Aimed at limiting deductions of interest where there is a disproportionate ratio between loan capital and equity in a company, a 3:1 debt-to-equity safe harbor ratio was introduced as being a reasonable level of gearing. The Commissioner was required to determine whether the financial assistance to fixed capital ratio was excessive, and if so, to disallow the interest relating to the excessive portion of the financial assistance.

The Commissioner was required to consider the facts and circumstances of each case and, in this regard, the scope of the Commissioner's powers under section 31(3) were limited by Practice Note 2 (PN2).

3. The new section 31

In order to align the new legislation with the wording of Article 9 of the OECD MTC, which is based on the “separate entity” approach that the OECD Guidelines are also based on, transactions between the South African connected person and their offshore related parties should be conducted at arm’s length.

The safe harbor rules fall away along with PN2, which will be replaced with a new PN. Therefore, under the new legislation, SARS is required to apply the theoretical separate entity approach for determining how prices should be set between independent entities dealing at arm’s length. The OECD Guidelines do not discuss or provide recommendations around the design or implementation of thin capitalization legislation and neither do they recommend appropriate debt-to-equity ratios, from the point of view of the beneficiary of the offshore related-party financing arrangements.

Nevertheless, from 1 April 2012, SARS will deny deductions for interest that is deemed to be excessive by reference to the arm's length principle, which is defined in the OECD Guidelines as the pricing terms and conditions agreed upon between independent parties dealing at arm’s length. As yet, SARS has not provided guidance on how it intends applying the arm’s length principle to a South African company that is in receipt of financial assistance from offshore connected persons.

The approach commonly adopted by a number of other revenue authorities in this area is to hypothesize as to whether the beneficiary of the funding could have borrowed the same amount as that lent to them by connected persons from a third party, as an independent entity. The terms and conditions attached to the related-party financial assistance are also an important factor that revenue authorities look at as part of their compliance duties.

This approach is commonly referred to as the “could have” argument and is based on an analysis of the strength of the tested party’s balance sheet which, typically, a third-party lender would consider in deciding whether to lend to the tested party. The balance sheet analysis is designed to establish the ability of the tested party to service the debt and pay back the principal according to normal bank lending parameters.

Common metrics used by banks in this regard include debt service ability (interest coverage ratios), free cash flow analysis (debt/EBITDA ratios) and existing borrowings, as well as the terms and conditions attached (covenants) including the seniority of various debt levels.

4. Our Services

It is imperative that South African tax residents consider both inbound financial assistance and the capital structure of their CFCs going forward under the arm’s length principle. The phase-in of the new legislation offers a window for clients to test, plan and potentially correct any thinly capitalized positions proactively.

With the aid of our corporate finance team, assisted by our overseas colleagues who have significant experience in this area, we are well positioned to provide tailored strategies for our South African clients who are in receipt of financial assistance from offshore connected persons.

We are also well placed to provide advice on the implications of thinly capitalized CFCs of South African residents, which advice can be designed on a global basis so as to facilitate compliance from the perspective of a South African tax resident’s CFCs. Specifically, we have the capabilities to assist you to determine an arm’s length debt capacity with respect to offshore connected person financial assistance.

We recognize that higher debt-to-equity ratios are common in certain industries including banking and financial services, and for this reason our approach is based on an analysis of the capital structure of our client’s industry.

Our advice will include a detailed analysis of our client’s balance sheet as a starting point while local financial market and credit rating information will also be incorporated into our services, so as to develop robust and defendable strategies for our clients. International tax compliance is a priority for all our clients with offshore connected person dealings, and this is given even greater focus as a result of SARS’ increased vigilance in the area generally and transfer pricing and thin capitalization specifically.
5. Conclusion

For the reasons outlined above, we would urge our clients to:

• Consider the nature and extent of their offshore connected person financial transactions
• Pay close attention to the level of their connected person debt in relation to their CFCs
• Think about possible approaches to calculating arm’s length debt amounts on connected person debt

With effect from 1 April 2012, South Africa’s amended section 31 rules will more closely align to the wording of Article 9 of the OECD and UN Model Tax Conventions under which transfer pricing and thin capitalization adjustments are dealt with through South Africa’s tax treaty network. Accordingly, from now on, SARS officials will more closely follow the OECD Guidelines when conducting thin capitalization audits by applying the arm’s length principle to South African resident taxpayers in receipt of connected person debt and the capital structure of their CFCs.

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