Thin capitalisation rules are specific anti-avoidance provisions, very closely related to transfer pricing as they are designed to combat the extraction of profits from South Africa. The obvious reason for this is that interest paid to a related non-resident would be deductible in the hands of the South African company (therefore not subject to corporate tax or dividend withholding tax) and would be exempt in the hands of the non-resident recipient. Dividends, however, would not be deductible in the hands of the South African company but would be subject to dividend withholding tax at 15% and, in all likelihood, subject to tax in the foreign jurisdiction.

Historically a company was said to be “thinly capitalised” when its equity was less than the prescribed rate in comparison with its debt capital. In terms of SARS Practice Note 2, a debt/equity ratio that did not exceed 3:1 was acceptable for the purposes of s31(3) of the South African Income Tax Act.

This has all changed now. With effect from 22 March 2013 the thin capitalisation rules have been adjusted to incorporate the arm’s length principle, as the previous Practice Note 2 was replaced with the new Draft Interpretation Note. Accordingly, a company with its year-end on or after 31 March 2013 would need to adhere to the new regulations. At the Transfer Pricing Summit in September 2013 in Johannesburg, SARS emphasised that:

- There would be no interim period for taxpayers to rely on the debt-to equity ratio of 3:1 after 22 March 2013 as this had now been abolished.
- SARS is concerned about the non-existence of agreements as transactions entered into by third party companies should be contractually defined.
- SARS, however, made the statement that it is still considering introducing a safe harbour debt/equity ratio. This would in all likelihood be 1:1 or 1.5:1 at most, whereafter taxpayers would need to justify their arm’s length borrowings, should they fall outside this ratio.

Even though a safe harbour may exist in future, most South African taxpayers are likely to fall foul of this ratio and, therefore, would need to rely on transfer pricing principles to substantiate their borrowing positions.
Accordingly, taxpayers' borrowing positions, from a transfer pricing perspective, would need to be carefully evaluated when pricing these transactions. The arm's length principle requires that inter-company transactions be undertaken on similar terms to those entered into by independent companies.

Independent companies entering into borrowing relationships should be guided as follows:

- By determining the credit worthiness of the borrower. This leads to a debate on whether one should look at the entity on a standalone basis or in the context of the borrower being a member of a group when determining its credit rating. On a standalone basis the borrower within a multinational group would be treated as an independent party with its own financial status. In reality this would not be the case, as the transactions would be influenced by the fact that it is a member of a multi-national group and thereby shielded from certain influences. From the perspective of being a member of a group, a taxpayer, would be given the same credit rating as the multi-national group. Under this approach one would argue that a parent of a multi-national group would give implicit support to its subsidiary and would not let the subsidiary fail, should it run into financial difficulty.

- By being able to judge the expected loss fairly should the company default. Is the debt senior in relation to other loans? Accordingly, what is the priority for a claim to be paid? A subordinated claim will only paid be after the senior debt has been settled. What should also be taken into account is whether any guarantees are provided that would shield a loss should it occur.

- From the lender's perspective, the opportunity cost of making the loan should be evaluated. The terms of the loan should be considered together with the currency, market interest rates for the currency, repayment terms, fixed versus floating terms, country of the borrower etc.

Once these factors have been identified, it would be necessary for South African companies to perform an analysis to determine the arm's length amount that could be borrowed and the interest rate to be paid that would satisfy SARS. In performing this analysis, internal (relying on similar third party transactions that the company has entered into) or external (transactions between unaffiliated third parties) comparables could be used.

If an external comparable is used, data would normally be obtained from publicly available databases. The databases used would normally provide information on third party company loans and bond transactions and we expect SARS to follow the same process in determining whether South African companies would fall foul of the new thin capitalisation provisions.

**Loan agreements**

As mentioned by SARS at the Transfer Pricing Summit, it is vital proper legal documentation must accompany any related party loans. SARS expects that the related party loans are structured and documented in much the same way as agreements between third parties. If a certain clause is missing from a related party contract, of which it normally forms a part, SARS may impute the clause and either recalculate the pricing of the loan accordingly or disallow the
loan in its entirety. This also could be said if there is no agreement in place, which could lead to the adverse consequence of double taxation where one revenue authority deems the transaction to be debt and the other, equity. Therefore, related party loan agreements, which might have seemed to be unnecessary in the past, now need to be drafted and documented.

In conclusion, with the introduction of the new Draft Interpretation Note, South African companies are facing significant challenges to ensure that they adhere to the arm's length principles for related party loans. The decisions regarding related party loans would have an influence on the company as a whole and we expect greater co-ordination between the financial director and the group’s treasury department.

As SARS is increasing its focus on disallowing the interest expense as a deduction, taxpayers should arm themselves with proper transfer pricing and legal documentation. If properly structured and documented, related party loans should not cause financial directors sleepless nights.

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