South Africa issues thin capitalization guidance – U.S. businesses financing South African operations should review compliance

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SARS draft interpretation note on thin capitalization

The South African Revenue Service (SARS), March 22, issued a draft interpretation note regarding the new thin capitalization rules, which now form part of South Africa's transfer pricing provisions.

Background. South Africa introduced thin capitalization rules in its tax laws in 1995. Under the rules in effect until 2012, related party debt financing was viewed as excessive and resulted in the non-deductibility of interest to the extent the debt-to-equity ratio exceeded 3:1.

The thin cap rules were changed effective the assessment year starting on or after April 1, 2012, and the new requirements became part of the general transfer pricing provisions. The 3:1 debt-to-equity safe harbor was eliminated and instead the new rules introduced the arm’s length standard for related party financing transactions.

Before the issuance of the current draft interpretative note the SARS had not issued any guidance regarding the practical application of the new thin cap rules.

Draft interpretative note. Under the new thin capitalization rules, taxpayers are not permitted to deduct the portion of the interest related to a loan that is in excess to what would have been agreed upon between unrelated parties in an arm's length transaction.

According to the interpretative note, if the difference between the actual conditions of the loan and what would have been the arm’s length terms and conditions results in a tax benefit to either party, then the taxpayer is required to calculate its taxable income based on the arm's length conditions.

The arm's length conditions should be determined through a detailed transfer pricing analysis including a functional analysis, review of comparables and other qualitative and quantitative factors.

The interpretative note also indicates that SARS would not accept notional interest charges to South African permanent establishments (PEs).
RIA observation: South Africa reserved the right to use version 7 of the OECD Model Tax Convention and Commentaries (OECD Commentaries), which predates the July 2010 update of the same. The SARS interpretation of notional charges to PEs is in accordance with version 7 of the OECD Commentaries.

The SARS will apply a risk-based audit approach in selecting potential thin capitalization cases for review. The note describes the detailed financial ratio based on EBITDA (earnings before interest, taxes, depreciation and amortization) used by the SARS in selecting audit cases. If the ratio of debt-to-EBITDA is above 3:1, taxpayers are at risk of being audited. However, the SARS warns taxpayers to not view the 3:1 ratio as a safe harbor as taxpayers within the range may also be selected for audit based on subjective criteria, such as economic substance of the transaction.

The SRAS also provides documentation guidelines in the note. Thus, South African taxpayers should retain the following documentation with respect to related party loans:

- Description of funding structure;
- Description of the taxpayer’s business;
- Copies of relevant agreements;
- Analysis of financial strategy;
- Group structure;
- Copies of relevant financial statements;
- Financial forecasts that are contemporaneous with the financing transaction; and
- Transfer pricing study supporting the arm’s length nature of the transaction from the borrower’s perspective.

RIA observation: U.S. MNEs with operations in South Africa may have to carefully review the level of interest charged to South African related parties to ensure compliance with the new rules. Additionally, as previously there was a thin capitalization safe harbor for related party financing transactions, taxpayers may not have prepared in the past the documentation listed by the SARS to support the interest charged.