Where to with thin capitalisation?

The South African Revenue Service ("SARS") believes that the current thin capitalisation rules are not aligned with the views of the Organisation for Economic Co-operation and Development ("OECD") in that the thin capitalisation rules should form part of transfer pricing principles. Interest between connected parties should only be deductible to the extent that the underlying debt finance would have been granted if such funding was advanced by an unconnected party on an arm’s length basis. In other words, the extent of the debt must be measured against the arm’s length principle as a first test and only then should we consider whether the interest rate charged is an arm’s length price.

The current section 31(3) of the Income Tax Act, Act 58 of 1962 ("the Act") provides that a portion of the interest paid to a connected person will be disallowed where the total financial assistance was excessive in relation to the fixed capital contributed by such a connected person.

The proposed new section 31 of the Act deals with financial assistance as part of the transfer pricing provisions and the section no longer measures the ratio of the financial assistance in relation to the fixed capital. Thin capitalisation is therefore no more than one aspect of the transfer pricing rules. In other words, it appears that the current 3:1 debt/equity ratio, provided for in the SARS Practice Note 2, which was used to measure excessive financial interest, may no longer be applied. Based on the current wording of the new section 31, SARS may no longer be able to set any debt to equity safe harbour ratios.

This may indicate that the approach of SARS is shifting away from a quantitative rule of thumb (the 3:1 ratio) to a more
traditional transfer pricing analysis. If so, the new thin capitalisation provisions may require greater scrutiny from SARS and a more detailed transfer pricing analysis taking into account the specific facts and circumstances of each taxpayer. The rationale for debt funding as well as the economic environment in which an entity operates may then play a bigger role in determining the extent of the funding that will be acceptable to ensure an interest deduction. To determine whether a company is thinly capitalised will then require the application of the arm’s length principle. This is nothing more than an objective test to determine not only what a company could have borrowed but what it would have borrowed in an arm’s length situation. This inevitably involves a consideration of the subjective purpose behind the debt funding obtained.

In the absence of any guidelines from SARS on how thin capitalisation will be measured under the new rules (a new Practice Note is expected towards the end of 2010) we believe that SARS may take a principle’s based approach to thin capitalisation, one that observes the legislative requirement of applying the arm’s length principle. One hopes that the guidance given by SARS would include:

1. the use of synthetic credit scoring techniques to support a thin capitalisation analysis;
2. the status of senior debt when banks exchange debt for equity;
3. a focus on the special characteristics of Private Equity funding; and
4. an emphasis on whether a transaction would have been conducted at arm’s length rather than whether a transaction could have occurred.

This approach may result in a change in focus from SARS, away from the quantitative analysis of the past to a more commercial and market focused approach, which is based on a detailed understanding of the specific facts and circumstances
relating to the financing transaction, possibly resulting in making it more difficult for taxpayers in South Africa to obtain an interest deduction on funding received from connected parties.

Based on our interpretation of the new section 31, as well as the international developments on thin capitalisation, we believe that the practice of SARS may no longer provide a safe harbour ratio and that taxpayers will have to focus on broad principles to determine the arm’s length level of debt. This will place a greater emphasis on the importance of thin capitalisation when determining the arm’s length position which will require a thorough understanding of the business and the markets and drivers affecting the borrowing decisions and requirements.

Taxpayers must be prepared to fully document their decision processes in relation to debt financing and provide corroborative evidence to support their borrowing position. Taxpayers will be required to justify the level of debt funding based on an arm’s length position, without any quantitative safe harbour ratios, and only then can one determine the arm’s length interest rate that can be charged on such debt funding.