South Africa releases draft guidance on thin capitalization

April 8, 2013

In brief

The South African Revenue Service (SARS) on March 22 issued long-awaited guidance on the thin capitalization provisions of the South African Income Tax Act (the Act). The draft interpretation note could affect US multinationals with debt-funding into South Africa. The key features of the note are summarized below.

In detail

Before enactment of new South African thin capitalization rules in 2012, the previous South African thin capitalization regime provided a safe harbor for debt-to-equity of 3:1.

The new thin capitalization rules, which apply to tax years commencing on or after April 1, 2012, are part of the country's transfer pricing legislation. In general, the new thin capitalization rules provide that, to the extent financial assistance (in terms of the amount of the debt and/or the interest rate) is not arm's-length, the tax authorities will apply a primary transfer pricing adjustment, in the form of a disallowance of interest deductions, and a secondary adjustment, in the form of a deemed interest-bearing loan.

Until recently, SARS had issued no guidance on how to apply the new rules. On March 22, 2013, SARS issued a draft interpretation note on the new rules.

According to the draft interpretation note, SARS will require taxpayers to consider whether related-party debt is issued under arm's-length terms from the perspectives of both the lender and the borrower. The arm's-length amount of the debt is considered to be the lesser of the amount that could have been borrowed and the amount that would have been borrowed in a transaction between unconnected parties.

Under the draft interpretation note, a functional analysis will be required to support the appropriateness of the taxpayer's arm's-length debt assessment.

Taxpayers also will be required to consider comparable data, taking into account the quantitative and qualitative factors that third-party lenders would consider when making lending decisions. SARS is currently investigating the availability of a third-party South African-focused database to assist in assessing the appropriateness of a taxpayer's comparable data and the arm's-length amount of debt.

SARS also will consider economic substance in determining the debt or equity nature of an arrangement. 'Debt' would include items that are economically equivalent to debt, such as finance leases, certain structured derivative financial instruments, and components of hybrid instruments.

SARS will adopt a risk-based audit approach in selecting potential thin capitalization cases for audit. In selecting cases, SARS will consider transactions in which the debt-to-EBITDA (earnings before interest, taxes, depreciation, and amortization) ratio of the South African taxpayer exceeds 3:1 to be of greater risk.

Note: this is not a safe harbor. SARS will consider a taxpayer to be thinly capitalized if some or all of the following circumstances exist:

- The taxpayer is carrying a greater quantity of interest-bearing debt than it could sustain in its own right
- The duration of the lending is greater than in the case of an arm's-length arrangement
- The repayment or other terms do not reflect arm's-length arrangements.

The takeaway

According to the draft interpretation note, SARS will expect taxpayers to retain the proper documentation to support their capitalization position.

Therefore, groups with debt funding into South Africa should review their thin capitalization positions to ensure that they comply with the new rules and that they have the necessary supporting documentation in place.

Let's talk

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