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Submission File
27 September 2017

South African Revenue Service
Private Bag X923
Pretoria
0001
BY E-MAIL: [REDACTED]

Dear Sir/Madam

COMMENTS ON THE DRAFT INTERPRETATION NOTE ON THIN CAPITALISATION

1. We herewith take an opportunity to present our comments on behalf of the South African Institute of Chartered Accounts (SAICA) Transfer Pricing sub-committee (a sub-committee of the SAICA National Tax Committee) on the Draft Interpretation Note on Thin Capitalisation (Draft IN) released by the South African Revenue Service (SARS).
2. It is understood that SARS is in the process of finalising the Draft IN so SAICA would like to take this opportunity to provide some comments on the Draft IN in light of the Organisation for Economic Cooperation and Development's (OECD) Final Report under Base Erosion and Profit Shifting (BEPS) Action 4 and the guidance contained therein¹, together with recent case law creating an international precedent².
3. It is further acknowledged that the OECD BEPS Action 4 recommendation is considered a best practice approach and should be adopted as an alternate to existing thin capitalisation provisions, or in addition to existing thin capitalisation provisions. It also notes that Action 4 is not a minimum standard requirement under BEPS.

OBSERVATIONS

Direct and Indirect Funding

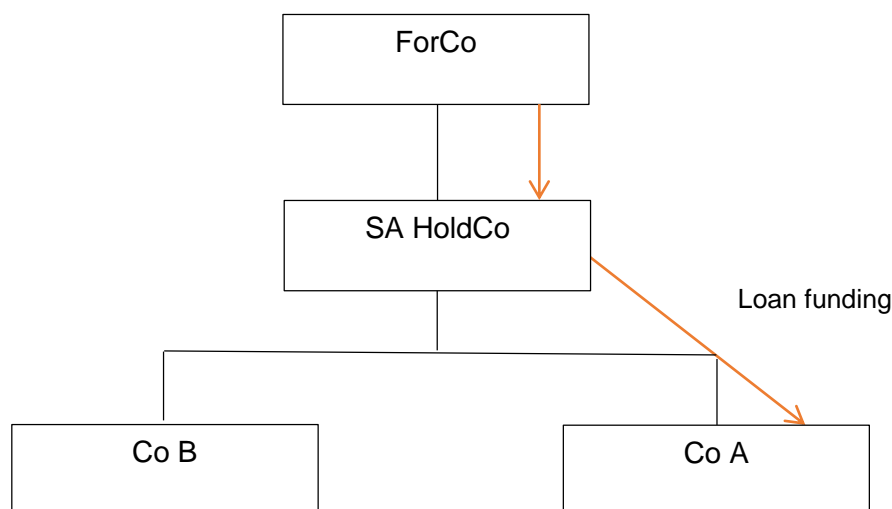
4. Multinationals sometimes provide funding through local headquarter companies which on lend to an operating company within the local group. The Draft IN does not currently provide guidance on at which level the thin capitalisation test should be performed or whether the test should be performed on both entities.

¹ OECD/G20 Base Erosion and Profit Shifting: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments - 2015 Final Report.

² Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (2017) FCAFC 62

5. For instance in the example below, ForCo provides a loan to SA Holdco which on lends to its subsidiary A. SA Holdco is merely a holding company with no operating revenue and it will therefore potentially fall foul of any Earnings before Interest, Taxes, Depreciation and Amortization (EBITDA) to Debt test advocated by SARS in assessing the risk of the transaction (see later). This could create a disallowance for some or all the interest expense in SA Holdco resulting in an adverse tax burden.

Figure 1



6. Submission: SARS should consider applying the thin capitalisation test at the level of the economic user of the loan, in this case Company A and disregard the application of the thin capitalisation test at the level of SA HoldCo. This should be clarified.
7. Alternatively, if SARS intends to adopt Action 4 in substitution to the current thin capitalisation rules, SARS should adopt the proposed group ratio approach as an alternative as advocated in the OECD Action 4 report (see below).

Guarantees

Implicit support

8. In the Draft IN SARS considers two aspects. Firstly, in assessing the creditworthiness of the borrowing entity it should be considered on a stand-alone basis, i.e. without taking into consideration parental support; and secondly, the existence of guarantees should be ignored.
9. The impact of parental support on both the creditworthiness of the borrowing entity and the effect of implicit guarantees was tested in the following cases:
 - *HM the Queen v General Electric Capital Canada Inc.* 2010 FCA 344; and
 - *Chevron Australia Holdings Pty Ltd v Commissioner for Taxation* FCAFC 62.



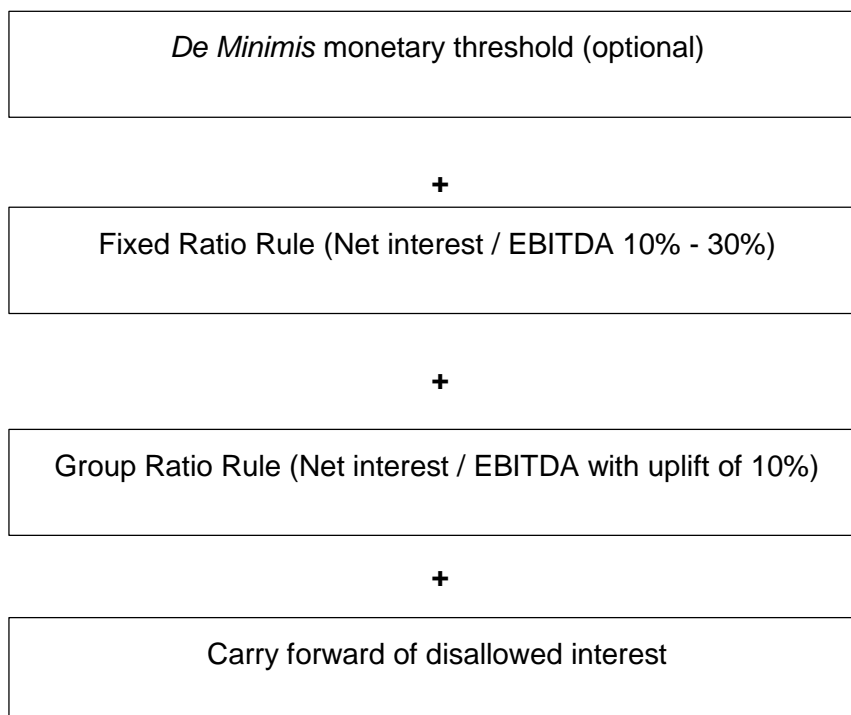
10. In terms of both these cases, it was held that an implicit guarantee or halo effect exists as a result of a company being a member of a group. A subsidiary's credit rating should therefore not be determined solely on the strength of its balance sheet as a stand-alone entity. There would need to be some recognition of its association with its parent, which would enhance its credit rating.
11. There is no basis for ignoring the affiliation between a subsidiary and its parent company and the starting point in assessing the loan arrangement should be what a commercial lender would do. Independent in the consideration of the arm's length test does not require the parties within the group to be independent of each other, but rather that the terms and conditions of the arrangement reflect independent characteristics seen between an independent lender and an independent borrower.
12. This enhanced ratio is still considered a passive benefit and would not attract a charge to a guarantee fee in the same way as an explicit guarantee would.

13. Submission: In finalising the Draft IN SARS is requested to consider the international precedent from the above cases.

Determining the arm's length amount of debt

14. SARS advocates a full transfer pricing analysis to support an arm's length amount of debt to be supported by a borrowing entity. This follows the broader OECD guidance applicable to transfer pricing. SARS advocates the use of the following ratios as indicators to use in undertaking this analysis:
 - Debt : EBITDA
 - Interest Cover
 - Debt : Equity
15. The OECD in Action 4 under the BEPS program recommends the following best practice approach:

Figure 2



16. Each of the above are discussed below in the context of the Draft IN.

De minimis rule

17. The purpose of this is to remove the requirement to test the appropriateness of the interest expense for those entities which have a low level of interest expense. The threshold needs to be set taking into account the interest rate climate of the jurisdiction.

18. Where other sections of the Income Tax Act No 58 of 1962 (ITA), notably section 23M, provide protection from excessive interest deductions, the argument for applying a *de minimis* exemption is further strengthened.

19. Submission: In order to alleviate the burden of supporting inbound loan transactions for taxpayers who receive small levels of debt, it would be beneficial for SARS to adopt a *de minimis* rule.

20. Section 29 of the Tax Administration Act No 28 of 2011 (TAA) already proposes a *de minimis* rule for documentation purposes, which suggests that requiring taxpayers to support small loan transaction through an onerous analysis would be contrary to this requirement. Thus a *de minimis* interest expense of R5 million could be applied.

Fixed ratio rule

21. In applying an arm's length test, SARS has indicated a ratio of: Debt: EBITDA of 3:1 or below to be of low risk. However this is not presented as a safe harbour. Thus, it provides no comfort to taxpayers that the arrangement will not be the subject of an audit and potential adjustment. It does not however consider the cost of the debt to the taxpayer.
22. The OECD advocates a fixed ratio rule of net interest to EBITDA. This limits an entity's interest expense as a percentage of its profits ensuring the interest expense is linked to the borrowing entity's economic activity. The percentage limit proposed is 10% - 30% with an uplift in cases where the jurisdiction has a high interest rate environment and a group ratio rule is not adopted (see below).

Group ratio rule

23. Because the use of a fixed ratio looks purely at the borrowing entity without taking cognisance of the group, the OECD recommends the fixed ratio rule be augmented through the use of a group ratio rule.
24. This allows the fixed ratio to be exceeded provided the group as a whole falls within the parameters set under the group ratio rule, thus taking into account any implicit support afforded by entities within the group. For jurisdictions with a high interest environment, the OECD proposes an uplift of at least 10% to the percentage under the group ratio rule.

25. Submission: SARS is also requested to consider adopting the guidance advocated in Action 4 of the OECD report for determining excessive debt levels and interest expense notably the fixed and group ratio rule and aligning this to the provisions of section 23M of the ITA. SARS is further requested to consider applying similar tests as a risk assessment as opposed to a Debt to EBITDA test for the purposes of section 31 of the ITA.

Interest rate pricing

26. In addition to providing a risk ratio for the quantum of the debt, SARS has also proposed an interest rate, which it considers represents low risk as follows:
- Weighted average JIBAR rate plus 2% for Rand denominated loans; or
 - Weighted average relevant base rate of interest plus 2%.
27. These rates are not a safe harbour and do not preclude SARS from auditing and adjusting the arrangement, thus they provide no certainty to the taxpayer.
28. The rates are considered commercially unrealistic in the context of South Africa's credit position. The above is also contrary to the existing guidance contained in Practice Note 2 (not withdrawn) and international precedent.
29. Whilst there should be recognition of an implicit guarantee where the loan is provided in a group context, it is improbable this guarantee would have the result of reducing the arm's length interest rate to a level of a risk free rate.

30. Submission: SARS is requested to consider adopting the OECD recommended approach to limiting interest deductions. Where a taxpayer falls within these guidelines it is suggested there should not be a further test needed on the applicable interest rate. Commercially the level of debt, together with other terms and conditions will drive the interest rate applicable.

Carry forward of disallowed interest

31. Currently SARS does not permit a carry forward of disallowed interest under the transfer pricing provisions and in fact penalises the taxpayer further by re-characterising the excessive interest as a deemed dividend. This creates a serious impediment to business and problems with the withholding tax position.

32. In addition, there is limited clarity on the withholding tax position in terms of the interest amounts already paid and the liability under the dividend withholding tax.

33. The OECD in Action 4 advocates that the disallowed portion of the interest expense should be carried forward. This allows flexibility for volatile results and timing differences. Periods for which a carry forward is allowed should be restricted and an appropriate restriction could be the duration of the loan arrangement.

34. Submission: The imposition of a secondary adjustment through the re-characterisation of the excessive interest creates a significant cost and very few other jurisdictions apply secondary adjustments. SARS is requested to consider whether the secondary adjustment is required in light of the restrictions already imposed under Article 11(6) of the Double Tax Agreement's.

Interaction with other sections of the ITA

35. It is understood that SARS has adopted an arm's length test as a primary test for determining excessive interest deductions with section 23M representing a further interest limitation test as a secondary mechanism. Neither of the test currently align to the OECD Action 4.

36. Whilst the OECD guidance accepts the right of countries to retain a dual system, it also advocated adoption of Action 4 as a best practice approach.

37. Submission: SARS is requested to consider the need for a dual system and whether acceptance of the best practice approach represents a better solution for South Africa in creating certainty for foreign investors and limiting the risk of potential double taxation.



CONCLUSION

38. We would like to thank SARS for the opportunity to provide constructive comments in relation to the Draft IN on Thin Capitalisation. SAICA believes that a collaborative approach is best suited in seeking actual solutions to complex problems.

Should you wish to clarify any of the above matters please do not hesitate to contact us.

Yours sincerely

Karen Miller

**MEMBER OF THE TRANSFER PRICING
SUB COMMITTEE**

Madelein Grobler

**SAICA PROJECT MANAGER: TAX
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The South African Institute of Chartered Accountants