

# South Africa

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## I. Introduction

The South African transfer pricing legislation, practice documentation and its application in practice is based on the OECD Transfer Pricing Guidelines ("the Guidelines"). The South African transfer pricing legislation provides a mechanism through which the adoption of the internationally accepted "arm's length principle" is achieved.

In broad terms, the South African transfer pricing rules will currently find application when there is a supply of "goods and services" between "connected persons" in a cross-border context.

Two specific practice notes have been drafted by the South African Revenue Services ("SARS") with regard to transfer pricing and thin capitalisation ("the SARS Practice Notes"). In these practice notes, it is expressly stated that the OECD Guidelines must be followed in the absence of any specific guidance in South Africa.

## II. Issue One

*Should the interest rate to be charged to related parties reflect their stand-alone creditworthiness?*

The South African transfer pricing legislation and practice documentation does not specifically refer to a person's creditworthiness in the determination of a transfer price.

The contractual terms of a transaction involving members of a multinational corporation provide evidence about the form in which the responsibilities, risks and benefits have been assigned among those members. According to the SARS Practice Notes, these contractual terms are relevant in the course of determining a transfer price. The contractual terms of an agreement will ordinarily include reference to *inter alia* terms of credit.

According to the SARS Practice Notes, the determination of an arm's length standard involves scrutinising a transaction to confirm whether it should have the substantive financial characteristics of a transaction between independent parties, where each party will strive to get the utmost possible benefit from the transaction. A person's credit rating will have an impact on the rate of interest to be charged to them by a particular service provider, especially in a context where the parties to the transaction are not connected persons.

It is therefore submitted that a party's stand-alone creditworthiness is one of the relevant factors to be taken into account in the determination of a market related interest rate in South Africa.

## III. Issue Two

*Should stand-alone creditworthiness be adjusted upwards to reflect the possibility of parental or wider group financial support?*

The preemptory adjustment of a person's creditworthiness is not prescribed in the South African transfer pricing legislation nor is it addressed in the practice documentation.

As noted above, an arm's length transaction is a transaction which should have the substantive financial characteristics of a transaction between independent parties, where each party will strive to get the utmost possible benefit from the transaction.

The possibility of an independent party receiving parental or wider group financial support would not generally contribute to a person's stand-alone creditworthiness should that person be engaging in a credit transaction with an unconnected person. It is the authors' view therefore that it is unlikely that creditworthiness will be adjusted by SARS to reflect financial support as it would not reflect the substantive financial characteristics of a transaction between connected persons.

## IV. Issue Three

*Should related parties be charged guarantee fees?*

The preemptory charging of guarantee fees is not prescribed in the South African transfer pricing legislation nor is it noted in the practice documentation.

However, the provision of a guarantee is specifically included as a "service" and as "financial assistance" for purposes of the application of the South African transfer pricing and thin capitalisation rules respectively. Accordingly, such provision will be subject to the transfer pricing and thin capitalisation rules should the guarantee be provided to a related party in a cross-border context, be in the nature of a service and include a corresponding charge.

It may be noted that a guarantee arrangement entered into between unconnected persons would generally include a fee being levied for the service unless there is some other direct or indirect benefit received

due to the provision of such guarantee. A guarantee would ordinarily be provided to improve the credit rating of the borrower and would therefore be to its benefit.

It must be noted, however, that it may not be appropriate to levy a guarantee fee in certain circumstances.

If for example, a group holding company provides a guarantee to a subsidiary which is in substance given in pursuance of a transaction for the benefit of the group holding company and for its own purposes, there should not be any corresponding charge attached to it. This may be the case where such holding company intends to acquire an asset, but provides a guarantee to a subsidiary that will be required to acquire the necessary finance and be responsible for the settlement of the purchase price. In such a case, the provision of the guarantee is made to discharge the obligation of the holding company and enable the subsidiary to settle the purchase price. The subsidiary company derives no benefit through the provision of a guarantee and it is provided for mere administrative purposes and in the interest of convenience. The payment of a fee by the subsidiary in such circumstances will be unjustifiable in the context of the transaction.

In summary, it is clear that the non-charging of a fee in certain cases may therefore be deemed to be "arm's length". The provision of a guarantee will generally attract a fee to the extent that a service is being provided for the benefit of the recipient and not for purposes of the guarantor.

#### V. Issue Four

*How should related party guarantee fees be calculated? Should they be adjusted downwards to reflect the possibility of parental or group support?*

The possibility of an independent party receiving parental or wider group financial support when providing a guarantee will ordinarily bring about a reduction in the guarantee fee charged by such independent party. This follows as a result of the reduced risk involved on the part of the independent party.

As noted, the provision of a guarantee falls within the definition of "services" for purposes of the application of the South African transfer pricing and thin capitalisation rules respectively. The quantum of the fee to be charged will therefore need to comply with the arm's length standard and be market related. As noted above, it may be acceptable to not charge a fee in certain circumstances when determining an "arm's length" consideration

#### VI. Issue Five

*In cases where debt is raised from external sources but with the benefit of a related party guarantee, how is that guarantee taken into account in assessing the deductibility of interest (and other incidental costs of borrowing) by the borrower?*

Interest will remain freely deductible by the borrower as the loan finance is provided by an unrelated person. The provision of the guarantee by the related party will not have an impact on the deductibility of the interest.

SARS may adjust the consideration, for tax purposes, if the actual price is either less or greater than the price that would have been set if the supply or acquisition of goods or services had occurred between independent parties on an arm's length basis. It follows that the deductibility of a guarantee fee will therefore be limited in line with normal transfer pricing principles, to the extent that the fee is regarded as excessive.

#### VII. Issue Six

*How should the interest rates on cash pool debit and credit balances be determined?*

It is generally accepted in South Africa that a group treasury company which invests cash funds on behalf of other related group entities is performing a "service" as defined for purposes of the South African transfer pricing rules. Accordingly, it should be remunerated for such service in accordance with normal transfer pricing principles and receive an arm's length fee.

Should funds be advanced to a group treasury company, it is submitted that SARS will seek to apply the transfer pricing rules and ensure that the interest received is market related bearing in mind *inter alia* any risks undertaken by the group treasury company and the benefits derived by the investors.

Furthermore, any fee charged by the group treasury company for such a service, whether it is charged separately or charged through a reduction in the interest which is paid to the investor, will also be subject to normal transfer pricing principles (i.e. in line with market related rates).

#### VIII. Issue Seven

*How do the transfer pricing rules interact with any thin capitalisation rules?*

##### A. Thin Capitalisation

In the context of a South African company, the revenue authorities can disallow an income tax deduction for interest incurred on that portion of a foreign shareholder loan that is considered to be excessive in relation to the value of the shares held by the foreign shareholder. The South African revenue authorities have to date accepted a debt to equity ratio of up to 3:1 in regard to shareholder loans for thin capitalisation purposes, and this ratio has been confirmed in a practice note.

##### B. Transfer Pricing

Notwithstanding the limitations imposed on the deductibility of interest by the thin capitalisation rules, it must be noted that the transfer pricing rules will also find application and further limit the deductibility of interest but in accordance with an acceptable interest rate.

Where consideration relating to financial assistance is excessive in the sense that the consideration does not reflect an arm's length price, the revenue authorities may adjust the consideration in the hands of a South African resident to reflect an arm's length consideration in relation to the financial assistance

granted. Consideration, in the context of financial assistance, will be interpreted to include not only interest or related finance charges, but also a discount or premium.

Where the loan, advance or debt is denominated in South African Rands, a rate not exceeding the weighted average of the South African prime rate plus 2 percentage points will be an acceptable nominal annual interest rate. Where the loan, advance or debt is denominated in a foreign currency, a rate not exceeding the weighted average of the relevant inter bank rate plus 2 percentage points will be an acceptable nominal annual interest rate. Any interest exceeding the above mentioned prescribed rates will be regarded as excessive interest and will consequently not be allowed as a deduction for income tax purposes.

### **C. Amendments**

It should be noted that the South African transfer pricing and thin capitalisation will be amended with effect from October 1, 2011. SARS will also publish a new guidance note in this regard before that date.

The new rules will apply to any cross-border transaction, operation, scheme, arrangement or under-

standing entered into between connected persons and will be tested on an arm's length basis, taking into account, inter alia, whether any term or condition of that transaction is different from any terms or conditions that would have existed had those persons been independent persons dealing at arm's length.

The current thin capitalisation debt to equity ratio safe haven will cease to apply under the new rules. Instead the amount of any foreign shareholder loan funding will be tested against the loan funding that would have been made available if the foreign shareholder and the company had been independent persons dealing at arm's length. It is unknown whether any "safe-harbour" thin capitalisation ratio, like the current ratio of 3:1, will be contained in the proposed new guidance note.

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