SARS
South African Revenue Service

INTERPRETATION NOTE 127

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ACT	**:**	**INCOME TAX ACT 58 OF 1962**
SECTION	**:**	**SECTION 31**
SUBJECT	**:**	**DETERMINATION OF THE TAXABLE INCOME OF CERTAIN PERSONS FROM INTERNATIONAL TRANSACTIONS: INTRA-GROUP LOANS**

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Preamble

In this Note unless the context indicates otherwise –

- **“affected transaction”** means a transaction as defined in the **Annexure**;
- **“associated enterprise”** means a person as referred to in **4.1.4**;
- **“connected person”** means a person as referred to in **4.1.3**;
- **“controlled transaction**” means a transaction specified in paragraph (*a*) of the definition of an “affected transaction”;
- **“members”** means the constituent parts (including natural persons) of an MNE Group, each having a separate legal existence;
- **“MNE”** means a multinational enterprise;
- **“MNE group”** means any group[1] of connected persons or associated enterprises with business establishments in more than one country;
- **“multinational enterprise”** means any member of an MNE group;
- **“OECD”** means the Organisation for Economic Co-operation and Development;
- **“OECD Guidelines”** means the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations which are applicable to the particular year of assessment;
- **“OECD Model Tax Convention”** means the OECD Model Tax Convention on Income and on Capital;
- **“relevant party**” means a connected person or an associated enterprise specified in paragraph (*a*) of the definition of an “affected transaction”;[2]
- **“section”** means a section of the Act unless specified otherwise;
- **“tax benefit”** includes any avoidance, postponement or reduction of any liability for tax or penalty imposed in terms of the Act;[3]
- **“the Act”** means the Income Tax Act 58 of 1962; and
- any word or expression bears the meaning ascribed to it in the Act.

All guides and interpretation notes referred to in this Note are available on the SARS website at **www.sars.gov.za.** Unless indicated otherwise, the latest issue of these documents should be consulted.

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[1] A group being two or more persons.

[2] See **4.1.2** - **4.1.4**. Associated enterprises effective from years of assessment commencing on or after 1 January 2023.

[3] A tax or penalty imposed under the Act includes any tax or penalty imposed under the Act and is not limited to income tax.

1. Purpose

This Note provides taxpayers with guidance on the application of the arm's length principle in the context of the pricing of intra-group loans. The pricing of intra-group loans includes a consideration of both the amount of debt and the cost of the debt.

An intra-group loan would be incorrectly priced if the amount of debt funding, the cost of the debt or both are excessive compared to what is arm's length. The Note also provides guidance on the consequences for a taxpayer if the amount of debt, the cost of debt or both are not arm's length.

The guidance and examples provided are not an exhaustive consideration of every issue that might arise. Each case will be decided on its own merits taking into account its specific facts and circumstances.

The application of the arm's length principle is inherently of a detailed factual nature and takes into account a wide range of factors particular to the specific taxpayer concerned.

Section 31 was substituted by the Taxation Laws Amendment Act, 2011 with effect from years of assessment commencing on or after 1 April 2012. Practice Note 2 of 14 May 1996[4] and its Addendum of 17 May 2002, which gave guidance on section 31(3), were withdrawn for years of assessment commencing on or after 1 April 2012, since they were no longer applicable from the date the legislation changed.

2. Background

Taxpayers are broadly financed in two ways, namely using equity and debt. The returns on equity capital and debt capital are treated differently for tax purposes. Interest payments incurred in the production of income by a person carrying on a trade are, subject to certain conditions, exceptions and restrictions, deductible in determining taxable income while dividends and returns of capital are not deductible.

The way in which a taxpayer is financed has an impact on the calculation of the taxpayer's taxable income. This raises tax concerns regarding the balance between the amount of equity capital and debt capital. A taxpayer that is considered to have too much debt when considered against the amount of its equity is said to be thinly capitalised for tax purposes.

Thin capitalisation becomes a potential issue where a South African taxpayer is directly or indirectly funded by a non-resident relevant party.[5] The funding of a South African taxpayer with excessive intra-group, back-to-back or intra-group-guaranteed debt[6] may result in excessive interest deductions thereby depleting the South African tax base when there is a mismatch with the taxability of the interest income because of interest exemptions and reduced rates of withholding tax on interest.

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[4] "Income Tax: Determination of Taxable Income where Financial Assistance has been Granted by a Non-resident of the Republic to a Resident of the Republic".

[5] Associated enterprises effective from years of assessment commencing on or after 1 January 2023.

[6] That is, intra-group funding by a relevant party which is routed on a back-to-back basis through an independent party or debt from an independent party which is guaranteed by a relevant party.

South Africa introduced thin capitalisation rules in 1995. Under these rules, which were contained in section 31(3), the Commissioner was empowered to have regard to the international financial assistance rendered and if it was considered excessive in proportion to the particular lender's fixed capital in the borrower, the interest, finance charges or other consideration relating to the excessive financial assistance were disallowed. The Commissioner's views on what constituted excessive international financial assistance were documented in Practice Note 2 of 14 May 1996. These rules and Practice Note 2 have been repealed and are only applicable to years of assessment commencing before 1 April 2012.

For years of assessment commencing on or after 1 April 2012, thin capitalisation is no longer dealt with by a separate subsection of section 31 and is instead governed by the general transfer pricing provisions of section 31(2).[7] Section 31(2) applies to, for example, the amount of the intra-group loan and the rate of interest incurred during years of assessment commencing on or after 1 April 2012 irrespective of whether the underlying loan was initially granted before, on or after that date.

One of the most significant changes is that taxpayers must determine the acceptable amount of debt applying arm's length principles. The application of the arm's length principle to intra-group loans will be considered further in this Note.

The pricing of intra-group loans includes a consideration of both the amount of debt and the cost of the debt.

This Note deals with the provisions of section 31 which, as noted above, are applicable for years of assessment commencing on or after 1 April 2012. For example, in the case of a year of assessment ending on 31 December, the first year of assessment to which the new legislation applies is the year of assessment commencing on 1 January 2013 and ending on 31 December 2013.

3. The law

The relevant sections of the Act are quoted in the **Annexure**.

4. Application of the law

Section 31 requires taxpayers to –

- determine whether the actual terms and conditions of any transaction, operation, scheme, agreement or understanding meeting paragraph (*a*) of the definition of an "affected transaction"[8] are different from the terms and conditions that would have existed if the relevant parties had been independent persons dealing at arm's length; and
- if there is a difference which results or will result in a tax benefit for the taxpayer that is a party to the affected transaction, to calculate their taxable income or tax payable based on the arm's length terms and conditions of the affected transaction.

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[7] Section 57 of the Taxation Laws Amendment Act 24 of 2011.

[8] See the **Annexure** – section 31(1) "affected transaction".

Accordingly, if the actual terms and conditions of an affected transaction involving loans and other debt are not those that would have been agreed if the lender and borrower had been transacting at arm's length, and if this difference results or will result in a tax benefit[9] to any of the parties, then that taxpayer is required to calculate its taxable income based on the arm's length terms and conditions that should have applied to the affected transaction.

When a taxpayer assesses whether an affected transaction's non-arm's length term or condition results or will result in a tax benefit under section 31(2)(*b*)(*ii*), that assessment is based on an assumption that the non-arm's length term or condition, as appropriate, is taken into account in calculating taxable income or tax payable. If the answer is that it would give rise to a tax benefit compared to if an arm's length term or condition had applied, then the "actual" taxable income or "actual" tax payable by the person contemplated in section 31(2)(b)(*ii*) must be calculated as if the transaction had been conducted on an arm's length basis. The taxpayer is required to calculate their taxable income or tax payable on this basis and therefore the arm's length principle would need to be taken into account before any relevant return is submitted. See **9.1 Primary transfer pricing adjustment**.

The terms and conditions of an affected transaction may be tax motivated, however this is not a requirement under section 31.[10] An adjustment under section 31 may be required irrespective of whether the terms and conditions of an affected transaction were tax motivated.

Taxable income or tax payable must be calculated applying arm's length principles.

4.1 Paragraph (*a*) of the definition of an "affected transaction"

The wording of paragraph (*a*) of the definition of an "affected transaction" has been included in the **Annexure**.

It is impractical to give a detailed list of all the transactions which constitute affected transactions. Taxpayers must consider their particular facts and circumstances and identify transactions that potentially constitute an affected transaction per the definition referred to above.

4.1.1 Direct and indirect funding

The wording used in section 31 is wide and applies to transactions, operations, schemes, agreements and understandings that have been directly or indirectly entered into or effected between or for the benefit of either or both of the parties specified in the definition. The section is therefore far wider than a loan between two of the parties specified in paragraph (*a*) of the definition of an "affected transaction" and takes into account the chain of borrowing entities including the ultimate borrower.

In assessing whether a transaction, operation, scheme, agreement or understanding has been indirectly entered into or effected between or for the benefit of the parties indicated above, it is always necessary to consider the facts and circumstances of a particular case. For example, A (a foreign holding company) lends $10 million to B and B lends $9 750 000 to C (A's South African-resident subsidiary). B may or may not be a relevant party in relation to A and C. It is necessary to determine whether the transaction between A and B is a contributing factor to the financial assistance being

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[9] As defined in section 1(1), includes any avoidance, postponement or reduction of any liability for tax.

[10] Section 31(2) refers to a tax benefit and is accordingly not concerned with a taxpayer's reasons or motivations for the transaction.

considered between B and C and, if so, whether that link is sufficiently close so as to be considered indirect financial assistance or whether the link is too remote. It is possible that a sufficiently close link may only be present for part of the financial assistance in which case only that part will be considered indirect financial assistance. An assessment and judgement call as to whether the necessary link exists can only be made on a case-by-case basis when taking the particular facts and circumstances of the case into account.

Example 1 – Indirect financial assistance

Facts:

X, a foreign company, disposed of a significant asset for USD1 billion in year 1 and deposited the proceeds with a foreign bank, Bank A, on a 3-year fixed deposit.

In year 3 a South African company, which is 100% held by X, required R10 million to fund the expansion of its plant and independently approached various banks. Bank A and a local bank each provided the South African company with a loan of R5 million.

The fixed deposit was not used as security for the loan granted by Bank A or the local bank to the South African company.

Result:

The fixed deposit could conceivably be viewed as a contributing factor to the R5 million loan granted by Bank A. However, on these facts, the connection between the fixed deposit made by Bank A in year 1 and the loan granted to the South African company in year 3 is considered too remote to constitute indirect financial assistance.

Example 2 – Indirect financial assistance

Facts:

B, a South African company, which is 100% held by Z, a foreign company, needs R10 million to finance its plant expansion. B would like to obtain the finance on loan account repayable over 5 years.

Bank A is not prepared to lend to B unless Z places R11 million on deposit with Bank A for 5 years and 6 months. The agreement with Z is concluded and thereafter the agreement with B is concluded, neither of the agreements refers to the other agreement.

Result:

On these facts it is clear that Z's deposit is a contributing factor to the loan granted by Bank A to B. The direct connection between the deposit and the loan is sufficiently close to constitute indirect financial assistance.

The result would be the same irrespective of whether Bank A was an independent party or a connected party.

Example 3 – Indirect financial assistance

Facts:

X, a foreign company, holds 100% of the shares in two South African tax resident companies, B and C. B and C are both trading companies. B is funded by equity and retained profits. Company C is funded by minimal equity and significant levels of debt.

C wishes to expand its manufacturing facilities and requires a loan of R10 million to fund the expansion plans.

X grants B a loan of R10 million and B subsequently grants C a loan of R10 million. The R10 million does not result in B being thinly capitalised under section 31.

Result:

It is clear that the R10 million loan from X is a contributing factor to the loan granted by B to C. The direct connection between loan from X to B and the loan from B to C is sufficiently close to constitute indirect financial assistance.

Indirect financial assistance[11] may include, but is not limited to, back-to-back transactions with banks or other financial institutions (for example, one in which a non-resident MNE places funds on deposit with a bank and the bank then loans funds to a South African resident MNE), the provision of guarantees[12] by a non-resident MNE to a bank or other financial institution in connection with funding given by that bank or financial institution to a resident MNE, or other arrangements in which funding provided by a foreign relevant party is routed through one or more special purpose entities or other accommodating or tax-indifferent parties.[13] In general, indirect financial assistance will be treated as if the funding had been provided directly between the two relevant parties.

In a case that involves indirect financial assistance as a result of a guarantee provided by a non-resident relevant party to an independent party, the effect of the guarantee on the determination of how much the South African taxpayer could have borrowed will have to be considered on a case-by-case basis.

A guarantee from another party may be used to support the borrower's credit in the case of a loan between relevant parties. A lender placing reliance on a guarantee or guarantees would need to evaluate the guarantor(s) in a similar way to that in which it evaluates the original borrower. For the lender to take a guarantee into account in setting or adjusting the terms and conditions of a loan, it would need to be reasonably satisfied that the guarantor(s) would be able to meet any shortfall resulting from the borrower being unable to meet its obligations in full in the event of a default.[14]

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[11] See opening paragraphs in **4.1.1**.

[12] In the situation referred to in this instance, the guarantee provided by a member of a MNE to a third party in respect of finance to be provided by that third party to another member of the MNE may, depending on the facts, result in the loan being seen as being indirectly provided by one group member to the other.

[13] See section 80E for the meaning of accommodating or tax-indifferent parties.

[14] See paragraph 10.87 of Chapter X of the OECD Guidelines.

The possible indirect financial assistance impact of a guarantee on a loan (as referred to above) is an aspect which is different to and is considered in addition to the actual guarantee. A guarantee which is correctly priced in terms of arm's length principles may mean, but does not necessarily mean, that the guarantee does not have an indirect financial assistance implication for the loan.

Example 4 – Connected party credit protection

Facts:

Foreign Co is a multinational company that wishes to recapitalise its 100%-held South African subsidiary (SA Subco) by an additional R2 million.

There are two proposals on the table. Under the first proposal (Proposal 1), SA Subco will issue R0,5 million in equity to Foreign Co and borrow the remaining R1,5 million from SA Bank A at 8,5%. Under the second proposal (Proposal 2), SA Bank B is willing to lend SA Subco R2 million at 9%, provided that Foreign Co provides SA Bank B with credit protection in the event that SA Subco defaults on its loan obligations. Foreign Co will however charge SA Bank B an annual fee of 2,5 % of the loan value for providing such credit support. An independent party would not have provided credit protection for this transaction.

It is assumed for purposes of this example that the maximum amount SA Subco could borrow in an arm's length transaction would be R1,5 million and that the applicable arm's length interest rate would be 8,5% on the basis that there is a further equity injection of R0,5 million.

SA Subco accepted proposal 2.

Result:

Two adjustments will be required. First, R0,5 million of the loan will be treated as a direct loan by Foreign Co to SA Subco and the interest expense attributable to that portion of the loan will be denied in full. Second, SA Subco will be denied a deduction for 0,5% interest on the remaining R1,5 million of the loan.

This will result in the interest deduction enjoyed by SA Subco being reduced by R52 500 [(R500 000 × 9%) + (R1 500 000 × 0,5%)].

4.1.2 Parties specified in paragraph (*a*) of the definition of an "affected transaction"

The parties specified in the definition are detailed in the **Annexure**.

The parties potentially falling within the ambit of section 31 is wider than might have been the case under previous versions of the section 31 legislation. Section 31 includes, amongst others, certain situations where the transaction, operation, scheme, agreement or understanding is between a non-resident and another non-resident's permanent establishment in the Republic or alternatively between a resident and another resident's permanent establishment which is located outside the Republic.

This means, for example, that if a non-resident subsidiary of an MNE group provides a loan to another non-resident subsidiary of that MNE group and that subsidiary channels the funds through to its South African permanent establishment, the transaction potentially falls within the ambit of an affected transaction. The quantum of the loan and the interest rate must be considered under section 31 in the case of an affected transaction which is a loan (see **11** for a consideration of the application to permanent establishments).

"Connected person" (see **4.1.3**) and "associated enterprise" (see **4.1.4**) are terms used in paragraph (*a*) of the definition of an "affected transaction". "Connected person" and "associated enterprise" are not mutually exclusive. Depending on the facts a person could fall within the definition of "connected person" or "associated enterprise", or alternatively both definitions.

4.1.3 Connected person

The term "connected person" is defined in section 1(1). Guidance on the definition of a "connected person" is provided in Interpretation Note 67 "Connected Persons".

In addition, section 31(4) changes the section 1(1) definition where the transaction, operation, scheme, agreement or understanding relates to the granting of any financial assistance. Section 31(4) provides that the definition of "connected person" in section 1(1) applies "provided that the expression 'and no shareholder holds the majority voting rights in the company' in paragraph (*d*)(v) of that definition must be disregarded".

4.1.4 Associated enterprise

The term "associated enterprise" is defined in section 31 as an associated enterprise as contemplated in Article 9 of the OECD Model Tax Convention.[15] The definition is included in the **Annexure**.[16]

Example – Associated Enterprise

Facts:

X, a foreign tax resident company, holds 100% of the shares in Y, a foreign tax resident company, which in turn holds 100% of the shares in Z, a company that is tax resident in South Africa. X is listed on the Stock Exchange in Country A.

M, a foreign tax resident company, indirectly holds 60% of the shares in N, a foreign tax resident company, which in turn holds 80% of the shares in O, also a foreign tax resident company. M is listed on the Stock Exchange in Country B.

Company X and Company M have a common board of directors under which all the above-mentioned companies are practically managed and controlled. Pricing is a strategic strategy and the groups transfer pricing policies are set at a board level. Company X and Company M have an agreement in terms of which any returns to shareholders are equalised.

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[15] The inclusion of associated enterprises in section 31 is effective from years of assessment commencing on or after 1 January 2023.

[16] Detailed guidance on the definition of "associated enterprise" is beyond the scope of this Note. Additional guidance will be issued separately.

Z manufactures and sells products to O which in its role as the group's worldwide marketing and distribution centre on-sells the products worldwide. Pricing is managed and controlled by X and M, through a centralised pricing policy for the group that each member (for example Z and O) of the group must adhere to for transactions entered into between one another.

Result:

If the same persons participate directly or indirectly in the management, control or capital of two persons, those persons will constitute associated enterprises under *Article 9 of the OECD Model Tax Convention*. Only one criterion must be met, however practically often more than one criterion will be met in a particular situation. Z and O are associated enterprises under *Article 9 of the OECD Model Tax Convention* because the same persons (the board of directors of X and M) participate in the management and participate in the control of Z and O, which influences the pricing determination of transactions entered into between Z and O.

5. Application of the arm's length principle

5.1 General

SARS will consider a taxpayer's debt to be non-arm's length if, amongst other factors, some or all of the following circumstances exist:

- The taxpayer is carrying a greater quantity of debt than it could sustain on its own (that is, it is thinly capitalised).
- The duration of the lending is greater than would be the case at arm's length.
- The repayment, interest rate or other terms are not what would have been entered into or agreed to at arm's length.

In determining if the pricing of an intra-group loan (amount and cost) is arm's length, SARS follows the guidance on the application of and adherence to the arm's length principle in the OECD Guidelines.[17]

In applying the arm's length principle to the pricing of intra-group loans, the appropriate identification of what constitutes debt and equity and ensuring that all debt arrangements are considered, is critical. See **5.2** for additional commentary.

As noted in the OECD Guidelines, the application of the arm's length principle is based on a comparison of the conditions in a controlled transaction with the conditions that would have been made had the parties been independent and undertaking a comparable transaction under comparable circumstances. This analysis involves two key aspects:

- identify the commercial or financial relations between relevant parties and the conditions and economically relevant circumstances attaching to those relations in order to accurately delineate controlled transactions (see **5.3**); and

[17] OECD (2020), *Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS Actions 4, 8-10,* OECD, Paris, **www.oecd.org/tax/beps/transfer-pricing-guidance-on-financial-transactions-inclusive-framework-on-beps-actions-4-8-10.htm**.

- compare the conditions and economically relevant circumstances of the controlled transaction as accurately delineated with the conditions and economically relevant circumstances of the comparable transaction between independent enterprises (see **5.4)**.

In determining the arm's length conditions of intra-group loans, the same principles apply as described in Chapters I-III of the OECD Guidelines for any other controlled transaction.

5.2 Determination of whether a purported amount should be regarded as debt or equity

Commentary to Article 9 of the OECD Model Tax Convention notes at paragraph 3(b) that Article 9 is relevant "not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital."[18]

In considering whether an amount should be regarded as debt or equity, Chapter I of the OECD Guidelines, in particular the accurate delineation of the actual transaction under section D.1, is relevant. By accurately delineating a transaction one is then able to determine whether an amount is treated as debt or equity.

If it is considered that the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances, the guidance at section D.2 of Chapter I of the OECD Guidelines may also be relevant. Broadly it deals with the exceptional circumstances in which an actual transaction may be disregarded or substituted.

This approach is consistent with SARS's view that independent parties dealing at arm's length would look to the economic substance of an item when assessing whether it is debt or equity in nature or perhaps partly debt and partly equity in nature. In accurately delineating a transaction and determining the nature of a particular item, the principles and treatment which would be adopted in financial statements prepared in terms of International Financial Reporting Standards (IFRS) are a good guideline, bearing in mind that the facts and circumstances of the particular case must always be taken into account in assessing whether any adjustments are required. Debt for purposes of arm's length testing will therefore include, for example, straightforward loans (even if interest-free), advances and debts. In addition, it could include funding instruments that are economically equivalent to debt such as finance leases, redeemable preference shares (depending on the terms and conditions), certain structured derivative financial instruments and components of hybrid instruments.

Although the OECD guidance reflects an approach of accurate delineation of the actual transaction in accordance with Chapter I of the OECD Guidelines to determine the amount of debt to be priced, it is acknowledged that other approaches may be taken into account in determining whether an amount must be treated as debt or equity under domestic legislation. These approaches may include a multi-factor analysis of the

[18] As considered in the Committee on Fiscal Affairs' Report on "Thin Capitalisation" adopted by the Council of the OECD on 26 November 1986 and reproduced in Volume II of the full version of the OECD MTC at page R (4)-1.

characteristics of the instrument and the issuer. Another approach is that domestic law provisions may stipulate how a particular amount is to be treated.

The OECD Guidance is not intended to prevent countries from implementing approaches to address whether an amount is treated as debt or equity, or interest deductibility under domestic legislation, nor does it seek to mandate accurate delineation under Chapter I of the OECD Guidelines as the only approach for determining whether purported debt should be regarded as debt.

SARS will often apply the approach of accurately delineating a transaction to determine if an amount is to be treated as debt or equity, however it depends on the facts because in certain circumstances the Act prescribes how an amount must be treated. For example, sections 8F(2) and 8FA(2) deem certain amounts of interest to be a dividend *in specie* and not deductible.

5.3 Identifying the commercial or financial relations

As noted above, the first key aspect in applying the arm's length principle is to identify the commercial or financial relations between relevant parties and the conditions and economically relevant circumstances attaching to those relations in order to accurately delineate controlled transactions.

As with any controlled transaction, the accurate delineation of intra-group loans requires an analysis of the factors affecting the performance of businesses in the industry sector in which the MNE group operates. Differences exist among industry sectors and therefore factors such as the particular point of an economic, business or product cycle; the effect of government regulations; and the availability of financial resources in a given industry are relevant features that have to be considered in accurately delineating a controlled transaction. This examination takes into account the fact that MNE groups operating in different industry sectors may require, for example, different amounts and types of financing due to different capital intensity levels within the particular industry, or may require different levels of short-term cash balances due to different commercial needs in the particular industry. If the relevant MNEs are regulated, such as financial services entities subject to regulations consistent with recognised industry standards (for example, Basel requirements), due regard should be had to the constraints those regulations impose upon the MNE.

As described in Chapter I of the OECD Guidelines, the process of accurate delineation of the actual transaction also requires an understanding of how the particular MNE group responds to those identified factors. In this regard, the MNE's policies may inform the accurate delineation of the actual transaction through the consideration of, for example, how the MNE group prioritises the funding needs among different projects; the strategic significance of a particular MNE within the MNE group; whether the MNE is targeting a specific credit rating or debt-equity ratio; or whether the MNE is adopting a different funding strategy than the one observed in its industry sector (see **5.5.5**).

In accordance with the guidance established in Chapter I of the OECD Guidelines, identifying the conditions and economically relevant circumstances of the actual transaction should begin with a thorough identification of the economically relevant characteristics of the transaction including an examination of the contractual terms of the transaction (see **5.5.1**); the functions performed, assets used, and risks assumed (see **5.5.2**); the characteristics of the financial instruments (see **5.5.3**); the economic

circumstances of the parties and of the market (see **5.5.4**); and the business strategies pursued by the parties (see **5.5.5**).

5.4 Comparison of conditions and economically relevant circumstances of the tested transaction with comparable transactions between independent enterprises

In common with the analysis of any other transaction between relevant parties of an affected transaction, in applying the arm's length principle to an intra-group loan it is necessary to consider the conditions that independent parties would have agreed to in comparable circumstances.

Independent enterprises, when considering whether to enter into a particular intra-group loan, will consider all other options realistically available to them, and will only enter into the transaction if they see no alternative that offers a clearly more attractive opportunity to meet their commercial objectives (see paragraph 1.38 of Chapter I of the OECD Guidelines). In considering the options realistically available, the perspective of each of the parties to the transaction must be considered. For example, from the lender's perspective, other investment opportunities that may be contemplated, taking account of the specific business objectives of the lender and the context in which the transaction takes place. From the borrower's perspective, the options realistically available will include broader considerations than the entity's ability to service its debt, for example, the funds it actually needs to meet its operational requirements. In some cases, although an entity may have the capacity to borrow and service an additional amount of debt, it may choose not to do so to avoid placing negative pressure on its credit rating and increasing its cost of capital, and jeopardising its access to capital markets and its market reputation (see comments upon "The lender's and borrower's perspectives" in **6.1.1**).

In an ideal scenario, a comparability analysis would enable the identification of intra-group loans between independent parties which match the tested transaction in all respects. With the many variables involved, it is more likely that potential comparables will be different from the tested transaction. Where differences exist between the tested transaction and any proposed comparable, it will be necessary to consider whether such differences will have a material impact on the consideration. If so, it may be possible, where appropriate, to make comparability adjustments to improve the reliability of a comparable. This is more likely to be achievable where the adjustment is based on a quantitative factor and there is good quality data easily available (for example, on currency differences) than, for example, in trying to compare loans to borrowers with qualitative differences or where data is not so readily available (for example, borrowers with different business strategies).

5.5 The economically relevant characteristics of actual intra-group loans

To inform an analysis of the terms and conditions of an intra-group loan as part of the accurate delineation of the actual transaction (see **5.3**), or do a comparability analysis in seeking to price the accurately delineated actual transaction (see **5.4**), the following economically relevant characteristics should be considered.

5.5.1 Contractual terms

The terms and conditions of a loan between independent enterprises are usually explicitly stated in a written agreement. However, between relevant parties the contractual arrangements may not always provide information in sufficient detail or may be inconsistent with the actual conduct of the parties or other facts and

circumstances. It is therefore necessary to look to other documents, the actual conduct of the parties – notwithstanding that such consideration may ultimately result in the conclusion that the contractual form and actual conduct are in alignment – and the economic principles that generally govern relationships between independent enterprises in comparable circumstances in order to accurately delineate the actual transaction in accordance with section D.1.1 of Chapter I of the OECD Guidelines.

5.5.2 Functional analysis

In accurately delineating an actual intra-group loan, a functional analysis is necessary. This analysis seeks to identify the functions performed, the assets used and the risks assumed by the relevant parties to the controlled transaction.

For example, in the case of an intra-group loan, the key functions performed by a lender in deciding whether and under what terms to advance funds would typically include an analysis and evaluation of the risks inherent in the loan, the capability to commit capital of the business to the investment, determining the terms of the loan and organising and documenting the loan. It may also include ongoing monitoring and periodic review of the loan (see **8 - Timing**). Such a functional analysis is likely to include consideration of similar information to that which a commercial lender or ratings agency would consider in determining the creditworthiness of the borrower. An associated lender will not necessarily perform all of the same functions at the same intensity as an independent lender. However, in considering whether a loan has been advanced on conditions which would have been made between independent enterprises, the same commercial considerations and economic circumstances are relevant (see comments on “The lender’s and borrower’s perspectives” and “Use of credit ratings” in **6.1.1** and **6.1.2**).

When, under accurate delineation, the lender is not exercising control over the risks associated to an advance of funds or does not have the financial capacity to assume the risks, such risks should be allocated to the enterprise exercising control and having the financial capacity to assume the risk (see paragraph 1.98 of Chapter I of the OECD Guidelines). For example, consider a situation where Company A advances funds to Company B. Consider further that the accurate delineation of the actual transaction indicates that Company A does not exercise control functions related to the advance of funds but that Company P, the parent company of the MNE group, is exercising control over those risks, and has the financial capacity to assume such risks. Under Chapter I analysis, Company P will bear the consequences of the playing out of such risks and Company A will be entitled to no more than a risk-free return (see section D.1.2.1 in Chapter I of the OECD Guidelines).

From the perspective of the borrower, the relevant functions would usually refer to ensuring the availability of funds to repay the principal and the interest on the loan in due time; providing collateral, if needed; and monitoring and fulfilling any other obligation derived from the loan contract (see comments on “The lender’s and borrower’s perspectives” in **6.1.1**).

In some cases, the functions of the lender and the borrower may be undertaken by the same entity in different transactions. That could be the case, for example, of centralised treasury activities within an MNE group where the treasury entity raises and provides funds to other MNEs of the MNE group. In those circumstances, the functional analysis should consider the applicability of the guidance in section C of the *OECD Guidance on Financial Transactions*, and, in particular, paragraphs 10.44 and 10.45.

5.5.3 Characteristics of financial instruments

There are a wide variety of financial instruments in the open market that present very different features and attributes, which may affect the pricing of those products or services. Consequently, when delineating actual intra-group loans, it is important to document the transactions' features and attributes.

For example, in the case of a loan, those characteristics may include, but are not limited to, the amount of the loan, its maturity, the schedule of repayment, the nature or purpose of the loan (for example, trade credit, merger, acquisition, mortgage), level of seniority and subordination, geographical location of the borrower, currency, collateral provided, presence and quality of any guarantee, and whether the interest rate is fixed or floating.

5.5.4 Economic circumstances

To achieve comparability requires that the markets in which the independent and relevant parties operate do not have differences that have a material effect on price or that appropriate adjustments can be made.

The prices of financial instruments may vary substantially on the basis of underlying economic circumstances, for example, across different currencies, geographic locations, local regulations, the business sector of the borrower and the timing of the transaction.

Macroeconomic trends such as central bank lending rates or interbank reference rates, and financial market events like a credit crisis, can affect prices. In this regard, the precise timing of the issue of a financial instrument in the primary market or the selection of comparable data in the secondary market can therefore be very significant in terms of comparability. For example, it is not likely that multiple year data on loan issuances will provide useful comparables. The opposite is more likely to be true, that is, that the closer in timing a comparable loan issuance is to the issuance of the tested transaction, the less the likelihood of different economic factors prevailing, notwithstanding that particular events can cause rapid changes in lending markets.

Currency differences are another potentially important factor. Economic factors such as growth rate, inflation rate and the volatility of exchange rates, mean that otherwise similar financial instruments issued in different currencies may have different prices. Moreover, prices for financial instruments in the same currency may vary across financial markets or countries due to regulations such as interest rate controls, exchange rate controls, foreign exchange restrictions and other legal and practical restrictions on financial market access.

5.5.5 Business strategies

Business strategies must also be examined in accurately delineating the actual intra-group loan and in determining comparability for transfer pricing purposes since different business strategies can have a significant effect on the terms and conditions which would be agreed between independent enterprises.

For example, independent lenders may be prepared to lend on terms and conditions to an enterprise undertaking a merger or acquisition which might otherwise not be acceptable to the lender for the same business if it were in a steady state. In this kind of scenario, the lender may take a view over the term of the loan and consider the borrower's business plans and forecasts, effectively acknowledging that there will be

temporary changes in the financial metrics of the business for a period as it undergoes changes. Section D.1.5 of Chapter I of the OECD Guidelines gives other examples of business strategies that must be examined in accurately delineating the actual transaction and determining comparability. The analysis of the business strategies will also include consideration of the MNE group's global financing policy, and the identification of existing relationships between the relevant parties such as pre-existing loans and shareholder interests (see Annex I to Chapter V of the OECD Guidelines about the information to be included in the master file).

For example, consider that Company A, part of the AB Group, advances funds with a term of 10 years to a relevant party, Company B, which will use the funding for short-term working capital purposes. This advance is the only loan in Company B's balance sheet. AB Group's policy and practices demonstrate that the MNE group uses a one-year revolving loan to manage short-term working capital. In this scenario, under the prevailing facts and circumstances, the accurate delineation of the actual transaction may conclude that an independent borrower under the same conditions of Company B would not enter into a 10-year loan agreement to manage its short-term working capital needs and the transaction would be accurately delineated as a one-year revolving loan rather than a 10-year loan. The consequences of this delineation would be that assuming the working capital requirements continue to exist, the pricing approach would be to price a series of refreshed one-year revolving loans.

In any case, the reliability of results is generally improved to the extent comparable borrowers pursue similar business strategies to the tested borrower involved in an intra-group transaction.

6. Intra-group loans

This section of the Note deals with specific issues related to determining whether the rate of interest provided for in a loan contract and the amount of the loan are at arm's length. The analysis included in this section of the Note is based on the assumption that the transactions are respected as loans pursuant to an accurate delineation as contained under Chapter I of the OECD Guidelines and relevant sections of the Act (see **5.2**).

6.1 General considerations

6.1.1 The lender's and borrower's perspective

In considering the commercial and financial relations between the relevant parties, and analysing the economically relevant characteristics of the transaction, both the lender's and borrower's perspective should be taken into account, acknowledging that these perspectives may not align in every case.

As in any other transfer pricing scenarios, the guidance in section D.1 of Chapter I of the OECD Guidelines applies to determine whether the lender and the borrower assume risks related to intra-group loans. In particular, it is important to consider the risks that the funding arrangements carry for the lender and the risks related to the acceptance and use of the funds from the perspective of the borrower. These risks will relate to repayment of the amount transferred, compensation expected for the use of that amount over time and compensation for other associated risk factors.

The lender's perspective in the decision of whether to make a loan, how much to lend, and on what terms, will involve an evaluation of various factors relating to the borrower, wider economic factors affecting both the borrower and the lender and other options realistically available to the lender for the use of the funds.

An independent lender will carry out a thorough credit assessment of the potential borrower to enable the lender to identify and evaluate the risks involved and to consider methods of monitoring and managing these risks. That credit assessment will include understanding the business itself as well as the purpose of the loan, how it is to be structured and the source of its repayment which may include analysis of the borrower's cash flow forecasts and the strength of the borrower's balance sheet. When a relevant party is making a loan to another relevant party, it will not necessarily follow all of the same processes as an independent lender. For example, it may not need to go through the same process of information gathering about the borrower's business, as the required information may already be readily available within the MNE group. However, in considering whether the loan has been made on conditions which would have been made between independent enterprises, the same commercial considerations such as creditworthiness, credit risk and economic circumstances are relevant.

In the case of a loan from the parent entity of an MNE group to a subsidiary, the parent entity already has control and ownership of the subsidiary, which would make the granting of security less relevant to its risk analysis as a lender. Therefore, in evaluating the pricing of a loan between relevant parties it is important to consider that the absence of contractual rights over the assets of the borrowing entity does not necessarily reflect the economic reality of the risk inherent in the loan. If the assets of the business are not already pledged as security elsewhere, it will be appropriate to consider under the Chapter I of the OECD Guidelines analysis whether those assets are available to act as collateral for the otherwise unsecured loan and the consequential impact upon the pricing of the loan.

Credit risk for the lender is the potential that the borrower will fail to meet its payment obligations in accordance with the terms of the loan. In deciding whether a prospective loan is a good commercial opportunity, a lender will also consider the potential impact of changes which could happen in economic conditions affecting the credit risk it bears, not only in relation to the conditions of the borrower but in relation to potential changes in economic conditions, such as a rise in interest rates, or the exposure of the borrower to movements in exchange rates.

Generally, borrowers seek to optimise their weighted average cost of capital and to have the right funding available to meet short-term needs and long-term objectives. When considering the options realistically available to it, an independent business seeking funding and operating in its own commercial interests will seek the most cost effective solution, with regard to the business strategy it has adopted. For example, in respect of collateral, in some circumstances, assuming that the business has suitable collateral to offer, this would usually be secured funding, ahead of unsecured funding, recognising that a business's collateral assets and its funding requirements may change over time, for example because collateral is finite, the decision to pledge collateral on a particular borrowing precludes the borrower from pledging that same collateral on a subsequent borrowing. Therefore, an MNE pledging collateral would take into account its options realistically available regarding its overall financing (for example, possible subsequent loan transactions).

Borrowers will also consider the potential impact of changes in economic conditions such as interest rates and exchange rates, as well as the risk of not being able to make timely payments of interest and principal on the loan if the borrower's business encounters unexpected difficulties and the risk of not being able to raise more capital (either debt or equity) if necessary.

Macroeconomic circumstances may lead to changes in the financing costs in the market. In such a context, a transfer pricing analysis with regard to the possibilities of the borrower or the lender to renegotiate the terms of the loan to benefit from better conditions will be informed by the options realistically available to both the borrower and the lender.

The economic conditions of loans should also be viewed in the context of laws and regulations that may affect the position of the parties. For example, insolvency law in the jurisdiction of the borrower may provide that liabilities towards relevant parties are subordinated to liabilities towards independent parties.

6.1.2 Use of credit ratings

The creditworthiness of the borrower is one of the main factors that independent investors take into account in determining an interest rate to charge and the amount of the debt. Credit ratings can serve as a useful measure of creditworthiness and therefore help to identify potential comparables or to apply economic models in the context of relevant party transactions. Furthermore, in the case of intra-group loans and other financial instruments that are the subject of controlled transactions, the effect of group membership may be an economically relevant factor that affects the pricing of these instruments. Accordingly, this subsection elaborates on the use of credit ratings and the effect of group membership in the context of pricing intra-group loans.

Credit ratings can be determined for the overall creditworthiness of the MNE or an MNE group[19] or for a specific issuance of debt. As detailed in the following paragraphs, determining credit ratings requires consideration of quantitative (for example, financial information) and qualitative factors (for example, industry and country in which the MNE or MNE group operates).

In applying the arm's length principle, SARS requires taxpayers to consider the transaction from both the lender's perspective and the borrower's perspective. That is, from the lender's perspective, whether the amount borrowed could have been borrowed at arm's length (that is, what a lender is prepared to lend and therefore what a borrower could have borrowed) and from the borrower's perspective, whether the amount would have been borrowed at arm's length (that is, what a borrower acting in the best interests of its business would have borrowed). The arm's length amount of the debt is the lesser of the amount that could have been borrowed and the amount that would have been borrowed in a transaction between parties dealing at arm's length.

For example, taking all the relevant facts and circumstances into account, the arm's length amount of debt may be nil in circumstances where a taxpayer with a very healthy balance sheet, excess cash reserves and spare borrowing capacity borrowed from an offshore parent company when all the relevant facts indicate that there was no business need or reason or commercial benefit for the additional finance (assume the

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[19] For the purpose of this guidance, the credit rating of an MNE group is intended to refer to the credit rating of the ultimate parent entity of the MNE group calculated on consolidated financial statements.

return was not greater than the cost involved). In this example independent lenders may have been prepared to lend to a person in the taxpayer's position but a person in the taxpayer's position would not have borrowed from an independent person on an arm's length principle. As with all thin capitalisation cases, the circumstances specific to the taxpayer will be considered on a case-by-case basis. The answer in the example may have been different if some of the facts were different, for example, the taxpayer may have a business need in the form of planned commercial expansion.

As noted in **4** and this section of the Note, taxpayers are required to determine the amount of debt and the cost of the debt that could have been borrowed and would have been borrowed at arm's length from an independent party and to take that amount into account when preparing their tax return and assessing what portion of the related expenditure, if any, is not deductible as a result of section 31. This requires taxpayers to perform a functional analysis and a comparability analysis to support the appropriateness of their arm's length debt assessment.

(a) The credit rating of an MNE or MNE group

The credit rating of an MNE or MNE group (usually referred to as the "issuer credit rating") is an opinion about its general creditworthiness. Such an opinion is usually premised on the MNE or MNE group's capacity and willingness to meet its financial obligations in accordance with the terms of those obligations. The credit rating of an MNE or MNE group is effectively a form of relative ranking of the creditworthiness in comparison to other borrowers. In general, a lower credit rating will indicate a greater risk of default and be expected to command a higher rate of return for lenders.

Information is readily available in many lending markets on the different rates of interest charged for differently rated enterprises and such information may usefully contribute to performing comparability analyses. Financing transactions that the borrowing MNE or another MNE within the group has with external lenders may also be reliable comparables for interest rates charged by relevant parties (see **6.2.1**, paragraphs 6 and 7). Financing transactions undertaken by the borrowing MNE or another entity in the MNE group, for example the MNE group parent, will be reliable comparables only where the differences between the controlled and uncontrolled transactions do not materially affect the interest rate or reasonably accurate adjustments can be made.

As a credit rating depends on a combination of quantitative and qualitative factors, there is still likely to be some variance in creditworthiness between borrowers with the same credit rating. In addition, when making comparisons between borrowers using the kind of financial metrics typically seen as important to lenders, such as debt-earnings or debt-equity ratios, it is important to note that the same financial metrics will not necessarily result in the same credit rating if there are other differences between the rated parties. For example, it may require stronger financial metrics to obtain a given rating in some industries than to obtain the same rating for a borrower in other industries. More intrinsically risky industries and those with less stable revenue streams tend to require better financial ratios in order to obtain the same rating.

There may be special circumstances, such as in the case of start-up entities, or those that have recently been part of a merger, that may have an impact on the credit rating of a group entity. These special situations should be taken into consideration.

It is important that the MNE group appropriately documents the reasons and selection of the credit rating used for a particular MNE when pricing intra-group loans.

(b) The credit rating of a specific debt issuance

The credit rating of a particular debt issuance ("issue rating") is an opinion about the creditworthiness of the issuer with respect to a specific financial instrument. The issue rating considers specific features of the financial instrument, for example, guarantees, securities and level of seniority.

The credit rating of an MNE or MNE group may differ from an issue rating due to the fact that the credit risk of a financial instrument is linked to its specific features and not only to the risk profile of the borrowing MNE. On prevailing facts and circumstances and provided there is comparability between the independent party debt issuance and the controlled transaction, when both an issuer and issue ratings are available, the issue rating of the particular debt issuance would be more appropriate to use to price the controlled intra-group loan.

(c) Credit rating determinations

Particular considerations should be borne in mind when determining a credit rating for a specific MNE within an MNE group for the purpose of assessing controlled transactions. Where an MNE has a publicly available credit rating published by an independent credit rating agency, that rating may be informative for an arm's length analysis of the MNE's controlled financing transactions. However, in most cases, publicly available credit ratings are only available for the MNE group. An approach often used for a specific MNE is to apply quantitative and qualitative analyses of the individual characteristics of the MNE using publicly available financial tools or independent credit rating agencies' methodologies to seek to replicate the process used to determine the credit rating of the MNE group. This approach also involves considering improvements in creditworthiness that the specific MNE would be assumed to receive as a result of being part of the MNE group.

(d) The use of publicly available financial tools or methodologies to approximate credit ratings

Publicly available financial tools are designed to calculate credit ratings. Broadly, these tools depend on approaches such as calculating the probability of default and of the likely loss should default occur to arrive at an implied rating for the borrowing. This can then be compared to a market database in a search for comparables to arrive at a price or price range for the borrowing. In considering whether the application of these tools results in a reliable assessment of the credit rating of controlled transactions, potential issues that need to be borne in mind include that the results are not based on a direct comparison with transactions between independent parties but are subject to the accuracy of the input parameters, a tendency to rely more on quantitative inputs at the expense of qualitative factors, and a lack of clarity in the processes (that is, the workings of the underlying algorithms and processes may not be transparent).

The credit rating methodology used in publicly available financial tools may be significantly different in certain respects from the credit rating methodologies applied by independent credit rating agencies to determine official credit ratings and the impact of any such differences should be carefully considered. For example, publicly available tools generally use only a limited sample of quantitative data to determine a credit rating. Official credit ratings published by independent credit rating agencies are derived as a result of far more rigorous analysis that includes quantitative analysis of historic and forecast entity performance as well as detailed qualitative analysis of, for example, management's ability to manage the entity, industry specific features and the entity's market share in its industry.

For these reasons, the reliability of credit rating results derived from the use of publicly available financial tools may be improved to the extent the analysis can demonstrate consistency of ratings using such tools with those provided by independent credit rating agencies.

In conducting a credit rating analysis, it is important to note that the financial metrics may be influenced by current and past controlled transactions (such as sales, or interest expenses). If it appears that such controlled transactions are not in accordance with the arm's length principle, the credit rating derived in light of such intra-group transactions may not be reliable. (See also guidance in **5.3**). These considerations apply both to controlled transactions that may affect the current earnings of the MNE and to previous funding and other intra-group transactions that may have had an impact on the measures of income and capital of the MNE that are the subject of quantitative analysis.

(e) Effect of group membership

The effect of group membership is relevant for informing the conditions under which an MNE would have borrowed from an independent lender at arm's length in two ways in particular. Firstly, the external funding policies and practices of group management will assist in informing the form and terms and conditions of the debt the MNE would have entered into with an independent lender, including the pricing (that is, interest rate paid), and all economically relevant characteristics such as the type of loan, its term, currency, security, covenants and business strategies. Secondly, the MNE may receive support from the group to meet its financial obligations in the event of the borrower getting into financial difficulty. Paragraph 1.158 of Chapter I of the OECD Guidelines is relevant to analyse the effect of group membership on the terms and conditions of a borrowing when the borrowing MNE obtains an incidental benefit arising solely by virtue of group affiliation, that is, passive association.

In the context of intra-group loans, this incidental benefit that the MNE is assumed to receive solely by virtue of group affiliation, is referred to as implicit support. The effect of potential group support on the credit rating of an entity and any effect on that entity's ability to borrow or the interest rate paid on those borrowings would not require any payment or comparability adjustment. See Example 1 at paragraphs 1.164 - 1.166 of Chapter I of the OECD guidelines and section D.3 of the OECD Transfer Pricing Guidance on Financial Transactions.

Implicit support from the group may affect the credit rating of the borrower or the rating of any debt which it issues. The relative status of an entity within the group may help determine what impact that potential group support has on the credit rating of a debt issuer. Entities of an MNE group will be more or less likely to receive group support according to the relative importance of the entity to the MNE group as a whole and the linkages between the entity and the rest of the MNE group, either in its current form or in terms of future strategy. An MNE with stronger links, that is integral to the group's identity or important to its future strategy, typically operating in the group's core business, would ordinarily be more likely to be supported by other MNEs within the MNE group and consequently have a credit rating more closely linked to that of the MNE group. Conversely, it may be reasonable to assume that an entity would be likely to receive support from the rest of the MNE group in more limited circumstances where it does not show those same indicators or the linkages are weaker. In the case of an entity where there is evidence that no support would be provided by the MNE group, it may be appropriate on the prevailing facts and circumstances to consider the entity based on its own stand-alone credit rating only.

Another key consideration would be the likely consequences for other parts of the MNE group of supporting or not supporting the borrower. The criteria used to determine the status of an entity in this regard may include such considerations as legal obligations (for example, regulatory requirements), strategic importance, operational integration and significance, shared name, potential reputational impacts, negative effects on the overall MNE group, general statement of policy or intent, and any history of support and common behaviour of the MNE group with respect to third parties. The relative relevance of those factors may vary from one industry to another.

The impact of an assessment of implicit support is a matter of judgement. The kind of information on which the MNE group would base a decision of whether or not to provide support to a borrower in particular circumstances may not be available to a tax administration, as is frequently the case in transfer pricing examinations, and the existence of information asymmetry may affect the ability of tax administrations to establish the likelihood of support (see section B.2 in Chapter IV of the OECD Guidelines). Furthermore, changing facts and circumstances affecting the willingness or ability of the MNE group to provide support may mean that there is no decision by the MNE group itself until the eventuality for such support arises. This contrasts, for example, where the MNE receives a formal guarantee from another MNE within the MNE group. The past behaviour of an MNE group as regards providing support may be a useful indicator of likely future behaviour but an appropriate analysis should be undertaken to identify whether different conditions apply.

(f) Use of MNE group credit rating

It is also important to note that although there are established approaches to estimate a credit rating for a particular MNE or debt issuance, the considerations detailed above mean that a pricing approach based on the separate entity credit ratings that are derived from publicly available financial tools (see **6.1.2(d)** paragraph 1), the implicit support analysis, the difficulties of accounting for controlled transactions reliably and the presence of information asymmetry may pose challenges that, if not resolved, may result in outcomes that are not reliable.

Where this is the case, the credit rating of the MNE group may also be used for the purpose of pricing the accurately delineated loan where the facts so indicate, particularly in situations such as where the MNE is important to the group as described in **6.1.2(e)**, third and fourth paragraphs, and where the MNE's indicators of creditworthiness do not differ significantly from those of the group. An MNE group credit rating is unaffected by controlled transactions and reflects the actual basis on which the group seeks external funding from independent lenders. In situations where an MNE group does not have an external credit rating, consideration may be given to conducting the credit rating analysis at the MNE group level for assessing the controlled transaction. In all cases, the MNE group credit rating, like any other credit rating, will be appropriate only if it is determined to be the most reliable indicator of the MNE credit rating considering all the facts and circumstances.

(g) Covenants

The purpose of covenants in a loan agreement is generally to provide a degree of protection to the lender and so limit its risk. That protection may be in the form of incurrence covenants or maintenance covenants.

Incurrence covenants require or prohibit certain actions by the borrower without the consent of the lender. Incurrence covenants may, for example, prohibit the borrower from taking on additional debt, creating any charge on the assets of the entity or disposing of particular assets of the entity, thus giving some degree of certainty over the balance sheet of the borrower.

Maintenance covenants typically refer to financial indicators which must be met at regular, predetermined intervals during the life of a covenanted loan. Maintenance covenants can act as an early warning system so that in the event of financial underperformance by the borrower, the borrower and/or lender can move to take remedial action at an early stage. This can help to protect independent lenders against information asymmetry.

There may be less information asymmetry between entities (that is, better visibility) in the intra-group context than in situations involving independent parties. Intra-group lenders may choose not to have covenants on loans to relevant parties, partly because they are less likely to suffer information asymmetry and because it is less likely that one part of an MNE group would seek to take the same kind of action as an independent lender in the event of a covenant breach, nor would it usually seek to impose the same kind of restrictions. Where there is an absence of covenants in any written agreement between the parties, it will be appropriate to consider under Chapter I of the OECD Guidelines, guidance whether there is, in practice, the equivalent of a maintenance covenant between the parties and the consequential impact upon the pricing of the loan.

(h) Guarantees

A guarantee from another party may be used to support the borrower’s credit. A lender placing reliance on a guarantee or guarantees would need to evaluate the guarantor(s) in a similar way to that in which it evaluates the original borrower. For the lender to take a guarantee into account in setting or adjusting the terms and conditions of a loan, it would need to be reasonably satisfied that the guarantor(s) would be able to meet any shortfall resulting from the borrower being unable to meet its obligations in full in the event of a default.

6.2 Determining the arm’s length interest rate of intra-group loans

The following paragraphs present different approaches to pricing intra-group loans. As in any other transfer pricing situation, the selection of the most appropriate method should be consistent with the actual transaction as accurately delineated, in particular, through a functional analysis (see Chapter II of the OECD Guidelines).

6.2.1 Comparable uncontrolled price method (CUP method)

Once the actual transaction has been accurately delineated, arm’s length interest rates can be sought based on consideration of the credit rating of the borrower or the rating of the specific issuance taking into account all of the terms and conditions of the loan and comparability factors.

The widespread existence of markets for borrowing and lending money and the frequency of such transactions between independent borrowers and lenders, coupled with the widespread availability of information and analysis of loan markets may make it easier to apply the CUP method to financial transactions than may be the case for other types of transactions. Information available often includes details on the characteristics of the loan and the credit rating of the borrower or the rating of the

specific issuance. Characteristics which will usually increase the risk for the lender, such as long maturity dates, absence of security, subordination, or application of the loan to a risky project, will tend to increase the interest rate. Characteristics which limit the lender's risk, such as strong collateral, a high-quality guarantee, or restrictions on future behaviour of the borrower, will tend to result in a lower interest rate.

The arm's length interest rate for a tested loan can be benchmarked against publicly available data for other borrowers with the same credit rating for loans with sufficiently similar terms and conditions and other comparability factors. Given the presence and the extent of competition often present within lending markets, it might be expected that, given the characteristics of the loan (for example, amount, maturity and currency.) and the credit rating of the borrower or the rating of the specific issuance (see **6.1.2**), there would be a single rate at which the borrower could obtain funds and a single rate at which a lender could invest funds to obtain an appropriate reward. In practice, however, there is unlikely to be a single "market rate" but a range of rates although competition between lenders and the availability of pricing information will tend to narrow the range.

In the search for comparability data, a comparable is not necessarily restricted to a stand-alone entity. In examining commercial loans, where the potentially comparable borrower is an MNE and has borrowed from an independent lender, provided all other economically relevant conditions are sufficiently similar, a loan to an MNE from a different MNE group or between MNEs of different MNE groups could be a valid comparable.

Arm's length interest rates can also be based on the return of realistic alternative transactions with comparable economic characteristics. Depending on the facts and circumstances, realistic alternatives to intra-group loans could be, for example, bond issuances, loans which are uncontrolled transactions, deposits, convertible debentures and commercial papers. In the evaluation of those alternatives as potential comparables it is important to bear in mind that, based on facts and circumstances, comparability adjustments may be required to eliminate the material effects of differences between the controlled intra-group loan and the selected alternative in terms of, for example, liquidity, maturity, existence of collateral or currency.

When considering issues of comparability, the possibility of internal CUPs should not be overlooked.

Whereas it is unlikely that an MNE group's average interest rate paid on its external debt meets the comparability requirements to be considered as an internal CUP, it may be possible to identify potential comparable loans within the borrower's or its MNE group's financing with an independent lender as the counterparty. As with external CUPs, it may be necessary to make appropriate adjustments to improve comparability. See Example 1 at 1.164 - 1.166 of the OECD Guidelines.

6.2.2 Loan fees and charges

In considering arm's length pricing of loans, the issue of fees and charges in relation to the loan may arise. Independent commercial lenders will sometimes charge fees as part of the terms and conditions of the loan, for example arrangement fees or commitment fees in relation to an undrawn facility. If such charges are seen in a loan between relevant parties, they should be evaluated in the same way as any other intra-group transaction. In doing so, it must be borne in mind that independent lenders'

charges will in part reflect costs incurred in the process of raising capital and in satisfying regulatory requirements, which relevant parties might not incur.

6.2.3 Cost of funds

In the absence of comparable uncontrolled transactions, the cost of funds approach could be used as an alternative to price intra-group loans in some circumstances. The cost of funds will reflect the borrowing costs incurred by the lender in raising the funds to lend. To this would be added the expenses of arranging the loan and the relevant costs incurred in servicing the loan, a risk premium to reflect the various economic factors inherent in the proposed loan, plus a profit margin, which will generally include the lender's incremental cost of the equity required to support the loan.

One consideration to be kept in mind with the cost of funds approach is that it should be applied by considering the lender's cost of funds relative to other lenders operating in the market. The cost of funds can vary between different prospective lenders, so the lender cannot simply charge based on its cost of funds, particularly if there is a potential competitor who can obtain funds more cheaply. A lender in a competitive market may seek to price at the lowest possible rate to win business. In the commercial environment, this will mean that lenders drive operating costs as low as possible and seek to minimise the cost of obtaining funds to lend.

The application of the cost of funds approach requires consideration of the options realistically available to the borrower. On prevailing facts and circumstances, a borrowing MNE would not enter into a transaction priced under the cost of funds approach if it could obtain the funding under better conditions by entering into an alternative transaction.

In some intra-group transactions, the cost of funds approach may be used to price loans where capital is borrowed from an independent party which passes from the original borrower in the group through one or more associated intermediary enterprises, as a series of loans, until it reaches the ultimate borrower. In such cases, where only agency or intermediary functions are being performed, as noted at paragraph 7.34 of the OECD Guidelines, "it may not be appropriate to determine the arm's length pricing as a mark-up on the costs of the services but rather on the costs of the agency function itself".

6.2.4 Credit default swaps

Credit default swaps reflect the credit risk linked to an underlying financial asset. In the absence of information regarding the underlying asset that could be used as a comparable transaction, taxpayers and tax administrations may use the spreads of credit default swaps to calculate the risk premium associated to intra-group loans.

As financial instruments traded in the market, credit default swaps may be subject to a high degree of volatility. This volatility may affect the reliability of credit default swaps as proxies to measure the credit risk associated to a particular investment in isolation, since the credit default spreads may reflect not only the risk of default but also other non-related factors such as the liquidity of the credit default swaps contracts or the volume of contracts negotiated. Those circumstances could lead to situations where, for example, the same instrument may have different credit default swaps spreads.

Accordingly, the use of credit default swaps to approximate the risk premium associated to intra-group loans will require careful consideration of the above-mentioned circumstances to arrive at an arm's length interest rate.

6.2.5 Economic modelling

Certain industries rely on economic models to price intra-group loans by constructing an interest rate as a proxy to an arm's length interest rate.

In their most common variation, economic models calculate an interest rate through a combination of a risk-free interest rate and a number of premiums associated with different aspects of the loan (for example, default risk, liquidity risk, expected inflation or maturity). In some cases, economic models would also include elements to compensate the lender's operational expenses.

The reliability of economic models' outcomes depends upon the parameters factored into the specific model and the underlying assumptions adopted. In evaluating the reliability of economic models as an approach to pricing intra-group loans it is important to note that economic models' outcomes do not represent actual transactions between independent parties and that, therefore, comparability adjustments would be likely required. However, in situations where reliable comparable uncontrolled transactions cannot be identified, economic models may represent tools that can be usefully applied in identifying an arm's length price for intra-group loans, subject to the same constraints regarding market conditions considered in **6.2.3**, paragraph 2.

6.2.6 Bank opinions

In some circumstances taxpayers may seek to evidence the arm's length rate of interest on an intra-group loan by producing written opinions from independent banks, sometimes referred to as a "bankability" opinion, stating what interest rate the bank would apply were it is to make a comparable loan to that particular enterprise.

Such an approach would represent a departure from an arm's length approach based on comparability since it is not based on comparison of actual transactions. Furthermore, it is also important to bear in mind the fact that such letters do not constitute an actual offer to lend. Before proceeding to make a loan, a commercial lender will undertake the relevant due diligence and approval processes that would precede a formal loan offer. Such letters would not therefore generally be regarded as providing evidence of arm's length terms and conditions.

7. Risk-free and risk-adjusted rates of return

7.1 Determining a risk-free rate of return

Where, in accordance with the guidance in this Note, the accurate delineation of the actual transaction shows that a funder lacks the capability, or does not perform the decision-making functions, to control the risk associated with investing in a financial asset, it will be entitled to no more than a risk-free return as an appropriate measure of the profits it is entitled to retain (see paragraph 1.103 of the OECD Guidelines and its footnote). In this context, the funder's costs related to the borrowing associated to the funding should be considered in determining the risk-free rate of return, and subject to other constraints, the funded party would still be entitled to a deduction up to an arm's length amount in respect of the funding. The difference between those amounts would be allocable to the party exercising control over the investment risk in accordance with the guidance in this chapter.

A risk-free rate of return is the hypothetical return which would be expected on an investment with no risk of loss. Ultimately, there is no investment with zero risk, and the reliability of available proxies for approximating a risk-free rate of return will depend on prevailing facts and circumstances.

An approach which is widely used in practice is to treat the interest rate on certain government issued securities as a reference rate for a risk-free return, as these securities are generally considered by market practitioners not to carry significant default risk. The intention of the guidance in this section of the Note is to outline an approach for reference purposes without suggesting that a particular government security should always be used to determine a risk-free rate.

To eliminate currency risk, the reference security for determining the risk-free rate would need to be a security issued in the same currency as the lender's cash flows, that is, the functional currency of the lender rather than its country of domicile. When there are multiple countries issuing bonds in the same currency, the reference point for the risk-free rate of return should be the government security with the lowest rate of return as any difference in rate must be due to differences in risk between the issuers (see **5.5.4**, paragraph 4). However, where the government security rate is higher than the interbank rate, the interbank rate may be used.

Another relevant aspect in determining the risk-free rate of return will be the temporal proximity of the reference security to the tested transaction. The security should ideally be issued at the time, or have a similar remaining maturity, as the controlled transaction that was entered into to eliminate the effect of differences which may be present between securities issued at different times (see paragraph 1.113 of the OECD Guidelines). Another key consideration would be the maturity of the financial instrument. The duration of the reference security should match the duration of the loan since the duration of a loan will usually affect its price. The duration of the controlled loan should be determined as part of the process of accurate delineation of the actual transaction. For example, a financial instrument which is short-term under the written contractual terms between the parties but which is consistently replaced with a new instrument may, depending upon the exact facts and circumstances, be accurately delineated as a long-term loan.

Due to difficulties in practice, practical solutions might be considered for estimating the risk-free rate of return. For example, assume a situation where Company A, an MNE, is not entitled to more than a risk-free return under the guidance in Chapter X of the OECD Guidelines in relation to an advance of funds with a term of one year to a relevant party, Company B. In approximating that return, the starting point would be to identify a security issued at the time of the provision of the funding in the same currency as Company A's functional currency. Assume that the tax administration of Country X, where Company A is resident, identifies three securities issued in Company A's functional currency by the governments of Country X, Country Y and Country Z with a term of one year. The credit ratings of the issuing governments are A for Country X, B for Country Y and AA for Country Z. In specifying a minimum credit rating for the issuing government to consider the issued security as a risk-free investment comparable to the controlled financial transaction, the tax administration of Country X may select the security issued by Country Z as a reference for the risk-free rate of return since it represents the lowest rate of return available at the time of the provision of the funding on all outstanding government bonds in the relevant currency with a term of one year.

To approximate risk-free rate of returns, highly rated government issued securities are not the only reference, and other alternatives may be considered on prevailing facts and circumstances of each case, for example interbank rates, interest rate swap rates or repurchase agreements of highly rated government issued securities.

The risk-free rate of return may be relevant, for example, as a component in calculating a risk-adjusted rate of return on an investment or as the return allocable to an investor who has provided funding but has not assumed any of the risks related to the funding.

7.2 Determining a risk-adjusted rate of return

As stated in paragraph 6.61 of the OECD Guidelines, “where a party providing funding exercises control over the financial risk associated with the provision of funding, without the assumption of, including the control over, any other specific risk, it could generally only expect a risk-adjusted rate of return on its funding.” (See paragraphs 1.85 and 1.103 of the OECD Guidelines).

Therefore, in determining the risk-adjusted rate, it is important to identify and differentiate the financial risk which is assumed by the funder in carrying on its financing activity, and the operational risk that is assumed by the funded party and is connected to the use of the funds, for example, for developing an intangible asset. Guidance on the relationship between risk assumption in relation to the provision of funding and the operational activities for which the funds are used is given in paragraphs 6.60 - 6.64 of the OECD Guidelines.

For example, consider a situation where Company F advances a loan to a relevant party, Company D, which undertakes the development of an intangible. Consider further that under the guidance in Chapter X of the OECD Guidelines it is determined that Company F controls and consequently is allocated the financial risk associated with funding the development of the intangible, including the potential risk of Company D failing to develop the intangible and therefore being unable to repay the loan. However, Company F does not assume the risk of developing the intangible, which is entirely assumed by Company D under the accurate delineation of the actual transaction. Accordingly, in the event that the *ex-post* results derived from the exploitation of the developed intangible were higher (or lower) than the results calculated on an *ex-ante* basis, Company F would not be entitled to that difference but to a risk-adjusted rate of return as described in this section of the Note.

In general, the expected risk-adjusted rate of return on a funding transaction can be considered to have two components, that is, the risk-free rate and a premium reflecting the risks assumed by the funder.

When the funder is assuming the financial risk under the guidance provided in this section of the Note and is therefore exposed to the potential playing out of that risk, it will encounter the upside and downside consequences of that risk outcome. Therefore, the assumption of that risk will warrant an expected remuneration higher than a risk-free rate of return.

A risk-adjusted rate of return can be determined under different approaches, for example, based on the return of a realistic alternative investment with comparable economic characteristics or the cost of funding (see **6.2.1**).

It may be possible to find a reasonable indicator of a risk-adjusted rate of return from comparable uncontrolled transactions or by considering realistically available alternative investments reflecting the same risk profile. Depending on the facts and circumstances, realistic alternatives to an intra-group loan could be bond issuances or loans which are uncontrolled transactions (see **6.2.1**, paragraph 5).

Another approach to determining the risk-adjusted rate of return would be to add a risk premium to the risk-free return, based on the information available in the market on financial instruments issued under similar conditions and circumstances.

For example, consider the same fact pattern as described in the sixth paragraph under **7.1** above, in this particular scenario, assume that Company A is found to be entitled to a risk-adjusted rate of return under the guidance provided in this section of the Note. To determine that return, the tax administration of Country X considers adding a risk premium to the risk-free rate of return, that is, the security issued by the government in Country Z with a term of one year. To estimate the risk-adjusted return, Country X's tax administration considers that corporate bonds issued by independent parties resident in Country X operating in the same industry as Company B yield a return comparable to the one that an independent party would have expected had it invested its funds in Company B under comparable circumstances.

Under an approach based on the cost of funds, the controlled transaction would be priced by adding a profit margin to the costs incurred by the lender to raise the funds advanced to the borrower. That mark-up should be proportionate to the risk assumed by the lender and calculated according to the guidance provided in **6.2.3**.

8. Timing

In order to determine whether an adjustment will be required under section 31 in the case of a term loan,[20] which falls within the definition of an affected transaction, it is necessary for taxpayers to specifically consider whether at the time of obtaining that debt, the amount of the debt and the cost of the debt are arm's length. In addition, after obtaining the debt a taxpayer must reassess the appropriateness of the level of debt and cost of the debt from time to time. It is not possible to give a standardised frequency of time at which a taxpayer must reassess whether the amount and cost of the debt is arm's length. The frequency and timing will depend on the nature of the particular taxpayer's business and the amount of change and variability it experiences. For example, some taxpayers may need to reassess quarterly but others may only need to test annually. The on-going assessment is in line with the principle of arm's length testing. Practically, annual testing is often sufficient but it will depend on the facts of the particular case.

For debt *akin to an overdraft*[21] the testing must also be performed when granted and from time to time at appropriate intervals. Similarly, some taxpayers may need to test quarterly but others may only need to test annually. In the case of financial assistance which is available for draw-down over time, the amount actually drawn down as well as the amount which may still be drawn down is important as both would impact on whether an independent party would be prepared to provide financial assistance.

[20] A term loan is usually a loan which is granted for a fixed period of time and must be repaid as agreed between the parties within that period.

[21] That is, debt where the amount is drawn down as required and does not have a fixed period of repayment.

The testing is performed using current information. For example, in the case of foreign currency-denominated loans it would be based on the exchange rate and on the amount of the loan at the time the testing is performed and would take into account the available facility at that time for debt akin to an overdraft. However, particularly in the case of on-going testing, even if the testing on the face of it reflects, for example, a thinly capitalised position it does not necessarily mean the taxpayer is thinly capitalised. It will be necessary to consider, for example, what is causing the taxpayer to be thinly capitalised, whether it is permanent or temporary, what remedial action is being taken and whether an independent party would require resultant restructuring. In a very simplified example, assume the exchange rate weakened by 75% due to factors which would almost certainly reverse and result in the exchange rate recovering within a month and that the taxpayer "was" solely thinly capitalised at a point in time because of weakening of the exchange rate. In this specific situation it is likely that the taxpayer would not be considered thinly capitalised. All of the detailed facts are critical.

Although current amounts of debt are used in the testing, significant variability in the amount of debt in a year of assessment could indicate that it is necessary to test the thin capitalisation position at more frequent points in time during that year of assessment.

9. Effect of an intra-group loan not being arm's length

9.1 Primary transfer pricing adjustment

As noted above, any interest, finance charges or deductions or inclusions in taxable income arising in relation to or *on the non-arm's length amount of debt* must be disallowed as a deduction (or inclusion, as appropriate) in determining the taxpayer's taxable income. Similarly, if any interest, finance charge or deductions or inclusions in taxable income arising in relation to *the arm's length amount of debt* is non-arm's length it must be disallowed as a deduction (or inclusion, as appropriate) in determining the taxpayer's taxable income. 'Deductions or inclusions in taxable income' is wide and looks at all "costs" associated with the debt, for example, foreign exchange gains and losses as calculated and requiring inclusion in or deduction from income under section 24I on a foreign currency denominated loan.

9.2 Secondary adjustments

For years of assessment ending on or after 1 January 2015, section 31(3) provides that if the affected transaction is between:

- a resident and a non-resident; or
- a resident and the foreign permanent establishment of a resident,

then the amount of any disallowed deduction or inclusion in income (see **9.1**) will:

- if the resident is a company, be deemed to be a dividend consisting of a distribution of an asset *in specie* declared and paid by that resident to the non-resident [section 31(3)(*i*)]; or
- if the resident is a person other than a company, be deemed to be a donation made by the resident to the other resident for purposes of donations tax under Part V of the Act [section 31(3)(*ii*)].

This means that in addition to the primary adjustment (see **9.1**) a taxpayer may also be subject to dividends tax[22] or donations tax on the amount of the disallowed deduction.

Under section 31(2), if there is a difference between the arm's length amount that is taken into account in calculating taxable income or the amount that, but for section 31(2), would have been taken into account (that is, the actual amount) the difference is subject to a secondary adjustment and constitutes a deemed dividend *in specie* for dividends tax purposes or a donation for donations tax purposes. Therefore, the secondary adjustment would apply irrespective of whether the taxpayer initially prepared their taxable income on an arm's length basis and submitted their return on that basis (for example, the taxpayer did not claim the excessive interest as a deduction) or whether it was subsequently adjusted after the return was submitted. For the reasons set out in the paragraphs below, a resident company will not qualify for an exemption from dividends tax under section 64FA(1) or a reduced rate of dividends tax under section 64FA(2) on a deemed dividend *in specie* which arises under section 31(3)(*i*). Accordingly, the deemed dividend will be subject to dividends tax at a rate of 20%.

For section 64FA(1) or section 64FA(2) to apply, the beneficial owner must submit the declaration and written undertaking referred to in that section to the company that is deemed to have declared and paid the deemed dividend *in specie*. The Act defines "beneficial owner" in section 64D as "the person entitled to the benefit of the dividend attaching to a share." A recipient of a deemed dividend *in specie* under s 31(3)(*i*) is not entitled to the benefit of the dividend because there is no benefit. There is no benefit because the deemed dividend *in specie,* which results from a difference determined between two taxable income calculations, is a figure calculated for tax purposes only which has resulting dividends tax implications. An actual benefit arises for the other party to an affected transaction (the recipient) when an expense is overpriced or income is understated, but this actual benefit is different to and distinct from the dividend which is deemed to arise under section 31(3)(*i*). The actual benefit arises before and irrespective of whether the Act deems a dividend to arise under section 31(3). Neither section 31(2) nor section 31(3) re-characterises the underlying expense or income to be a dividend; the deemed dividend under section 31(3)(*i*) arises over and above the underlying transaction. In addition, even if one assumes there is a benefit, that benefit would not be considered to be "attaching to a share". The benefit attaches to the "affected transaction" that gave rise to the application of section 31(2) and section 31(3)(*i*) and not to a share. There is no direct link or cause between the benefit and a share. The immediate cause of the adjustment in section 31(2) is the underlying transaction which was not conducted on an arms' length basis. Accordingly, the deemed recipient is not a "beneficial owner".

In the absence of a "beneficial owner" as defined in section 64D, the requirements of section 64FA(1) and section 64FA(2) cannot be met. Further, in the absence of a "beneficial owner" it is irrelevant whether the specific requirements in a potentially applicable tax treaty, referred to in section 64FA(2)(a) and which would otherwise need to be met, are met. The requirements include, for example the tax treaty definition of a dividend and the possible requirement for a specific holding in the capital or voting rights of a company.

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[22] See *Comprehensive Guide to Dividends Tax* for more detail on dividends tax.

In addition to the absence of a beneficial owner, for completeness it is noted that an affected transaction falling within the ambit of section 31 is a transaction which is unlikely to meet the requirements in section 64F as referred to in section 64FA(1)(*a*).

In the case of a deemed donation under section 31(3)(*ii*), Part V of Chapter II of the Act, which includes the exemptions from donations tax, must be considered in determining if donations tax is payable. Practically the exemptions are unlikely to apply but it will depend on the facts of each case.

The deemed dividend or deemed donation is deemed to have taken place on the last day of the period of 6 months following the end of the year of assessment in respect of which the primary adjustment is made. The relevant year of assessment is the year of assessment in respect of which the adjustment is made and it is not impacted by whether the taxpayer calculates the amount of the adjustment to include in its calculation of taxable income before or after the end of the year assessment when, for example, it is preparing its tax return.

Example 7 – Deemed Dividend

Facts:

X, a foreign company resident in Country A, holds 100% of the shares in Z, a company resident in South Africa. X lends Z R1,2 million on 30 June 2021. Interest is payable at 6% per year. X has a 31 December financial year-end.

Z determines that an arm's length amount of debt is R1 million and an arm's length interest rate is 6% per year.

Result:

Z must effect a primary adjustment in calculating its taxable income by not claiming a tax deduction for interest of R6 050 (R0,2 million × 6% × 184/365). This will increase Z's taxable income by R6 050 for the year ended 31 December 2021.

The differential of R6 050 will constitute a deemed dividend *in specie* by Z to X for the purposes of dividends tax. X will be liable for dividends tax at the rate of 20% on 30 June 2022, since section 31(3) deemed to be a dividend declared and paid on the last day of the period of six months following the end of the year of assessment (31 December 2021).

9.3 Potential non-application of section 31

Section 31 contains certain subsections that provide that section 31 will not apply to, amongst others, financial assistance in the specified circumstances and to the specified extent.

It is beyond the scope of this Note to go into detail on these subsections, however, for completeness it is noted that:

- section 31(5) potentially provides for the non-application of section 31 in respect of certain financial assistance provided to or by a headquarter company (see **12.1**);

- section 31(6) potentially provides for the non-application of section 31 in respect of certain financial assistance granted by a resident company to a controlled foreign company or a company that part of the same group of companies if the borrower is located in a high tax jurisdiction; and
- section 31(7) potentially provides for the non-application of section 31 in respect of certain financial assistance that is, amongst others, not obliged to be redeemed within 30 years from the date it is incurred and no interest was applicable during the year of assessment.

10. Documentation guidelines

Public Notice 1334 "Duty to keep the records, books of account or documents in terms of section 29 of the Tax Administration Act, 2011"[23] prescribes the records to be kept for transfer pricing purposes. Section 2 of the notice provides that a person must keep the records specified in sections 3 and 4 of the notice if that person has a) entered into a potentially affected transaction as defined in the notice and b) the aggregate of the person's potentially affected transactions for the year of assessment, without any offsetting, exceeds or is reasonably expected to exceed R100 million. The records specified in section 4 must be kept in respect of any potentially affected transaction that exceeds or is reasonably expected to exceed R5 million in value.

Section 5 of the notice requires a person who has entered into a potentially affected transaction but is not subject to the requirements of section 4 of the notice to "keep the records, books of accounts or documents that enable the person to ensure and SARS to be satisfied that the potentially affected transaction is conducted at arms' length."

In addition, Public Notice 1117 in terms of section 25 of the Tax Administration Act, 2011[24] requires the filing of the Country-by-Country Reports, master files and local files. Section 2 deals with the persons required to submit and the form of returns, section 3 deals with the due date for submitting a return, and section 4 deals with the manner in which to submit the said return.

See the public notices for more detail.

11. Tax treaties and permanent establishments

South Africa has reserved the right to use the version of Article 7 of the OECD Model Tax Convention, and the relevant commentary, immediately prior to the July 2010 update. Paragraph 2 of Article 7 of this Model requires that the profits to be attributed to a permanent establishment are those which that permanent establishment would be expected to make if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar market conditions. As South Africa interprets Article 7 in accordance with the Commentary as it stood before the 2010 Update, SARS will apply arm's length principles when attributing profits to a permanent establishment, but, outside of interest in the case of financial enterprises, will not accept notional charges or expenses in calculating the profits to be attributed to the permanent establishment. For example, the head office of a company which is not a financial enterprise, obtains external funding at an interest rate of 8% and directly on-lends it at an interest rate of 10% to its foreign branch in order to fund the acquisition of capital assets. The charging of interest at 10% between the head office and the

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[23] See Government Gazette 40375 dated 28 October 2016.

[24] See Government Gazette 41186 dated 20 October 2017.

foreign branch is, in context, considered to be notional and will not be permitted but the allocation of interest at 8% would be considered to be an allocation of an actual expense in determining the profit of the branch.

In applying the arm's length principle to situations involving permanent establishments (see **4.1.2**), SARS will apply consistent principles. The permanent establishment will be viewed as a separate enterprise which is subject to the application of the arm's length principle but notional charges will not be permitted as a deduction. The arm's length principle applied by SARS in pricing intra-group loans to other entities will apply equally to the permanent establishments falling within the ambit of an affected transaction (see **4.1.2**).

The portion of debt which is provided to a non-resident (or a resident) and that is attributable to its South African (or foreign) permanent establishment, is a question of fact. SARS will consider all the relevant facts and circumstances of each case when considering this issue. In regard to the allocation of debt to a permanent establishment, reference should be had to the 2008 OECD Report, *Attribution of Profits to Permanent Establishments*. This report gives guidance on the attribution to a permanent establishment of "free" capital to support the functions it performs, assets it uses and risks it assumes. The balance of funding required by the permanent establishment is the amount by reference to which its interest expense is calculated.

12. Headquarter companies

12.1 Relaxation of transfer pricing provisions- section 31(5)(*a*) and section 31(5)(*b*)

In principle, a headquarter company must comply with the transfer pricing provisions of section 31. However, there are two exceptions in circumstances involving the provision of financial assistance where the provisions of section 31 will not apply to a headquarter company.

The Act provides that where any transaction, operation, scheme, agreement or understanding has been entered into and in terms of which financial assistance is provided by –

- a non-resident person to a headquarter company, the provisions of section 31 will not apply to so much of that financial assistance which is directly applied to any foreign company in which the headquarter company directly or indirectly holds at least 10% of the equity shares and voting rights (section 31(5)(*a*);[25] or
- a headquarter company to a foreign company in which the headquarter company directly or indirectly holds at least 10% of the equity shares and voting rights, the provisions of section 31 will not apply to that financial assistance (section 31(5)(*b*).[26]

[25] The headquarter company may hold that interest alone or together with any other company forming part of the same group of companies.

[26] The headquarter company may hold that interest alone or together with any other company forming part of the same group of companies.

Example 9 – Headquarter company

Facts:

A non-resident connected person lends R50 million to a headquarter company. The headquarter company directly on-lends R20 million to a foreign company in which the headquarter company directly holds 30% of the equity shares and voting rights.

Result:

The provisions of section 31 will only apply to R30 million of the loan from the non-resident connected person which was used for unspecified purposes.

The provisions of section 31 will not apply to the loan of R20 million advanced by the headquarter company to the foreign company in which it holds 30% of the equity shares and voting rights.

12.2 Ring-fencing of interest expenditure incurred on financial assistance granted by a non-resident

Section 20C(2) limits the deduction for interest payable by a headquarter company on financial assistance granted to it by a non-resident person (if a company, it must directly or indirectly hold at least 10%[27] of the equity shares and voting rights in the headquarter company) to the amount of interest received by or accruing to the headquarter company from any portion of that financial assistance that was directly applied as financial assistance to specified foreign companies. The specified foreign companies are foreign companies in which the headquarter company directly or indirectly, alone or together with any other company forming part of the same group of companies, held 10% of the equity shares and voting rights in that foreign company.

Under section 20C(3), the amount disallowed under section 20C(2) must be –

- carried forward to the immediately succeeding year of assessment of the headquarter company; and
- deemed an amount of interest actually incurred by the headquarter company during that succeeding year of assessment on the financial assistance previously granted to the headquarter company by a person that is not a resident.

13. Advance pricing agreements

In relation to thin capitalisation, advance pricing agreements are the result of a process whereby taxpayers and tax administrations agree on the amount of debt which will and will not be considered arm's length. The process is conducted in advance of the transactions being undertaken or in advance of filing a tax return.

An advance pricing agreement process is not currently available in South Africa. However, SARS is considering an APA programme for the future.

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[27] It may hold that interest alone or together with any other company forming part of the same group of companies as that person.

14. Other

14.1 Section 23M and section 23N

Section 23M and section 23N contain certain limitations on the amount of interest[28] which may be deducted.

Section 31 applies prior to considering the impact, if any, of section 23M and section 23N. This is apparent from the wording in section 31, section 23M and section 23N. If the requirements of section 31 are met, section 31(2) requires that taxable income must be calculated as if the affected transaction had been entered into on arms' length terms and conditions.

"Adjusted taxable income", as defined in section 23M and section 23N, is a key component in determining the amount of interest that is allowed to be deducted under these sections. By definition, the starting point in determining "adjusted taxable income" is taxable income calculated before applying section 23M or section 23N and the definition also refers to, amongst others, the amount of interest received or accrued that forms part of taxable income and the amount of interest incurred that has been allowed as a deduction from income.

In calculating taxable income, and therefore the amount that is *prima facie* deductible, section 31(2) requires the application of the arm's length principle. Since section 31 is applied in calculating taxable income and, if applicable, would have an impact of the amount received or accrued that is part of taxable income, and that is incurred and has been allowed as a deduction, it is clear that section 31 applies before section 23M or section 23N.

Section 23M and section 23N are sections which potentially place a limitation on the amount of interest that would otherwise be deductible, that is the arm's length amount that is initially included in calculating taxable income after applying the arm's length principle under section 31 (if applicable) but before applying section 23N and section 23M. It is not a case of that if one provision (section 23M or section 23N) applies then the other (section 31) does not apply. Depending on the facts section 31, section 23M and section 23N could all apply.

Accordingly, when section 23M and section 23N refer to taxable income in the definition of "adjusted taxable income" and to the amount of interest which is included is part of taxable income or which is allowed to be deducted in section 23M(3) and section 23N(2), the reference is to the amount of taxable income and the amount of interest, after section 31 has been applied.

[28] Section 23M(1) and section 23N(1) contain a definition of "interest" for purposes of section 23M and section 23N respectively. The definitions are important as the scope of the definitions varies significantly. See **9.1** for the possible items included under a "primary adjustment" in section 31. Overlap between sections 23M, 23N and section 31 is possible if the requirements of the particular sections are met.

14.2 Section 7C

Broadly,[29] section 7C generally applies where a loan, advance or credit is provided by a natural person or a specified company at the instance of the natural person, to –

- a trust in respect of which that natural person or specified company, or a connected person in relation to them, is a connected person; or
- or a company if at least 20% of its equity shares are held, directly or indirectly, or at least 20% of its voting rights can be exercised, by the trust referred to above whether alone or together with specified persons (20% company).

If section 7C applies then under section 7C(2) no deduction, loss, allowance or capital loss may be claimed in respect of a disposal (including by way of reduction or waiver) or the failure, wholly or partly, of a claim for the payment, of any amount owing in respect of such loan, advance or credit.

In addition, if section 7C applies then under section 7C(3) an amount[30] equal to the difference between –

- the amount incurred by that trust or 20% company during a year of assessment as interest in respect of that loan, advance or credit; and
- the amount that would have been incurred by that trust or 20% company at the official rate of interest,

must, for purposes of donations tax, be treated as a donation made to that trust by that natural person or specified company, on the last day of that year of assessment of that trust or company.

Section 7C(5) provides that section 7C(2) and section 7C(3) do not apply if, amongst others, the loan, advance or credit constitutes an affected transaction as defined in section 31(1) that is subject to the provisions of that section.[31]

Example 10 – Income vested in a resident beneficiary by a non-resident discretionary trust derived in consequence of an "other disposition"

Facts:

X, a resident individual, lent R1 million to a non-resident discretionary trust interest free at the beginning of the year of assessment. Had the trust borrowed the funds from a financial institution, it would have paid interest at a market-related rate of 10% a year. The trust used the funds to purchase a property of R1 million which produced a rental return for the trust of R80 000 during the same year of assessment. Before the end of the year of assessment, the trustees took the decision to vest the full amount of the income of R80 000 in Y, a resident beneficiary.

X is also one of the trust's beneficiaries. X is a connected person under paragraph (a)(ii) of the definition of 'connected person' in section 1(1) to the non-resident discretionary trust.

The official rate of interest is 4,5%.

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[29] This is a broad summary - refer to section 7C for detail when considering if section 7C applies.

[30] Positive difference only.

[31] Section 7(5)(*e*).

Result:

The total income received by or accrued to the trust was R80 000. The full amount of R80 000 was derived in consequence of the interest-free loan by X to the trust. The amount would have constituted income as defined in section 1(1) had the trust been a resident. Under section 7(8), which is triggered before section 25B when the amount is initially received by or accrued to the trust, R80 000 is deemed to be received by or accrued to X, and as a result RNil is deemed to accrue to Y under section 25B(1). Despite Y receiving R80 000, RNil of that amount will comprise income for Y.

The loan by X to the non-resident discretionary trust is an affected transaction for purposes of section 31(1) because it is a transaction which has been entered between a resident and a non-resident that are connected persons in relation to each other. Section 7(8) applies first and if the amount attributed under section 7(8) is less than the arm's length return which is required for purposes of section 31, the difference between the two amounts will be included in X's taxable income calculation under section 31(2). Section 31(2) requires taxable income to be prepared on arm's length amounts. In this example, the amount included in X's income under section 7(8) is R80 000 and the arm's length amount is R100 000, therefore an additional amount of R20 000 will be included under section 31(2). The R20 000 adjustment under section 31(2) would also constitute a deemed donation under section 31(3) for purposes of donations tax

Even if the requirements of section 7C are met, section 7C(5)(*e*) provides that section 7C(2) and section 7C(3) do not apply if, amongst others, the loan, advance or credit constitutes an affected transaction as defined in section 31(1) that is subject to the provisions of that section. The affected transaction is subject to the provisions of section 31(2) and section 31(3) and therefore section 7C(2) and section 7C(3) do not apply.

14.3 Withholding tax on interest

The withholding tax on interest provisions in Part IVB of Chapter 11 of the Act are generally applicable to interest paid, or which becomes due and payable, to or for the benefit of a foreign person on or after 1 March 2015.[32]

Section 31(2), if applicable, requires that taxable income or tax payable of the person in whose hands the tax benefit results or will result must be calculated as if the terms and conditions of the affected transaction had been arm's length. It does not deem the underlying transaction to have been conducted at an adjusted amount for purposes of the Act as a whole and therefore does not alter the amount of interest paid or due and payable to the lender. Accordingly, any "adjustment" to taxable income or tax payable under section 31(2) will not impact on the calculation of withholding tax on interest under Part IVB of the Act. In addition, section 31(3) is a secondary adjustment which also does not re-characterise or alter the amount of interest paid or due and payable to the lender. For example, in a transaction falling within the ambit of section 31(2), Company A paid Company B, a foreign person, interest of R250 000. An arm's length amount of interest would have been R150 000. Accordingly, when calculating taxable income, Company A claimed a deduction for R150 000. In addition, under

[32] See Interpretation Note 115 "Withholding Tax on Interest" for detailed commentary on Part IVB.

section 31(3) the difference of R100 000 is deemed to be a dividend *in specie* declared and paid by Company A to Company B and Company A must consider possible dividends tax implications. Company B received interest of R250 000 which is subject to withholding tax on interest. From Company B's perspective there is no impact of the reduced deduction which Company A was entitled to under section 31(2) or the deemed dividend under section 31(3) on the amount subject to withholding tax on interest.

15. Conclusion

In summary:

- Section 31 applies to affected transactions which are broadly cross border[33] transactions between relevant parties that have been concluded on terms and conditions that would not have existed if the parties had been independent persons dealing at arm's length and those terms and conditions result or will result in a tax benefit.
- For years of assessment commencing on or after 1 April 2012, taxpayers must determine the acceptable amount of debt from affected transactions applying arm's length principles.
- Taxpayers are required to calculate taxable income based on the arm's length terms and conditions that should have applied to the affected transaction. This means that the interest and other charges relating to the non-arm's length amount of affected transaction debt and the amount of interest which is non-arm's length must be disallowed as deductions in computing taxable income.
- In addition to a disallowed deduction for the interest and other charges, the amount of the disallowed deduction will in certain cases be deemed to be a dividend which is subject to dividends tax or a donation subject to donations tax.
- Taxpayers must be able to substantiate their view of the extent to which the relevant party debt is considered to be arm's length and accordingly must retain appropriate documentation.
- The transfer pricing provisions have been relaxed in relation to certain transactions involving financial assistance and headquarter companies, with a corresponding limitation on the amount of the related interest deductions.
- South Africa does not currently have advance pricing agreements.
- Section 31 applies prior to considering the impact, if any, of section 23M and section 23N.

[33] Cross border is used widely here; it includes transactions between two non-residents and transactions between two residents where the transaction involves a South African permanent establishment or a foreign permanent establishment respectively.

- Section 31(2), if applicable, does not deem the underlying transaction to have been conducted at an adjusted amount for purposes of the Act as a whole and accordingly any “adjustment” to taxable income or tax payable under section 31(2) will not impact on the calculation of withholding tax on interest under Part IVB of Chapter II of the Act.

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Annexure – The law

Section 31

31. Tax payable in respect of international transactions to be based on arm's length principle.—(1) For the purposes of this section—

"affected transaction" means any transaction, operation, scheme, agreement or understanding where—

(*a*) that transaction, operation, scheme, agreement or understanding has been directly or indirectly entered into or effected between or for the benefit of either or both—

(i) (*aa*) a person that is a resident; and

(*bb*) any other person that is not a resident;

(ii) (*aa*) a person that is not a resident; and

(*bb*) any other person that is not a resident that has a permanent establishment in the Republic to which the transaction, operation, scheme, agreement or understanding relates;

(iii) (*aa*) a person that is a resident; and

(*bb*) any other person that is a resident that has a permanent establishment outside the Republic to which the transaction, operation, scheme, agreement or understanding relates; or

(iv) (*aa*) a person that is not a resident; and

(*bb*) any other person that is a controlled foreign company in relation to any resident,

and those persons are connected persons or associated enterprises[34] in relation to one another; and

(*b*) any term or condition of that transaction, operation, scheme, agreement or understanding is different from any term or condition that would have existed had those persons been independent persons dealing at arm's length;

"associated enterprise" means an associated enterprise as contemplated in article 9 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development[35]

"financial assistance" includes any—

(*a*) debt; or

(*b*) security or guarantee.

(2) Where—

(*a*) any transaction, operation, scheme, agreement or understanding constitutes an affected transaction; and

(*b*) any term or condition of that transaction, operation, scheme, agreement or understanding—

(i) is a term or condition contemplated in paragraph (*b*) of the definition of "affected transaction"; and

[34] Associated enterprise is effective for years of assessment commencing on or after 1 January 2023.
[35] Associated enterprise is effective for years of assessment commencing on or after 1 January 2023.

(ii) results or will result in any tax benefit being derived by a person that is a party to that transaction, operation, scheme, agreement or understanding or by a resident in relation to a controlled foreign company contemplated in subparagraph (iv) of the definition of "affected transaction",

the taxable income or tax payable by any person contemplated in paragraph (*b*)(ii) that derives a tax benefit contemplated in that paragraph must be calculated as if that transaction, operation, scheme, agreement or understanding had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm's length.

(3) To the extent that there is a difference between—

(*a*) any amount that is, after taking subsection (2) into account, applied in the calculation of the taxable income of any resident that is a party to an affected transaction; and

(*b*) any amount that would, but for subsection (2), have been applied in the calculation of the taxable income of the resident contemplated in paragraph (*a*),

the amount of that difference must, if that person is a resident and the other person to the affected transaction is a person as contemplated in paragraph (*a*)(i)(*bb*) or (*a*)(iii)(*bb*) of the definition of "affected transaction"—

(i) if that resident is a company, be deemed to be a dividend consisting of a distribution of an asset *in specie* declared and paid by that resident to that other person; or

(ii) if that resident is a person other than a company, be deemed, for purposes of Part V, to be a donation made by that resident to that other person,

on the last day of the period of six months following the end of the year of assessment in respect of which that adjustment is made: Provided that where the amount of that difference was prior to 1 January 2015 deemed to be a loan that constitutes an affected transaction, so much of that loan as has not been repaid before 1 January 2015 must—

(*a*) if that resident is a company, be deemed to be a dividend consisting of a distribution of an asset *in specie* that was declared and paid by that resident to that other person; or

(*b*) if that resident is a person other than a company, be deemed, for purposes of Part V, to be a donation made by that resident to that other person,

on 1 January 2015.

(4) For the purposes of subsection (2), where any transaction, operation, scheme, agreement or understanding has been directly or indirectly entered into or effected as contemplated in that subsection in respect of—

(*a*) the granting of any financial assistance; or

(*b*) intellectual property as contemplated in the definition of 'intellectual property' in section 23I(1) or knowledge,

"connected person" means a connected person as defined in section 1: Provided that the expression 'and no holder of shares holds the majority voting rights in the company' in paragraph (*d*)(v) of that definition must be disregarded.

(5) Where any transaction, operation, scheme, agreement or understanding has been entered into between a headquarter company and—

(*a*) any other person that is not a resident and that transaction, operation, scheme, agreement or understanding is in respect of the granting of financial assistance by that other person to that headquarter company, this section does not apply to so much of that financial assistance that is directly applied as financial assistance to any foreign company in which the headquarter company directly or indirectly (whether alone or together with any other company forming part of the same group of companies as that headquarter company) holds at least 10 per cent of the equity shares and voting rights;

(*b*) any foreign company in which the headquarter company directly or indirectly (whether alone or together with any other company forming part of the same group of companies as that headquarter company) holds at least 10 per cent of the equity shares and voting rights and that transaction, operation, scheme, agreement or understanding comprises the granting of financial assistance by that headquarter company to that foreign company, this section does not apply to that financial assistance;

(*c*) any other person that is not a resident and that transaction, operation, scheme, agreement or understanding is in respect of the granting of the use, right of use or permission to use any intellectual property as defined in section 23I (1) by that other person to that headquarter company, this section does not apply to the extent that the headquarter company—

(i) grants that use, right of use or permission to use that intellectual property to any foreign company in which the headquarter company directly or indirectly (whether alone or together with any other company forming part of the same group of companies as that headquarter company) holds at least 10 per cent of the equity shares and voting rights; and

(ii) does not make use of that intellectual property otherwise than as contemplated in subparagraph (i); or

(*d*) any foreign company in which the headquarter company directly or indirectly (whether alone or together with any other company forming part of the same group of companies as that headquarter company) holds at least 10 per cent of the equity shares and voting rights and that transaction, operation, scheme, agreement or understanding comprises the granting of the use, right of use or permission to use any intellectual property as defined in section 23I (1) by that headquarter company to that foreign company, this section does not apply to that granting to that foreign company.

(6) Where any transaction, operation, scheme, agreement or understanding that comprises the granting of—

(*a*) financial assistance; or

(*b*) the use, right of use or permission to use any intellectual property as defined in section 23I,

by a person that is a resident (other than a headquarter company) to a controlled foreign company in relation to that resident or in relation to a company that forms part of the same group of companies as that resident, this section must not be applied in calculating the taxable income or tax payable by that resident in respect of any amount received by or accrued to that resident in terms of that transaction, operation, scheme, agreement or understanding if—

(i) ……

(ii) that controlled foreign company has a foreign business establishment as defined in section 9D (1); and

(iii) the aggregate amount of tax payable to all spheres of government of any country other than the Republic by that controlled foreign company in respect of any foreign tax year of that controlled foreign company during which that transaction, operation, scheme, agreement or understanding exists is at least 67.5 per cent of the amount of normal tax that would have been payable in respect of any taxable income of that controlled foreign company had that controlled foreign company been a resident for that foreign tax year: Provided that the aggregate amount of tax so payable must be determined—

(*aa*) after taking into account any applicable agreement for the prevention of double taxation and any credit, rebate or other right of recovery of tax from any sphere of government of any country other than the Republic; and

(*bb*) after disregarding any loss in respect of a year other than that foreign tax year or from a company other than that controlled foreign company.

(7) Where—

(*a*) any transaction, operation, scheme, agreement or understanding has been entered into between a company that is a resident (for purposes of this subsection referred to as "resident company") or any company that forms part of the same group of companies as that resident company and any foreign company in which that resident company (whether alone or together with any other company that forms part of the same group of companies as that resident company) directly or indirectly holds in aggregate at least 10 per cent of the equity shares and voting rights and that transaction, operation, scheme, agreement or understanding comprises the granting of financial assistance that constitutes a debt owed by that foreign company to that resident company or any company that forms part of the same group of companies as that resident company;

(*b*) that foreign company is not obliged to redeem that debt in full within 30 years from the date the debt is incurred;

(*c*) the redemption of the debt in full by the foreign company is conditional upon the market value of the assets of the foreign company not being less than the market value of the liabilities of the foreign company; and

(*d*) no interest accrued in respect of the debt during the year of assessment,

this section must not apply to that debt.

Section 20C

20C. Ring-fencing of interest and royalties incurred by headquarter companies.—(1) For the purposes of this section—

"financial assistance" means financial assistance contemplated in section 31 (1); and

"royalty" means any amount that is, before taking into account section 49D (*c*), subject to the withholding tax on royalties in terms of Part IVA.

(2) Where a headquarter company has during any year of assessment incurred any interest in respect of any financial assistance granted to that headquarter company by a person—

(*a*) that is not a resident; and

(*b*) if that person is a company, that directly or indirectly (and whether alone or together with any other company forming part of the same group of companies as that person) holds at least 10 per cent of the equity shares and voting rights in that headquarter company,

the amount of that interest in respect of which a deduction is allowable to that headquarter company in that year of assessment is limited to so much of the amount of interest received by or accrued to the headquarter company as relates to any portion of that financial assistance that is directly applied as financial assistance to any foreign company in which the headquarter company directly or indirectly (whether alone or together with any other company forming part of the same group of companies as that headquarter company) holds at least 10 per cent of the equity shares and voting rights.

(2A) Where a headquarter company has during any year of assessment incurred any amount that constitutes a royalty payable to a person—

(*a*) that is not a resident; and

(*b*) if that person is a company, that directly or indirectly (and whether alone or together with any other company forming part of the same group of companies as that person) holds at least 10 per cent of the equity shares and voting rights in that headquarter company,

the amount of that royalty in respect of which a deduction is allowable to that headquarter company in that year of assessment is limited to so much of any amounts received by or accrued to the headquarter company in respect of—

(i) the use or right of use of or permission to use any intellectual property as defined in section 23I; or

(ii) the imparting of or the undertaking to impart any scientific, technical, industrial or commercial knowledge or information, or the rendering of or the undertaking to render, any assistance or service in connection with the application or utilisation of such knowledge or information,

from any foreign company in which the headquarter company directly or indirectly (whether alone or together with any other company forming part of the same group of companies as that headquarter company) holds at least 10 per cent of the equity shares and voting rights.

(3) Any amount that is disallowed as a deduction in any year of assessment of a headquarter company in terms of subsection (2) or (2A) must—

(*a*) be carried forward to the immediately succeeding year of assessment of the headquarter company; and

(*b*) where that amount is disallowed as a deduction—

(i) in terms of subsection (2), be deemed to be an amount of interest actually incurred by the headquarter company during that succeeding year in respect of financial assistance granted to that headquarter company by a person that is not a resident; or

(ii) in terms of subsection (2A), be deemed to be an amount actually incurred by the headquarter company during that succeeding year that constitutes a royalty payable to a person that is not a resident.

Article 9 of the OECD Model Tax Convention

1. Where:

(*a*) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State; or

(*b*) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State – and taxes accordingly – profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make such an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Agreement and the competent authorities of the Contracting States shall if necessary consult each other.