Thin Capitalisation Safe Harbour Rules: A Proposed Conceptual Legislative Design

L Goosen* and C Greeff**

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Authors

Lize Goosen
Cecileen Greeff

Affiliation

Stellenbosch University, South Africa

Email

lgoosen@sun.ac.za
cgreeff@sun.ac.za

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Abstract

Current legislation in respect of thin capitalisation is viewed as unclear and complex, which has resulted in both the Davis Tax Committee and National Treasury commenting that thin capitalisation safe harbour rules should be investigated for introduction into South African legislation. The aim of this article is to propose a conceptual legislative design for the introduction of thin capitalisation safe harbour rules into South African legislation, for non-complex inbound financial assistance transactions whilst still achieving compatibility with the arm's length principle. The Australian, New Zealand and Canadian thin capitalisation rules were examined to determine in what manner these countries have incorporated thin capitalisation rules into their legislation and to evaluate their compatibility with the arm's length principle. By designing domestic legislation to include specific features for the safe harbour rules, it is possible to introduce safe harbour rules into South African legislation that still achieves compatibility with the arm's length principle. The proposed conceptual legislative design may inform legislative amendment or the practice of the South African Revenue Service.

Keywords

Arm's length; compatibility; legislative design; OECD *Model Tax Convention*; OECD *Transfer Pricing Guidelines*; safe harbour rules; thin capitalisation.

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1 Introduction

Companies have the option to make use of debt or equity to finance their capital requirements. Many companies tend to make use of debt as opposed to equity, as the interest on debt may be allowed as a tax-deductible expense.[1] In comparison, dividends paid on equity raised for capital requirements do not result in a tax-deductible expense for the company. In the case where a company makes use of debt that is considered excessive in proportion to the company's equity, the company is referred to as being "thinly capitalised".[2]

Thin capitalisation can result in a loss to the fiscus through base erosion when a resident company is funded by a non-resident company, especially when these companies form part of the same group of companies[3] and the interest rate charged on the debt is not market related or the amount of debt is considered excessive.[4] Multinational enterprises often structure their debt obligations between companies that form part of the same group of companies to ensure that their income from interest earned is taxed in a low tax jurisdiction with the corresponding interest paid deducted from a company's profits in a higher tax jurisdiction, which can then result in base erosion.[5]

In order to limit base erosion in South Africa, transfer pricing provisions were introduced into the *Income Tax Act* 58 of 1962 (hereafter the *Act*) of

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* Lize Goosen. CA(SA) MTax (Stell). Lecturer, School of Accountancy, Stellenbosch University, South Africa. E-mail: lgoosen@sun.ac.za. ORCiD: https://orcid.org/0000-0002-9661-6808. This research was conducted by Lize Goosen as part of her master's thesis, under the supervision of Cecileen Greeff.

** Cecileen Greeff. CA(SA) MCom (Stell). Senior Lecturer, School of Accountancy, Stellenbosch University, South Africa. E-mail: cgreeff@sun.ac.za. ORCiD: https://orcid.org/0000-0002-4591-3124.

1 DTC 2016 https://www.taxcom.org.za/docs/New_Folder3/6%20BEPS%20Final %20Report%20-%20Action%204.pdf 8.

2 SARS 1996 https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-Arc-2019-01-Arc-01-Income-Tax-Practice-Note-2-of-1996-withdrawn-5-August-2019-with-effect-from-1-April-2012.pdf 1.

3 Section 1 of the *Income Tax Act* 58 of 1962 (hereafter the *Act*) defines "group of companies" as "two or more companies in which one company (hereinafter referred to as the 'controlling group company') directly or indirectly holds shares in at least one other company (hereinafter referred to as the 'controlled group company'), to the extent that (a) at least 70% of the equity shares in each controlled group company are directly held by the controlling group company, one or more other controlled group companies or any combination thereof; and (b) the controlling group company directly holds at least 70% of the equity shares in at least one controlled group company."

4 DTC 2016 https://www.taxcom.org.za/docs/New_Folder3/6%20BEPS%20Final%20Report%20-%20Action%204.pdf 10.

5 OECD 2012 https://web-archive.oecd.org/2013-01-08/221764-5.%20Thin_Capitalization_Background.pdf 3.

South Africa in 1995.[6] Transfer pricing provisions – such as section 31 of the *Act* – regulate the adjustment of prices at which goods and services are transferred between associated enterprises[7] or entities that are connected persons in relation to each other to reflect arm's length prices, specifically in respect of cross-border transactions between residents and non-residents. The term "arm's length" is not defined in the *Act*, but the benchmark is that transactions should be concluded on terms that independent third parties would have negotiated in the open market.[8]

The Davis Tax Committee compared current South African legislation to limit base erosion due to excessive interest deductions to the recommendations made by the Organisation for Economic Co-operation and Development (hereafter the OECD) in the report titled *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update: Inclusive Framework on BEPS*[9] (base erosion and profit shifting) hereafter the *Action 4 Report*),[10] and reported that current legislation in respect of thin capitalisation is unclear and complex.[11] The Davis Tax Committee recommended that it may be preferable in the South African context to evaluate the amount of debt relative to a taxpayer's equity, separately from its price of debt.[12] National Treasury also reviewed South African legislation pertaining to excessive interest deductions in their 2020 Discussion Paper titled *Reviewing the Tax Treatment of Excessive Debt Financing, Interest Deductions and Other Financial Payments*.[13] Both the Davis Tax Committee[14] and National Treasury[15] indicated that thin

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6 SARS 1999 https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf 6.

7 With effect from 1 January 2023 the definition of "associated enterprise" was added to s 31 of the *Act* to mean "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".

8 SARS 1999 https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf 8.

9 OECD 2016 https://www.oecd-ilibrary.org/docserver/9789264268333-en.pdf?expires=1618222878&id=id&accname=guest&checksum=7B862F70AEB47E9896 6AB6C6BCB65C88.

10 The OECD issued the *Action 4 Report* in 2016 which details the OECD's guidelines for preventing base erosion by way of excessive interest deductions.

11 DTC 2016 https://www.taxcom.org.za/docs/New_Folder3/6%20BEPS%20Final%20Report%20-%20Action%204.pdf 33.

12 DTC 2016 https://www.taxcom.org.za/docs/New_Folder3/6%20BEPS%20Final%20Report%20-%20Action%204.pdf 32.

13 National Treasury 2020 http://www.treasury.gov.za/public%20comments/Reviewing%20the%20Tax%20Treatment%20of%20Excessive%20Debt%20Financing,%20Interest%20Deductions%20and%20Other%20Financial%20Payments.pdf.

14 DTC 2016 https://www.taxcom.org.za/docs/New_Folder3/6%20BEPS%20Final%20Report%20-%20Action%204.pdf 54.

15 National Treasury 2020 http://www.treasury.gov.za/public%20comments/Reviewing%20the%20Tax%20Treatment%20of%20Excessive%20Debt%20Financing,%20Interest%20Deductions%20and%20Other%20Financial%20Payments.pdf 48.

capitalisation safe harbour rules should be investigated for introduction into South African legislation.

Thin capitalisation safe harbour rules are transfer pricing provisions that may relieve eligible taxpayers from certain requirements, for example arm's length price adjustments, which may be imposed by a country's transfer pricing legislation.[16] This is typically done by defining an acceptable debt-to-equity ratio.[17] For example, if a safe harbour rule considers a debt-to-equity ratio of 3:1 as acceptable, a company would not be viewed as thinly capitalised if its debt-to-equity ratio falls within the applicable safe harbour ratio. Accordingly, the company would be relieved from the burden of having to determine arm's length interest amounts that may have been applicable if not for the safe harbour rule. If the safe harbour threshold is not met, the specified ratio is then used to limit the amount of debt on which the tax-deductible interest should be calculated.[18] Alternatively, a tax authority may determine an interest rate that is indicative of an arm's length rate.[19]

The OECD directs that countries that do make use of safe harbour rules should take into consideration that the design of safe harbour rules requires careful attention.[20] This article attempts to provide a proposed conceptual legislative design for the introduction of thin capitalisation safe harbour rules into South African legislation, that achieves compatibility with the arm's length principle contained within Article 9(1) of the OECD *Model Tax Convention* (hereafter the OECD MTC), for non-complex inbound financial assistance transactions.[21] The OECD MTC is used by OECD member countries and other non-members, such as South Africa, as the basis for bilateral tax treaties.[22] Compatibility is, therefore, important, as the standard South African tax treaty model incorporates the arm's length principle of

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16 OECD 2022 https://read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2022_0e655865-en#page211 204.

17 OECD 2012 https://web-archive.oecd.org/2013-01-08/221764-5.%20Thin_Capitalization_Background.pdf 12.

18 OECD 2012 https://web-archive.oecd.org/2013-01-08/221764-5.%20Thin_Capitalization_Background.pdf 12.

19 SARS 1996 https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-Arc-2019-01-Arc-01-Income-Tax-Practice-Note-2-of-1996-withdrawn-5-August-2019-with-effect-from-1-April-2012.pdf 3.

20 OECD 2022 https://read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2022_0e655865-en#page211 207-211.

21 For the purposes of this article, the authors define "non-complex inbound financial assistance transactions" as basic forms of debt, such as loans or credit facilities, with clearly defined terms (e.g., fixed or variable interest rates, specific repayment schedules) and without the inclusion of complex financial instruments like derivatives or convertible debt. The transactions occur between related parties (e.g., a foreign parent company and its South African subsidiary).

22 De Wet *Seeking Deviations* 1.

Article 9(1) of the OECD MTC.[23] In addition, South African transfer pricing legislation is closely aligned with the arm's length principle of the OECD.[24]

This article's focus is on debt (i.e. non-complex inbound financial assistance transactions) and the resulting interest on debt transactions between associated enterprises,[25] excluding transactions concerning natural persons. The following items are excluded from the scope of this article: section 23N of the *Act,* as it specifically addresses interest limitations concerning reorganisation and acquisition transactions; sections 8F and 8FA of the *Act,* which deal with hybrid debt instruments and interest; and withholding taxes on interest and exchange control regulations in relation to foreign loans. The compatibility of the thin capitalisation safe harbour rules with other articles of the OECD MTC does not form part of this article. The limited scope of this article does not allow conclusions to be drawn regarding the compatibility of potential thin capitalisation safe harbour rules with the OECD MTC as a whole.[26]

To this end, section 2 of the article discusses the arm's length principle, current South African domestic legislation relating to thin capitalisation, together with the applicable articles in existing South African tax treaties, to determine compatibility with the arm's length principle and to provide the legislative framework required to determine the features of thin capitalisation safe harbour rules that are essential for compatibility. Section 3 of the article examines the legislative design of thin capitalisation safe harbour rules of Australia, New Zealand, and Canada.[27] These three

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23 De Wet *Seeking Deviations* 8.

24 SARS 1999 https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf.

25 An "associated enterprise" is defined in s 31 of the *Act* as "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". Article 9 of the OECD *Model Tax Convention on Income and on Capital: Condensed Version* (2017) (the OECD MTC) states that two enterprises are associated enterprises "where 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 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, …".

26 In addition, the impact of the OECD's Pillar One and Pillar Two initiatives was not considered, because Pillar One Amount A still lacks consensus and any consideration of potential impact would be premature. Pillar One Amount B constitutes a simplification mechanism. However, it is applicable only to certain entities engaged in the routine wholesale distribution of tangible goods. Therefore, a consideration of the impact of Amount B on entities falling into the ambit of Amount B would be of very limited use in the authors' opinion.

27 Although there are African countries with thin capitalisation safe harbour rules, the focus of this article is on developed countries due *inter alia* to the general issues in obtaining comparables, benchmarking and general tax authority capacity in Africa. Additionally, developed countries have been at the forefront of addressing BEPS

countries have advanced transfer pricing legislation in place that includes thin capitalisation safe harbour rules, with substantial literature available on the topic. Based on sections 2 and 3, section 4 of the article proposes a legislative design for the introduction of thin capitalisation safe harbour rules into South African legislation. The article then ends with section 5 as the conclusion and also provides further recommendations.

2 Theoretical overview

2.1 Arm's length in the context of thin capitalisation safe harbour rules

Article 9(1) of the OECD MTC[28] authorises profit adjustments of enterprises of contracting states to reflect market-related terms in respect of financial and commercial arrangements.[29] The Commentary on Article 9 of the OECD MTC refers to market-related adjustments as arm's length adjustments, consequently establishing the justification for the application of the arm's length principle in the calculation of taxable income according to domestic tax legislation.[30] As multinational enterprise groups generally fall within the ambit of associated enterprises, companies transacting across borders within the group on terms that are not considered to be market related would accordingly be expected to adjust their profits to reflect arm's length prices in terms of Article 9(1) of the OECD MTC.[31] Article 9(2) of the OECD MTC requires a corresponding adjustment to the profits of the associated enterprise in the other contracting state.[32] However, paragraph 6 of the Commentary on Article 9 of the OECD MTC states that the corresponding adjustment is not automatic.[33] The contracting state will effect a corresponding adjustment only if it considers the adjustment made in the other state to be justified, both in terms of the manner in which arm's length prices were established and the amount of the adjustment.[34]

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concerns. Their safe harbour rules are designed to mitigate risks more effectively, ensuring that the tax base is protected against aggressive tax planning strategies. In addition, safe harbour rules from developed countries may be perceived as more credible and reliable, thus fostering greater taxpayer confidence and compliance. Adopting these rules for the South African context, rather than the rules of other African countries, may help build trust between taxpayers and tax authorities, leading to better adherence and reduced disputes.

28 The OECD MTC provides a uniform standard for member countries on the taxing rights and obligations to be negotiated between countries.

29 *OECD Model Tax Convention* 226.

30 *OECD Model Tax Convention* 226.

31 DTC 2016 https://www.taxcom.org.za/docs/New_Folder3/6%20BEPS%20Final%20Report%20-%20Action%204.pdf 10.

32 *OECD Model Tax Convention* 34.

33 *OECD Model Tax Convention* 227.

34 *OECD Model Tax Convention* 227.

The tax treaty negotiated between contracting states is therefore important, as it will determine if the arm's length principle forms the basis for negotiation between these contracting states. It is also important to understand what constitutes arm's length in the context of debt. In the Commentary on Article 9 of the OECD MTC,[35] it is stated that arm's length, in relation to debt and the resultant interest on debt should be determined taking both the interest rate and the amount of debt of the transaction into account.[36] Determining an arm's length price, accordingly an arm's length interest rate, is a complex process in itself and often expensive for taxpayers.[37] The determination of whether the amount of debt provided constitutes an arm's length debt amount or should rather be considered to constitute another kind of payment, such as equity, is still considered complex,[38] despite additional guidance released by the OECD in 2020 on the determination of arm's length prices in relation to thin capitalisation and debt transactions in its *Transfer Pricing Guidance on Financial Transactions Report.*[39]

The OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022* (hereafter the OECD *Transfer Pricing Guidelines*) contains the internationally agreed upon principles on the determination of arm's length prices as directed in the OECD Commentary to Article 9.[40] Due to the complexity surrounding the determination of arm's length in respect of debt, many countries, although subscribing to the arm's length principle, have devised their own methods to simplify transfer pricing by introducing safe harbour rules into their legislation.[41] In Africa specifically, carrying out a comparability analysis can be very difficult due to a lack of wide open markets and the challenges in obtaining comparable prices from competing companies in the same industries, and there are limited, if any, African benchmarking databases.[42] Foreign operations in developed countries are accordingly used as the basis for comparable prices, which then have to be adjusted for geographical and market structure differences, as well as

35 *OECD Model Tax Convention* 226 para 3(b).
36 *OECD Model Tax Convention* 226.
37 SAICA 2020 https://saicawebprstorage.blob.core.windows.net/uploads/resources/2020_09_30_SAICA_submission_Excessive_Debt_Financing_Interest_deductions_and_other_financial_payments.pdf 8.
38 Condoleon *et al* 2020 https://news.bloombergtax.com/transfer-pricing/insight-debt-characterization-and-application-of-oecd-accurate-delineation-analysis.
39 OECD 2020 https://www.oecd.org/en/publications/transfer-pricing-guidance-on-financial-transactions-inclusive-framework-on-beps-actions-4-8-10_794bcddd-en.html 8-10.
40 OECD 2022 https://read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2022_0e655865-en#page211.
41 Picciotto 2018 https://opendocs.ids.ac.uk/opendocs/bitstream/handle/20.500.12413/14117/ICTD_WP86.pdf?sequence=1&isAllowed=y 27.
42 Oguttu 2020 *INTERTAX* 83.

interest rate and country risk differences, compounding the complexity of determining appropriate arm's length prices.[43] This is widely considered to be an uncertain and resource-intensive process.[44]

The *Thin Capitalisation Report* was the first OECD report that specifically discussed the factors to consider in the context of thin capitalisation as well as the varying international approaches followed to counter base erosion due to thin capitalisation.[45] This Report also discussed the interaction between a country's domestic tax legislation and tax treaties in relation to Article 9 of the OECD MTC. The *Thin Capitalisation Report* noted the following important factors to consider:[46]

- Article 9 of the OECD MTC does not prevent a country from implementing domestic thin capitalisation rules, provided that these rules result in adjustments that approximate arm's length profits;
- Article 9 of the OECD MTC is relevant in respect of the determination of arm's length to both the amount of the debt provided and the rate of interest charged on the loan in question; and
- should thin capitalisation rules be applied, including both earnings stripping[47] and safe harbour rules, this should prevent the taxable profits of an enterprise from being adjusted over and above the arm's length profit.

The *Thin Capitalisation Report* accordingly provided the first indication of the importance of arm's length, both in respect of the interest rate and the amount of debt, and it reiterated that should thin capitalisation rules, either earnings stripping or safe harbour rules, be applied, the adjusted profit should approximate arm's length. Despite the principles provided for the use of safe harbour rules in the *Thin Capitalisation Report*, the OECD initially had a negative view of the use of safe harbour rules.[48] In the OECD *Transfer Pricing Guidelines* published in 1995 the OECD concluded that safe harbours can result in "fundamental problems" and are typically not regarded as compatible with the arm's length principle, which serves as the

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43 Oguttu 2020 *INTERTAX* 83.

44 National Treasury 2020 http://www.treasury.gov.za/public%20comments/Reviewing%20the%20Tax%20Treatment%20of%20Excessive%20Debt%20Financing,%20Interest%20Deductions%20and%20Other%20Financial%20Payments.pdf.

45 OECD *Thin Capitalisation.*

46 OECD *Thin Capitalisation* 13-14.

47 Earnings stripping rules limit the tax-deductible interest amount by applying a fixed ratio or percentage to the pre-tax earnings of a company, with typically no restriction on the amount of debt in a company's capital structure.

48 Picciotto 2018 https://opendocs.ids.ac.uk/opendocs/bitstream/handle/20.500.12413/14117/ICTD_WP86.pdf?sequence=1&isAllowed=y 28.

basis for determining transfer prices.[49] The OECD did, however, accept over time that some types of safe harbours were required, especially for developing countries that lack access to comparable data to conduct the required comparability analysis of transactions.[50] Accordingly, the OECD *Transfer Pricing Guidelines* was amended in 2013 to include a section providing guidance on safe harbours.[51] The OECD describes a safe harbour as:

> A provision that applies to a defined category of taxpayers or transactions and that relieves eligible taxpayers from certain obligations otherwise imposed by a country's general transfer pricing rules. A safe harbour substitutes simpler obligations for those under the general transfer pricing regime.[52]

Safe harbour rules are typically used to restrict the amount of debt on which tax-deductible interest should be calculated, generally by defining an acceptable debt-to-equity ratio.[53] The *Thin Capitalisation Report* states that a high debt-to-equity ratio would *inter alia* indicate that an interest payment may not have been at arm's length.[54] However, approaches followed where the debt-to-equity ratio exceeds a predetermined fixed ratio and interest deductions are limited accordingly may be viewed as arbitrary in nature and considered not to represent arm's length prices, even if the ratio is based on market-related ratios.[55] Nevertheless, it is crucial to highlight that the *Thin Capitalisation Report* asserts that a safe harbour rule based on a fixed ratio should be considered compatible with the arm's length principle, provided that the taxpayer is allowed to demonstrate that its debt-to-equity ratio reflects the arm's length principle.[56] The *Thin Capitalisation Report* further states that should tax authorities impose rigid safe harbour rules, with taxpayers provided with no option to elect the use of the safe harbour or to demonstrate the arm's length principle, such inflexible legislation may result in incompatibility with the arm's length principle. This could be the case should other tax jurisdictions not consider adjustments made in

49 OECD 1995 https://www.oecd-ilibrary.org/docserver/g2g7fa2a-en.pdf?expires=1725969931&id=id&accname=guest&checksum=14DA2775FF3FD4D59C6EF7D336C4EF2B IV-40.

50 Picciotto 2018 https://opendocs.ids.ac.uk/opendocs/bitstream/handle/20.500.12413/14117/ICTD_WP86.pdf?sequence=1&isAllowed=y 29.

51 OECD 2022 https://read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2022_0e655865-en#page211 203.

52 OECD 2022 https://read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2022_0e655865-en#page211 204.

53 Arnold 2019 *BFIT*.

54 OECD *Thin Capitalisation* 14.

55 OECD *Thin Capitalisation* 36.

56 OECD *Thin Capitalisation* 37.

accordance with the safe harbour rules to be representative of the arm's length principle.[57]

OECD member countries have debated the question of whether thin capitalisation safe harbour rules should be restricted by the arm's length principle as contained within Article 9(1) of the OECD MTC, as this could influence whether or not rules of this type should be utilised by a country in its legislative design.[58] According to Fernandes[59] most commentators on the subject support the view that all interest limitation rules should conform to the arm's length principle. This can be achieved either by applying criteria to the rules that are compatible with the arm's length principle, or by establishing rules that directly implement this principle.[60]

2.2 South African legislation pertaining to the limitation of interest

South Africa's transfer pricing legislation initially included thin capitalisation safe harbour rules in section 31(3) of the *Act* that applied to interest-bearing financial assistance granted by a non-resident to a resident who was a "connected persons" as defined in the *Act*.[61] Section 31(3) of the *Act* gave the Commissioner the authority to disallow interest deductions if the Commissioner was of the opinion that the aggregate value of the financial assistance provided was excessive in relation to the fixed capital of the connected person. This provision was known as the thin capitalisation rules, and the South African Revenue Service (hereafter the SARS) provided specific safe harbour rules published in their 1996 Practice Note 2, in terms of debt-to-equity ratio[62] debt levels and interest rates that served as benchmarks for taxpayers and the SARS. If a taxpayer did not exceed the specified safe harbour ratio (originally prescribed by the SARS as a debt-to-equity ratio of 3 to 1), no further arm's length adjustments were required in respect of the debt amount, unless the Commissioner was not satisfied that an arm's length interest rate had been applied.[63] All thin capitalisation safe harbour rules were removed from section 31 of the *Act* in 2012 to align South African legislation with the guidelines established by the OECD,

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57 OECD *Thin Capitalisation* 37.

58 Arnold 2019 *Can Tax J* 1072.

59 Fernandes 2017 *Revista Direito Tributário Internacional Atual*.

60 Fernandes 2017 *Revista Direito Tributário Internacional Atual* 233.

61 SARS 1996 https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-Arc-2019-01-Arc-01-Income-Tax-Practice-Note-2-of-1996-withdrawn-5-August-2019-with-effect-from-1-April-2012.pdf 3, 9.

62 The debt-to-equity ratio is a financial ratio indicating the relative proportion of debt and shareholders' equity used to finance a company's assets.

63 SARS 1996 https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-Arc-2019-01-Arc-01-Income-Tax-Practice-Note-2-of-1996-withdrawn-5-August-2019-with-effect-from-1-April-2012.pdf 3.

which at that stage did not include any guidance on safe harbour rules and recommended an arm's length approach.[64]

The draft Interpretation Note[65] released by the SARS in 2013 provided at least some factors that would indicate when the SARS could perceive a taxpayer to be thinly capitalised, such as, a debt: EBITDA (earnings before interest, taxes, depreciation and amortisation) ratio in excess of 3 to 1.[66] However, all references to thin capitalisation safe harbour rules or risk indicators were removed in the final Interpretation Note 127 titled *Determination of the Taxable Income of Certain Persons from International Transactions: Intra-Group Loans,*[67] released by the SARS in January 2023, despite the benefits that can be derived from their introduction into legislation. The advantages of safe harbour rules encompass, among other things, the simplification of compliance and the reduction of associated costs for eligible taxpayers. They also provide assurance to eligible taxpayers regarding compliance and enable tax authorities to concentrate their resources on high-risk transactions and allocate them more effectively.[68] In addition, safe harbour rules may also stimulate foreign investment in a country and promote economic growth.[69]

Currently no thin capitalisation safe harbour rules are included in South African tax legislation, and debt transactions form part of the general definition of "affected transactions" in section 31(1) of the *Act*. Debt transactions are, therefore, subject to the arm's length principle in respect of both the amount of debt and the interest rate charged.[70] While South Africa is not a member of the OECD, it has key partner status, which indicates that South Africa will endeavour to adhere to the principles established by the OECD in the OECD MTC and other recommended

64 *Taxation Laws Amendment Act* 7 of 2010.

65 SARS 2013 https://www.sars.gov.za/wp-content/uploads/Legal/Drafts/LAPD-LPrep-Draft-2013-10-Draft-IN-Determination-Taxable-Income-International-Transactions-Thin-Capitalisation.pdf.

66 The debt: EBITDA ratio is a financial ratio indicating the relative proportion of debt to a company's earnings before interest, tax, depreciation and amortisation (EBITDA).

67 SARS 2023 https://www.sars.gov.za/wp-content/uploads/Legal/Notes/Legal-IN-127-Determination-of-the-taxable-income-of-certain-persons-from-international-transactions-Intra-group-loans.pdf.

68 OECD 2022 https://read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2022_0e655865-en#page211 205-206.

69 SAICA 2020 https://saicawebprstorage.blob.core.windows.net/uploads/resources/2020_09_30_SAICA_submission_Excessive_Debt_Financing_Interest_deductions_and_other_financial_payments.pdf 8.

70 SARS 2013 https://www.sars.gov.za/wp-content/uploads/Legal/Drafts/LAPD-LPrep-Draft-2013-10-Draft-IN-Determination-Taxable-Income-International-Transactions-Thin-Capitalisation.pdf 9.

transfer pricing policies.[71] South Africa uses Article 9(1) of the OECD MTC as the foundation for its corresponding article in tax treaty negotiations, with some minor deviations in respect of the corresponding adjustment in terms of Article 9(2) in accordance with the United Nations *Model Tax Convention*. De Wet[72] and West[73] agree that the standard South African tax treaty model is based on the principles of the OECD MTC. It is, therefore, posited that most South African tax treaties, with specific reference to Article 9, can be considered compatible with the arm's length principle as established in Article 9(1) of the OECD MTC.

Up until 2012 section 31 of the *Act* was the only section in the *Act* dealing specifically with thin capitalisation, by way of limiting interest deductions where it was determined that the terms on which transactions were concluded did not meet arm's length requirements.[74] In order to align with the OECD's *Action 4 Report* recommendations, section 23M of the *Act* – in essence an earnings stripping rule – was introduced into South African legislation in 2013.[75]

2.2.1 Section 31 of the Act

Section 31 of the *Act* serves as an anti-avoidance provision that aims to address "affected transactions"[76] entered into between "connected persons"[77] as defined in the *Act*, in cases where one party is a resident and the other is a non-resident, and is applicable when a tax benefit is obtained on terms that are not at arm's length.[78] In terms of section 31 of the *Act*, the taxpayer is required to evaluate a transaction from both the borrower's and the lender's perspectives, taking all relevant facts and circumstances into

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71 OECD 2021 https://www.oecd.org/global-relations/keypartners/south-africa-and-oecd.htm#:~:text=In%202007%20the%20OECD%20Council,a%20sustained%20and%20comprehensive%20manner.

72 De Wet *Seeking Deviations* 8.

73 West 2017 *International Taxation in China*.

74 DTC 2016 https://www.taxcom.org.za/docs/New_Folder3/6%20BEPS%20Final%20Report%20-%20Action%204.pdf 29.

75 *Taxation Laws Amendment Act* 31 of 2013. S 23M limits the deduction of interest paid between connected persons, with reference to a specified formula, in instances where the recipient is not taxed on the interest.

76 "Affected transactions" encompass any transactions, operations, arrangements, agreements or understandings that are either directly or indirectly undertaken between or for the advantage of specific parties, who are either connected persons or, starting from the 1st of January 2023, associated enterprises. These transactions involve terms or conditions that deviate from those that would be present if the parties involved were independent entities conducting transactions at arm's length.

77 The *Act* defines "connected person" by identifying connected persons in relation to different types of persons, namely natural persons; trusts; partnerships or foreign partnerships; companies and close corporations.

78 Section 31 of the *Act* 58.

account.[79] A taxpayer's debt will be considered to be non-arm's length if *inter alia* the taxpayer bears a higher debt load than it can reasonably handle, meaning the taxpayer is thinly capitalised; the duration of the lending contract is longer than what would be expected under arm's length conditions; or if the terms, including the repayment and interest rates, do not align with what independent parties would typically agree upon.[80] Consequently, although this is a resource intensive process, section 31 of the *Act* does align with the OECD's guidance on the application of and compliance with the arm's length principle in terms of their *Transfer Pricing Guidance on Financial Transactions Report,*[81] and the application thereof should result in arm's length interest deductions for a taxpayer, as is confirmed by Interpretation Note 127.[82]

The burden of proof falls on the South African taxpayer to demonstrate, as per section 31 of the *Act*,[83] that the transaction, encompassing both the funding amount and the interest rate applied, was executed under arm's length conditions.[84] Oguttu[85] is of the view that South Africa's current domestic transfer pricing provisions as outlined in section 31 of the *Act* follow international standards and are aligned with the arm's length principle, if perhaps not explicitly in terms of legislation, as is so indicated by the SARS in Practice Note 7.[86] Accordingly, it is posited that section 31 of the *Act* can be considered compatible with the arm's length principle of

[79] SARS 2023 https://www.sars.gov.za/wp-content/uploads/Legal/Notes/Legal-IN-127-Determination-of-the-taxable-income-of-certain-persons-from-international-transactions-Intra-group-loans.pdf 6.

[80] SARS 2023 https://www.sars.gov.za/wp-content/uploads/Legal/Notes/Legal-IN-127-Determination-of-the-taxable-income-of-certain-persons-from-international-transactions-Intra-group-loans.pdf 11.

[81] OECD 2020 https://www.oecd.org/en/publications/transfer-pricing-guidance-on-financial-transactions-inclusive-framework-on-beps-actions-4-8-10_794bcddd-en.html 8-10.

[82] SARS 2023 https://www.sars.gov.za/wp-content/uploads/Legal/Notes/Legal-IN-127-Determination-of-the-taxable-income-of-certain-persons-from-international-transactions-Intra-group-loans.pdf 11.

[83] If the SARS determines that the taxpayer did not transact at arm's length in accordance with s 31(2), s 31(3) of the *Act* requires the SARS to impose the primary and secondary adjustments based on what the SARS perceives to be arm's length, together with penalties. Any amount of excessive interest deducted (that is interest that relates to a non-arm's length debt amount or interest on arm's length debt amount which is calculated at a non-arm's length interest rate) will be added back to a taxpayer's taxable income as the primary adjustment in terms of s 31(2) of the *Act*. S 31(3) of the *Act* reclassifies the amount of the primary adjustment to be a dividend in the form of a distribution *in specie* declared and paid by the resident, for which a secondary adjustment will be required, subject to dividends tax, which is currently at 20 per cent.

[84] DTC 2016 https://www.taxcom.org.za/docs/New_Folder3/6%20BEPS%20Final%20Report%20-%20Action%204.pdf 27.

[85] Oguttu 2022 *CILSA*.

[86] SARS 1999 https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf.

Article 9(1) of the OECD MTC. However, section 31 of the *Act* cannot be evaluated in isolation, as section 23M of the *Act* and its interaction with section 31 should also be examined to determine its compatibility with the arm's length principle.

2.2.2 Section 23M of the Act

Section 23M was introduced into the *Act* in 2013 (effective from 1 January 2015). The objective of this section is to restrict the deductible interest[87] amount for a debtor[88] when there exists a "controlling relationship"[89] between the parties, and the interest is not subject to taxation in South Africa[90] for the creditor.[91] The deductible interest amount is limited and is calculated on the basis of a specific formula.[92] For years of assessment ending on or after 31 March 2023, the formula was amended and currently limits interest (as defined) to an amount determined by multiplying the adjusted taxable income as defined in section 23M(1) of the *Act*[93] by 30 per cent. Reasons for the changes included *inter alia* that the initial 40 percent was already perceived as too high in 2014, and recent micro-level data analysis from the SARS indicated that 30 percent would be fair.[94] This is also in line with the recommended rate provided by the OECD's *Action 4*

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87 For years of assessment ending on or after 31 March 2023, the definition of "interest" for this purposes of s 23M of the *Act* is expanded to include not only s 24J interest, but also payments that are economically equal to interest or incurred for raising finance.

88 The persons who incur interest. These persons can either be residents or non-residents with a permanent establishment in South Africa to which the debt is effectively connected.

89 Section 23M of the *Act* defines "controlling relationship" as "a relationship where a person, whether alone or together with any one or more persons that are connected persons in relations to that person; or persons that are connected persons in relation to that person, directly or indirectly hold at least 50 per cent of the equity shares or can exercise at least 50 per cent of the voting rights or participation rights, in a company."

90 The interest received or accrued in the hands of the creditor will not be subject to taxation in South Africa if, for example, it is exempt under s 10(1)(h) of the *Act*, or to the extent that withholding taxes on the interest were levied at a rate of less than 15% due to the application of a tax treaty.

91 Section 23M of the *Act*.

92 The formula is: $X + (A\% \times Y) – Z$, where X is the interest received or accrued to the taxpayer, A is $40 \times [(\text{average repurchase rate} + 400 \text{ basis points})/10]$, Y is the adjusted taxable income as defined in s 23M(1) of the Act, and Z is the interest incurred by the taxpayer in respect of debt not subject to s 23M.

93 The adjustments (reductions and add-back) to be made to obtain the "adjusted taxable income" and applicable exemptions are not discussed in this article.

94 National Treasury 2020 http://www.treasury.gov.za/public%20comments/Reviewing%20the%20Tax%20Treatment%20of%20Excessive%20Debt%20Financing,%20Interest%20Deductions%20and%20Other%20Financial%20Payments.pdf 47.

Report.[95] The OECD's recommendation to make use of a fixed ratio rather than a calculated ratio (based on the repurchase rate) was also implemented.

Section 23M of the *Act*, being a fixed ratio limitation provision, bears similarities to the recommended earnings stripping rules of the OECD, in so far as it limits interest deductions based on a fixed formula.[96] However, the OECD recommended earnings stripping rules are much broader than the current section 23M of the *Act,* which is applicable only when the interest income of a recipient is not subject to tax. It was indicated in the public commentary to the OECD Discussion Draft on the BEPS *Action 4 Report*, that several institutions were of the opinion that the OECD deviates from the arm's length principle by recommending an earnings stripping approach.[97] As with safe harbour rules based on fixed ratios, there remains uncertainty about whether earnings stripping rules can be regarded as compatible with the arm's length principle of Article 9(1) of the OECD MTC. [98]

Section 23M of the *Act* does not refer to the arm's length principle in any way and was based on an arbitrary percentage deduced from financial accounting information supplied by Statistics SA as long ago as 2014, initially, and is currently based on the OECD's best practice recommendation to apply a 30 per cent interest limitation ratio.[99] Bredenkamp[100] posits that applying section 23M of the *Act* likely does not result in arm's length interest due to the lack of any comparability requirements to determine arm's length prices. A taxpayer's interest will be limited in terms of section 23M, with no option for the taxpayer to demonstrate arm's length interest. Accordingly, even though section 31 of the *Act* is considered to adhere to the arm's length principle, the application of section 23M may result in non-arm's length interest deductions, which may result in taxpayers in countries party to tax treaties with South Africa to dispute the final interest deductions allowed where applicable.

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95 OECD 2016 https://www.oecd-ilibrary.org/docserver/9789264268333-en.pdf?expires=1618222878&id=id&accname=guest&checksum=7B862F70AEB47E98966AB6C6BCB65C88 2, 3.

96 National Treasury 2020 http://www.treasury.gov.za/public%20comments/Reviewing%20the%20Tax%20Treatment%20of%20Excessive%20Debt%20Financing,%20Interest%20Deductions%20and%20Other%20Financial%20Payments.pdf 47.

97 OECD 2015 https://web-archive.oecd.org/2015-02-17/340527-public-comments-action-4-interest-deductions-other-financial-payments-part1.pdf.

98 Bredenkamp *Analysis of Section 23M* 56.

99 National Treasury and SARS 2014 http://www.treasury.gov.za/legislation/bills/2014/TLAB-TALAB/2014%20October%2016%20-%20Response%20document%20TLAB%20and%20TALAB.pdf 14.

100 Bredenkamp *Analysis of Section 23M* 51.

2.2.3 *The interaction between sections 31 and 23M of the Act*

In some instances both the transfer pricing provisions in section 31 of the *Act* and the interest limitation provisions of section 23M of the *Act* may be applicable to the same transaction, which could also influence the compatibility of these sections with the arm's length principle. To illustrate, if a foreign holding company offers financial support to its South African subsidiary and does not pay tax on the interest income received, both sections 31 and 23M of the *Act* may apply. Although different views on the order of application of sections 31 and 23M of the *Act* remain,[101] Interpretation Note 127 clarifies the SARS' view on the order of application, and states that section 31 should be applied prior to section 23M.[102] Accordingly, section 31 of the *Act* should, therefore, be applied first to determine arm's length interest, both in respect of interest rates and debt amounts. Should section 23M be applied subsequent to section 31 of the *Act* to the same transaction, concern remains that it may result in a further disallowance of interest that may no longer reflect arm's length interest, as this adjustment is based on a fixed ratio which may not represent an arm's length amount. It is accordingly posited that when both sections 31 and 23M of the *Act* apply to the same transaction, the resulting interest that is allowed as a deduction may not be compatible with the arm's length principle.

3 The legislative design and features of thin capitalisation safe harbour rules

3.1 Domestic legislation relevant to thin capitalisation safe harbour rules

Tax authorities can address the risk of base erosion through the introduction of legislation that limits the deductible amount of interest in the calculation of taxable profit.[103] There are typically three approaches followed to limit excessive interest deductions:[104]

- the arm's length approach in accordance with Article 9 of the OECD MTC, whereby an arm's length interest rate and debt amount must be determined, limiting interest deductions to the arm's length interest amount;

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101 Neuhaus *Limitation of the Deduction of Interest* 47.

102 SARS 2023 https://www.sars.gov.za/wp-content/uploads/Legal/Notes/Legal-IN-127-Determination-of-the-taxable-income-of-certain-persons-from-international-transactions-Intra-group-loans.pdf 37.

103 OECD 2012 https://web-archive.oecd.org/2013-01-08/221764-5.%20Thin_Capitalization_Background.pdf *7.*

104 OECD 2012 https://web-archive.oecd.org/2013-01-08/221764-5.%20Thin_Capitalization_Background.pdf *8.*

- safe harbour rules, typically a fixed ratio whereby a maximum allowable debt amount for which interest can be deducted is set; and
- earnings stripping rules, limiting excessive interest based on a ratio with reference to earnings, for instance a percentage of EBITDA.

Neither Article 9 of the OECD MTC nor the OECD *Transfer Pricing Guidelines* prohibits a country from implementing its own domestic thin capitalisation rules, provided that its rules do not result in profit adjustments in excess of arm's length interest.[105] Countries are not prevented from using a combined approach to combat base erosion resulting from excessive interest deductions, although the OECD recommends an earnings stripping rule that restricts interest deductions to a fixed percentage of a company's EBITDA as best practice in its *Action 4 Report*.[106] The *Action 4 Report* does, however, specifically state that a thin capitalisation rule such as a safe harbour rule based on a debt-to-equity ratio could be employed to limit interest deductions in addition to the recommended earnings stripping rules.[107]

The OECD draft paper *Thin Capitalisation Legislation: A Background Paper for Country Tax Administrations*[108] discusses *inter alia* the various methods followed by countries that employ thin capitalisation safe harbour rules based on a specific ratio, such as a debt-to-equity ratio.[109] Typically the ratio will determine an acceptable level of debt, with interest up to that level of debt allowed as a deductible expense. Some ratios aim to approximate an arm's length level of debt in relation to a taxpayer's equity or assets, in which case it may be used as a safe harbour rule.[110] In such a case any interest in excess of the safe harbour may be challenged and disallowed, unless the taxpayer can prove that the profit adjustment represents arm's length interest. As there is no internationally agreed upon standard for the formulation of a fixed ratio, and the ratio is often regarded as inconsistent with the arm's length principle, there is concern that this approach may lead

105 OECD *Thin Capitalisation* 39.

106 OECD 2016 https://www.oecd-ilibrary.org/docserver/9789264268333-en.pdf?expires=1618222878&id=id&accname=guest&checksum=7B862F70AEB47E98966AB6C6BCB65C88.

107 OECD 2016 https://www.oecd-ilibrary.org/docserver/9789264268333-en.pdf?expires=1618222878&id=id&accname=guest&checksum=7B862F70AEB47E98966AB6C6BCB65C88 *25.*

108 OECD 2012 https://web-archive.oecd.org/2013-01-08/221764-5.%20Thin_Capitalization_Background.pdf.

109 OECD 2012 https://web-archive.oecd.org/2013-01-08/221764-5.%20Thin_Capitalization_Background.pdf *12-13.*

110 OECD 2012 https://web-archive.oecd.org/2013-01-08/221764-5.%20Thin_Capitalization_Background.pdf *12.*

to disagreement between countries on what constitutes arm's length profits.[111]

It is further stated in the mentioned OECD draft paper that countries have the choice, depending on their legal system, on the manner of inclusion of their thin capitalisation safe harbour rules into their legislation.[112] One approach followed is to include brief reference to the safe harbour rules in primary legislation, with the detailed application of the rules explained in secondary legislation or separate guidance provided by way of the tax authority's regulations and circulars, for instance.[113] Another approach is to include the full detail of such rules in the primary legislation of a country.[114] It is posited that the second approach is more rigid than the first, as it will be more difficult to regularly update specific thin capitalisation rules that form part of primary legislation.

3.2 Tax treaties

Depending on the type of safe harbour rules employed in a country, there may consequently be concerns regarding the compatibility of these safe harbour rules with the arm's length principle in terms of Article 9(1) of the OECD MTC and existing tax treaties. It is, therefore, important that any thin capitalisation safe harbour rules included in domestic legislation should approximate the arm's length principle. Alternatively, should a country's domestic legislation limit interest in a way that does not conform to the arm's length principle, a country may negotiate tax treaties that deviate from the OECD MTC, by including or amending tax treaty provisions to specifically allow the application of thin capitalisation rules.[115] When countries negotiate new treaties, these amended articles may be included in the new agreements.

3.2.1 Australia, New Zealand and Canada

Despite the OECD's *Action 4 Report* recommendation, Australia[116] and New Zealand[117] have retained thin capitalisation safe harbour rules in their income tax legislation and until recently did not incorporate earnings stripping rules. Canada[118] has also opted to retain thin capitalisation safe

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111 OECD 2012 https://web-archive.oecd.org/2013-01-08/221764-5.%20Thin_Capitalization_Background.pdf *12.*

112 OECD 2012 https://web-archive.oecd.org/2013-01-08/221764-5.%20Thin_Capitalization_Background.pdf *21.*

113 OECD 2012 https://web-archive.oecd.org/2013-01-08/221764-5.%20Thin_Capitalization_Background.pdf *21.*

114 OECD 2012 https://web-archive.oecd.org/2013-01-08/221764-5.%20Thin_Capitalization_Background.pdf *21.*

115 Fross 2013 *European Taxation*.

116 *Income Tax Act* 27 of 1997 *(Australia).*

117 Income Tax Act 97 of 2007 (New Zealand).

118 *Income Tax Act RSC* 1985 c 1 (5th Supp) (Canada).

harbour rules in its legislation. All three countries are OECD members and are therefore committed to following the recommendations and guidelines as provided by the OECD in accordance with the OECD MTC and OECD *Transfer Pricing Guidelines*.[119]

By comparing the three selected countries' standard tax treaties with the OECD MTC, it was established that all three countries use the OECD MTC as the basis for their tax treaties and include a corresponding article in their tax treaties based upon the standard Article 9 of the OECD MTC with some minor exceptions. By comparing the selected countries' corresponding articles with one another and Article 9 of the OECD MTC, it was determined that the articles corresponding to Article 9 of the OECD MTC do not deviate significantly in any of the three selected countries and can be considered compatible with Article 9 of the OECD MTC.

3.2.1.1 Australia

Australia recently amended their thin capitalisation rules to be more aligned to the OECD's recommended earnings stripping approach.[120] However, in the view of the authors, these amended rules are not compatible with the arm's length principle. The authors are also of the opinion that, despite the amendments to Australia's thin capitalisation safe harbour rules, the thin capitalisation safe harbour rules in place prior to these amendments continue to serve as a foundation for legislative design from a South African perspective, especially given the purpose of this article, which is to propose safe harbour rules that achieve compatibility with the arm's length principle. In respect of the previous legislation and rules, it was established that Australia did in fact deviate from the guidance provided in the OECD *Transfer Pricing Guidelines* in respect of the determination of arm's length prices in the following respects:

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119 Duff "Interest Deductibility and International Taxation" 23:15.

120 For income years commencing on or after 1 July 2023, Australia's thin capitalisation safe harbour rules were amended, which amendment is applicable to most multinational businesses operating in Australia with at least $2 million in debt deductions. The three new tests apply to "general class entities", which includes most multinational businesses. The first test is a fixed ratio test which limits interest deductions to 30% of EBITDA. The second test is a group ratio test which limits net debt deductions by applying a ratio of the worldwide group's net interest expense to the group's EBITDA. The third test is a third-party debt test that disallows all debt deductions not attributable to third-party debt. The current safe harbour test and worldwide gearing ratio test remain in place for entities classified as financial entities and authorised deposit-taking institutions (ADIs). The existing arm's length debt test is retained for ADIs. Financial entities that are not ADIs may opt for the new third-party debt test, while the existing arm's length debt test for non-ADIs has been repealed. See Australian Government, Australian Taxation Office 2024 https://www.ato.gov.au/about-ato/new-legislation/in-detail/businesses/multinational-tax-integrity-package-thin-capitalisation-rules.

- Under the transfer pricing provisions,[121] arm's length was determined in relation to its interest rate only, whereafter the thin capitalisation rules may have become applicable.[122]

- With reference to the thin capitalisation rules,[123] an interest deduction will be limited only if the entity's total debt surpasses the prescribed maximum allowable debt.[124] The thin capitalisation safe harbour rules provided the taxpayer with three alternatives in determining a maximum allowable debt amount:

  i) a safe harbour debt amount, whereby the maximum allowable debt was determined by way of a debt-to-equity ratio (prescribed as 1.5 to 1 for general entities, and 15 to 1 for financial entities);[125]

  ii) a worldwide global gearing test, in terms of which an entity is allowed to gear up its Australian operations to the same level of gearing as its global group in certain circumstances (this accordingly allowed businesses to obtain more debt than would be allowable under the safe harbour debt amount, if the global group maintains a higher debt-to-equity ratio than the Australian business);[126]

  iii) an arm's length debt test, in terms of which the maximum allowable debt amount that would have been negotiated between an independent lending entity and a borrower transacting at arm's length had to be established.[127]

Although the debt-to-equity safe harbour debt amount based on a fixed ratio may not have been considered to adhere to the arm's length principle, there was flexibility in terms of the worldwide gearing test and the arm's length debt test that was available to taxpayers as alternatives.[128] The taxpayer could choose which one of the alternatives to use, and was not restricted to only the safe harbour debt amount. The Australian Taxation Office believed that the arm's length debt test served as a proxy for the arm's length

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121 Division 815 of *Income Tax Act* 27 of 1997 (Australia).

122 Ernst & Young 2020 https://www.ey.com/en_gl/tax-alerts/australia-detailed-analysis-on-final-taxation-ruling-and-guidanance-on-the-australian-thin-capitalization-arms-length-debt-test.

123 Division 820 of *Income Tax Act* 27 of 1997 (Australia).

124 Division 820 s 820-890 of *Income Tax Act* 27 of 1997 (Australia).

125 PwC 2021 https://taxsummaries.pwc.com/australia/corporate/group-taxation.

126 PwC 2021 https://taxsummaries.pwc.com/australia/corporate/group-taxation.

127 PwC 2021 https://taxsummaries.pwc.com/australia/corporate/group-taxation.

128 Australian Government, Board of Taxation 2014 https://taxboard.gov.au/sites/taxboard.gov.au/files/migrated/2015/07/discussion_paper.pdf.

principle.[129] Furthermore, the Australian Taxation Office contended that the Australian transfer pricing regulations and the (then) thin capitalisation rules aligned with the arm's length principle outlined in Article 9(1) of the OECD MTC. This alignment was due to their capacity to approximate arm's length prices and debt levels while also granting taxpayers flexibility to establish arm's length interest in accordance with the arm's length debt test.[130] The authors of this article are accordingly of the view that the (previous) Australian transfer pricing provisions and thin capitalisation rules may be considered compatible with the arm's length principle.

3.2.1.2 New Zealand

By comparing the New Zealand transfer pricing and thin capitalisation provisions in the *Income Tax Act (New Zealand)* 97 of 2007 to the OECD *Transfer Pricing Guidelines*, it was determined that New Zealand deviates from these guidelines in the following respects:

- The transfer pricing provisions[131] are used to establish an arm's length interest rate only, not an arm's length debt amount. These transfer pricing provisions are however subject to restricted transfer pricing rules[132] that effectively place a ceiling on the interest rate of a company.[133] Although the Inland Revenue Department views the restricted transfer pricing rules as aligned with the arm's length principle, this approach is not international practice and may be viewed by some countries as not approximating the arm's length principle.[134]

- The thin capitalisation rules[135] limit the interest that is deductible by establishing a maximum allowable debt amount by way of two safe harbour rules in the form of prescribed debt-to-assets ratios.[136] These prescribed ratios are based on fixed formulas (currently 60 per cent {in

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[129] Australian Government, Board of Taxation 2014 https://taxboard.gov.au/sites/taxboard.gov.au/files/migrated/2015/07/discussion_paper.pdf 12.

[130] Australian Government, Australian Taxation Office 2020 https://www.ato.gov.au/business/thin-capitalisation/.

[131] Sections YD 5, GB 2 and GC 6 to GC 19 of *Income Tax Act* 97 of 2007 (New Zealand).

[132] The restricted transfer pricing rules were implemented in 2018 and apply to specific inbound related-party loans for borrowers that are viewed to be high risk for BEPS. These rules effectively determine an arm's length credit rating that should be used to calculate the deductible interest amounts.

[133] New Zealand Inland Revenue Department 2013 https://www.ird.govt.nz/international-tax/business/transfer-pricing/simplification-measures.

[134] New Zealand Inland Revenue Department 2018 https://taxpolicy.ird.govt.nz/-/media/project/ir/tp/publications/2018/2018-or-nbeps-bill/2018-or-nbeps-bill-pdf.pdf?modified=20200910081909&modified=20200910081909 59.

[135] Subpart FE of *Income Tax* Act 97 of 2007 (New Zealand).

[136] Subpart FE 6 of *Income Tax* Act 97 of 2007 (New Zealand).

respect of inbound investment} or 75 per cent {in respect of outbound investment}; and 110 per cent of the worldwide group's debt percentage). Consequently, since these rules rely on fixed percentages they might not be seen as approximating the arm's length principle. Moreover, taxpayers are not provided with the opportunity to demonstrate that their actual debt aligns with arm's length debt levels.[137]

Although the Inland Revenue Department is of the view that the current New Zealand restricted transfer pricing rules and thin capitalisation rules are consistent with international arm's length standards, it was concluded that some countries may not view the safe harbour rules as compatible with the arm's length principle, mainly as a result of prescribed ratios that may not be considered arm's length approximations, in addition to the inflexibility of the rules, with no arm's length alternative available to taxpayers.[138] Accordingly, the authors of this article posit that New Zealand's transfer pricing provisions and thin capitalisation rules may be considered incompatible with the arm's length principle by countries with rigid arm's length requirements.

3.2.1.3 Canada

The Canadian transfer pricing and thin capitalisation provisions in the *Income Tax Act RSC (Canada)* 1985[139] were also compared to the OECD *Transfer Pricing Guidelines*. It was established that Canada deviates from the OECD *Transfer Pricing Guidelines* in the following respects:

- The Canadian transfer pricing rules[140] do make provision for the establishment of arm's length in respect of both interest rates and debt amounts. Nevertheless, these transfer pricing provisions are primarily employed to ascertain an arm's length interest rate.[141]

- The Canadian thin capitalisation rules[142] limit interest deductions in terms of a fixed safe harbour ratio (currently prescribed as a debt-to-equity ratio of 1.5 to 1), with no option for taxpayers to demonstrate

137 Elliffe 2013 *ATF* 618.
138 New Zealand Inland Revenue Department 2017 https://taxpolicy.ird.govt.nz/en/publications/2017/2017-other-beps/16-ria-interest-limitation.
139 Section 247 of *Income Tax Act RSC* 1985 c 1 (5th Supp) (Canada).
140 Section 247 of *Income Tax Act RSC* 1985 c 1 (5th Supp) (Canada).
141 Saurez 2019 *Tax Notes International* 788.
142 Section 18(4) of *Income Tax Act RSC* 1985 c 1 (5th Supp) (Canada).

> arm's length debt amounts. Accordingly, the fixed ratio may be viewed as an arbitrary tool that does not result in arm's length interest.[143]

The authors of this article concluded that the Canadian transfer pricing provisions and thin capitalisation rules may be considered incompatible with the arm's length principle by countries with rigid arm's length requirements.

4 A proposed legislative design

4.1 Transfer pricing provisions

It is recommended that the sections in the *Act* determining what constitutes arm's length price – therefore interest rates – and what constitutes arm's length debt amounts – therefore whether a taxpayer is thinly capitalised – should be separated, as recommended by the Davis Tax Committee[144] and in line with the approaches followed in all three selected countries. An approach for the introduction of safe harbour rules into domestic legislation is recommended, whereby simplification measures in respect of interest rates are included as part of section 31 of the *Act*, and separate thin capitalisation provisions are included as a standalone section in the *Act*. In terms of this approach, safe harbour rules could be added to both the transfer pricing provisions and thin capitalisation provisions separately. This might provide more certainty and clarity for taxpayers in respect of which section to use to determine allowable interest rates and debt amounts.

It is proposed that section 31 of the *Act* should be amended to apply to the pricing of debt only, in terms of which taxpayers have to adjust their taxable income to reflect arm's length interest in terms of only interest rates and not debt amounts. Accordingly, interest rates in relation to transactions that fall within the ambit of section 31 of the *Act* must reflect arm's length rates, or interest in excess of arm's length would be denied as a deduction. In order to provide certainty for taxpayers, simplification measures could be added in secondary legislation in terms of which National Treasury could publish indicative interest rates for loans below a specific value in the Government Gazette, as in the New Zealand approach, that provides indicative interest rates for loans up to NZD 10 million.[145] The key issue would be for the SARS or another body to determine and provide National Treasury with the acceptable interest rates, or ranges of interest rates, that should be applied in South Africa, that reflects market conditions.

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143 Condoleon *et al* 2020 https://news.bloombergtax.com/transfer-pricing/insight-debt-characterization-and-application-of-oecd-accurate-delineation-analysis.

144 DTC 2016 https://www.taxcom.org.za/docs/New_Folder3/6%20BEPS%20Final%20Report%20-%20Action%204.pdf 54.

145 New Zealand Inland Revenue Department 2021 https://www.ird.govt.nz/international-tax/business/transfer-pricing/simplification-measures.

4.2 Thin capitalisation safe harbour rules

It is proposed that a standalone thin capitalisation section should be included in the *Act* to determine when a taxpayer will be viewed to be thinly capitalised. In terms of this thin capitalisation section, taxpayers' interest deductions will be limited should they exceed either a prescribed safe harbour ratio or a second worldwide gearing ratio. The previous thin capitalisation safe harbour debt-to-equity ratio of 3 to 1[146] is very high in comparison to the ratio in other countries, and is no longer based on current statistical figures of South African companies.

National Treasury, in conjunction with the SARS, should determine an acceptable fixed ratio such as a debt-to-equity or debt-to-assets ratio similar to that used by Australia (previously a debt-to-equity ratio prescribed as 1.5 to 1 for general entities and 15 to 1 for financial entities) and New Zealand (currently a debt-to-assets ratio prescribed as 60 per cent {in respect of inbound investment} or 75 per cent {in respect of outbound investment}; and 110 per cent of the worldwide group's debt percentage). This ratio should provide a simple measure to indicate excessive debt in a company's capital structure and detail the interest limitation consequences for exceeding the prescribed safe harbour ratio. It may also be beneficial, in terms of both the thin capitalisation safe harbour ratio and indicative interest rates, to establish through benchmarking whether different prescribed ratios or interest rate thresholds would be required for different industries to better reflect market conditions. The determination of which items should be included in the debt and asset values applied in the ratios should also be clearly defined in the guidance provided by the SARS or appointed body to the National Treasury, to be published as and when required.

Should a taxpayer exceed the prescribed safe harbour ratio the second ratio, namely the worldwide gearing ratio, that is linked to the capital structure of a taxpayer's worldwide group, would be beneficial in allowing a taxpayer to borrow at the same level as the rest of its group. The group gearing ratio should provide a rudimentary arm's length proxy for the taxpayer's group. This could be similar to the worldwide gearing test previously applied in Australia, in that it would enable a taxpayer to borrow up to the level of its group even if it exceeds the prescribed safe harbour ratio in specific circumstances.

It is also recommended that a *de minimis* threshold that exempts taxpayers with interest expenses below a specific amount should be included in the thin capitalisation rules. The current and previous Australian thin

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146 SARS 1996 https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-Arc-2019-01-Arc-01-Income-Tax-Practice-Note-2-of-1996-withdrawn-5-August-2019-with-effect-from-1-April-2012.pdf 3.

capitalisation rules are applicable only should an entity's total interest deductions exceed AUD 2 million in any tax year.[147] The key issue would be for National Treasury, in conjunction with the SARS or another body, to determine what would constitute the monetary threshold that should be applicable in South Africa.

The OECD recommends in its *Transfer Pricing Guidelines*[148] that taxpayers should have the option to elect whether or not to participate in a safe harbour. If no election in terms of the use of a safe harbour is available, a taxpayer should be given an option to demonstrate that its debt in relation to equity and resultant interest does represent arm's length amounts. Accordingly, to simplify legislation it is recommended that the thin capitalisation safe harbour rules apply to the same taxpayers as defined in section 31 of the *Act*. It should, therefore, address debt transactions, to be clearly defined in the *Act*, entered into between "connected persons" as defined in the *Act*, involving a resident and a non-resident party engaged in cross-border debt transactions. However, should taxpayers fall outside either of the prescribed safe harbour or worldwide gearing ratios, they should be given the option to demonstrate that their debt and related interest expenses do reflect arm's length prices. Provided that the other state party to a South African tax treaty considers the safe harbour rules and related adjustments to approximate arm's length interest, there should be no objection to making a corresponding adjustment in terms of the corresponding Article 9(2) of the OECD MTC.

It is important that any potential thin capitalisation rules approximate the arm's length principle to be compatible with existing South African tax treaties. It is recommended that a safe harbour should not discriminate against specific taxpayers but treat all taxpayers similarly. However, if the proposed safe harbour rules to be introduced are flexible enough and approximate the arm's length principle, discrimination should not be applicable. Should a state not consider the South African safe harbour rules to reflect the arm's length principle, it is important that the South African legislation allows the taxpayers the option to demonstrate arm's length amounts.

Where two jurisdictions can agree upon bilateral safe harbours, it could provide relief to taxpayers without resulting in double taxation.[149] Multilateral safe harbours are also recommended where the safe harbour can be

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147 Division 820: 820-835 of *Income Tax Act* 27 of 1997 (Australia).

148 OECD 2022 https://read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2022_0e655865-en#page211 208.

149 Ezenagu 2019 https://opendocs.ids.ac.uk/opendocs/bitstream/handle/20.500.12413/14620/ICTD_WP100.pdf?sequence=1.

negotiated on a continental or regional level.[150] For instance, from a South African perspective, multilateral safe harbours with main trade partners within the Southern African Development Community and BRICS[151] countries could be beneficial.[152] However, negotiating bilateral (and, even more so multilateral) safe harbours could be difficult and expensive, demanding time and resources not available to developing countries.[153]

It may be beneficial not only to describe the eligibility requirements and requirements of the safe harbour ratio or monetary thresholds in the *Act*, but to publish the prescribed ratios and specific thresholds as well as the interpretation and application of the safe harbour rules in the Government Gazette. The ratios and thresholds could be periodically updated as market indicators change. Primary legislation cannot be easily amended, whilst National Treasury in conjunction with the SARS can update prescribed maximum interest rates or applicable ratios and *de minimis* thresholds more regularly in the Government Gazette. Sufficient administrative guidance should be provided by the SARS by way of updated interpretation notes on the application and calculation of any thin capitalisation rules, with clarity as to the hierarchy in the application of the different interest limitation rules and the proposed thin capitalisation safe harbour rules.

4.3 Earnings stripping rules

The existing section 23M of the Act may not be deemed in alignment with the arm's length principle since it relies on a fixed formula. The OECD states in its *Action 4 Report*[154] that the use of the recommended earnings stripping rule in combination with a group ratio, for example an assets-based ratio, such as an equity-to-total assets ratio, is acceptable. According to the OECD an "equity escape" rule can also be incorporated into legislation in terms of which the earnings stripping rules will not apply if an entity can demonstrate that its equity-to-total assets ratio is equal to, within two percentage points, or exceeds that of its group.[155] Norway[156] and

150 Ezenagu 2019 https://opendocs.ids.ac.uk/opendocs/bitstream/handle/20.500.12413/14620/ICTD_WP100.pdf?sequence=1 24.

151 Brazil, Russia, India, China and South Africa.

152 Sweidan 2014 https://www.thesait.org.za/news/198312/Why-SARS-should-consider-transfer-pricing-safe-harbours.htm.

153 Ezenagu 2019 https://opendocs.ids.ac.uk/opendocs/bitstream/handle/20.500.12413/14620/ICTD_WP100.pdf?sequence=1 24.

154 OECD 2016 https://www.oecd-ilibrary.org/docserver/9789264268333-en.pdf?expires=1618222878&id=id&accname=guest&checksum=7B862F70AEB47E98966AB6C6BCB65C88 *62.*

155 OECD 2016 https://www.oecd-ilibrary.org/docserver/9789264268333-en.pdf?expires=1618222878&id=id&accname=guest&checksum=7B862F70AEB47E98966AB6C6BCB65C88 *62.*

156 PwC 2021 https://taxsummaries.pwc.com/australia/corporate/group-taxation.

Luxembourg[157] are both examples of countries that apply "equity escape" clauses as part of their thin capitalisation legislation.

It is accordingly proposed that section 23M of the *Act* be amended with the inclusion of an "equity escape" rule, in terms of which section 23M will not apply if the taxpayer is subject to the thin capitalisation safe harbour rules. In terms of the proposed "equity escape" rule that exempts a taxpayer from applying section 23M, there should consequently no longer be a concern that the application of section 23M could result in non-arm's length adjustments, provided that the thin capitalisation rules do approximate arm's length amounts. As an alternative, a *de minimis* threshold in respect of the total interest expense of a taxpayer could be included in section 23M of the *Act*. Potentially section 23M could be abandoned if section 31 and the standalone thin capitalisation rules to be included in the *Act* could be formulated in such a way as to cover the section 23M debt transactions as well.

5 Conclusion and recommendations

This article has examined the legislative design and features required of thin capitalisation safe harbour rules that should achieve compatibility with the arm's length principle with the aim of proposing a legislative design for the introduction of thin capitalisation safe harbour rules into South African legislation for non-complex inbound financial assistance transactions. It has been established that the determination of arm's length, with specific reference to debt transactions, is viewed as a resource intensive and complex process. Thin capitalisation safe harbour rules do provide a country with a method of simplifying transfer pricing requirements. Nevertheless, it is crucial that the legislative design and features of thin capitalisation safe harbour rules are consistent with the arm's length principle to prevent the potential for double taxation when implementing these regulations.

Section 3 of the article considered the different legislative approaches followed internationally, and specifically examined the thin capitalisation safe harbour rules utilised by Australia, New Zealand and Canada. Section 4 of the article proposed a legislative design for South Africa with recommendations for amendments to existing legislation in relation to transfer pricing provisions (section 31), and proposed thin capitalisation rules and earnings stripping rules (section 23M). It is submitted that the proposed legislative design for the introduction of thin capitalisation safe harbour rules into South African legislation should provide the necessary certainty and simplification measures to South African taxpayers and the SARS alike to establish what constitutes arm's length in terms of debt

157 Ernst & Young 2021 https://www.ey.com/en_lu/tax/luxembourg-tax-authorities-issue-guidance-on-the--equity-escape-.

amounts and interest for non-complex inbound financial assistance transactions. The proposed design should also still achieve compatibility with the arm's length principle contained within existing South African tax treaties, thereby reducing the risk of double taxation.

Further research is required to determine which financial ratios would best determine when a taxpayer should be viewed to be thinly capitalised. Further research that provides detailed benchmarking for the chosen financial ratio is also required to establish what the prescribed thresholds should be and whether different thresholds should apply for different industries. The same is applicable for other simplification measures, including indicative interest rates, as well as potential *de minimis* thresholds.

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List of Abbreviations

ADI	authorised deposit taking institutions
ATF	Australian Tax Forum
AUD	Australian Dollar
BEPS	base erosion and profit shifting
BFIT	Bulletin for International Taxation
Can Tax J	Canadian Tax Journal
CILSA	Comparative and International Law Journal of Southern Africa
DTC	Davis Tax Committee
EBITDA	earnings before interest, taxes, depreciation and amortisation
NZD	New Zealand Dollar
OECD	Organisation for Economic Co-operation and Development
OECD MTC	Organisation for Economic Co-operation and Development Model Tax Convention
SAICA	South African Institute of Chartered Accountants
SA Merc LJ	South African Mercantile Law Journal
SARS	South African Revenue Service