SECTION 31 OF THE INCOME TAX ACT 58, 1962 (“ITA”) – A DEFINITION OF TRANSFER PRICING AND THIN CAPITALISATION

Category: Commercial Law
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Section 31 of the ITA provides special anti-avoidance rules to regulate certain international transactions and this article intends to define and explain the two concepts referred to in this Section of the ITA being transfer pricing and thin capitalisation. The Katz Commission’s interim report found that general anti-avoidance provisions were not sufficient to counter practices where prices for the supply of goods or services are set between related parties not at market levels but at levels which recognise the incidence of a potential tax burden and seeks to minimise that burden1. The Katz commission proposed that counter legislation should be devised which would operate, not as a set of rigid rules, but as a series of guidelines to provide policies for assessing adequacy of pricing2.

Section 31 of the ITA was, therefore, introduced as an anti-avoidance measure to counter so called transfer pricing and thin capitalisation activities3. Without this provision it, would have been all to easy for taxpayers conducting border straddling businesses to minimise their tax liability by loading the profits of an entity operating in a low tax environment, at the expense of an associate entity operating in a country imposing a higher tax rate4. While exchange control regulations had previously managed the thin capitalisation situation the relaxation of exchange controls removed obstacles to profit extraction, thereby, using the interest mechanism and encouraging over gearing by foreign investors who are not taxable on interest derived in South Africa5. Practice note 26 was developed as a guide to administer section 31 of the ITA. It was developed to direct and monitor provisions which may be applied where financial assistance is granted in respect of international transactions or where financial assistance has been granted by non-residents of the Republic to a resident of the Republic7.

Transfer Pricing

Section 31(2) deals with transfer pricing and defines the rules of operation where goods or services are supplied in terms of an international agreement between connected persons and the price at which such goods and services are supplied or acquired is greater or less than the price expected if the parties to the transaction had been independent persons dealing at arms length. In such instances, the Commissioner is empowered in determining the taxable income of either the acquirer or the supplier to adjust the consideration in respect of the transaction to reflect in the arms length price8. In a nutshell, transfer pricing involves the pricing of goods or services outside their normal commercial parameters so as to gain some tax advantage9. The transfer pricing provisions accordingly, aim to adjust prices in order to reflect an arms length transaction being concluded on normal commercial grounds. Section 31 (2) only applies where one or both parties is a non-resident and does not apply to transactions that are purely between South Africa residents10. In essence, transfer pricing is seen as 0a technique exploited by group structures to shift profits from a high tax to a low tax jurisdiction on a pre-tax basis rather than as dividends out of after tax profits11.

Thin Capitalisation

Thin capitalisation, is often regarded as a category of transfer pricing12. Thin capitalisation is governed by section 31(3) of the ITA, which takes section 31(2) a step further by codifying specific thin capitalisation provisions13. Thin capitalisation relates to the funding of a business with a disproportionate degree of debt and insufficient equity, so as to provide the foreign investor the benefit of the interest income derived therefrom exempt, while, at the same time, conferring in the company the tax advantage relating to the deductibility of income payments on that debt14. Thin capitalisation provisions are, therefore, applied to limit the deductibility of interest on excessive debt funds, thereby, protecting the South African fiscus against distortions arising as a result of heavily geared foreign investments15. Section 31(3) was, therefore, introduced to address the re-characterisation of debt to equity resulting in the non-deductibility of interest, a phenomenon that could not have been accommodated in section 31(2) of the ITA dealing with transfer pricing. Thin capitalisation provisions can only be effectively applied if we assume that there is a difference in the treatment of interest and dividends, the merits of this assumption will not be addressed in this article.

We trust that this article was able to demystify and explain the anti-avoidance concepts of transfer pricing and thin capitalisation adequately.

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[1] Rickhoff (Editor): PricewaterhouseCoopers Income Tax Guide 2001-2002 , 2001, at p223
[2] ibid
[3] EB Broomberg & Des Kruger: Tax Strategy, 3rd Edition, 2002, at p251
[4] ibid atp251
[5] Op cit, note 24 at 223.
[6] GN 584 Government Gazette 17194, 24 May 1996
[7] ibid ,at par 1.1
[8] Rickhoff (Editor): PricewaterhouseCoopers Income Tax Guide 2001-2002 , 2001, at p224
[9] Arendse JA, Jordan J, Kolitz MA, Steyn M: Silke: South African Income Tax, 1999, Butterworths, 1998, at p448
[10] ibid at p447
[11] Explanatory Memorandum on the Income Tax Bill 1995
[12] ibid at, p448
[13] De Koker A (assisted by Kolitz M, Arendse J, Silke J), Silke on South African Income Tax, Memorial Edition Volume II, Butterworths, 2002, §17.60 at P 17-96
[14] ibid §17.60 at P 17-96 (as opposed to the non deductibility of dividends paid on equity capital)
[15] Arendse JA, Jordan J, Kolitz MA, Steyn M: Silke: South African Income Tax, 1999, Butterworths, 1998, at p447