An analysis of the South African income tax legislation in respect of transfer pricing

By

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DECLARATION

I, Ayesha Le Roux, declare that the work presented in this dissertation is original. It has never been presented to any other University or Institution. Where other people’s works have been used, references have been provided. It is in this regard that I declare this work as originally mine. It is hereby presented in partial fulfilment of the requirements for the award of the Master of Commerce (Taxation).

Signed………………………………..

Date………………………………….
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## Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>GLOSSARY</td>
<td></td>
<td>1</td>
</tr>
<tr>
<td>SUMMARY</td>
<td></td>
<td>2</td>
</tr>
<tr>
<td>KEY WORDS</td>
<td></td>
<td>3</td>
</tr>
<tr>
<td>Chapter 1</td>
<td>Introduction and Research goals</td>
<td>4</td>
</tr>
<tr>
<td>1.1</td>
<td>Introduction</td>
<td>4</td>
</tr>
<tr>
<td>1.2</td>
<td>Research objectives and method</td>
<td>6</td>
</tr>
<tr>
<td>Chapter 2</td>
<td>Transfer pricing</td>
<td>9</td>
</tr>
<tr>
<td>2.1</td>
<td>Introduction</td>
<td>9</td>
</tr>
<tr>
<td>2.2</td>
<td>Arm’s length principle</td>
<td>10</td>
</tr>
<tr>
<td>2.3</td>
<td>Transfer pricing methods</td>
<td>13</td>
</tr>
<tr>
<td>2.4</td>
<td>Conclusion</td>
<td>16</td>
</tr>
<tr>
<td>Chapter 3</td>
<td>Documentation</td>
<td>17</td>
</tr>
<tr>
<td>3.1</td>
<td>Introduction</td>
<td>17</td>
</tr>
<tr>
<td>3.2</td>
<td>Three-tiered standardised approach</td>
<td>18</td>
</tr>
<tr>
<td>3.3</td>
<td>The South African position</td>
<td>24</td>
</tr>
<tr>
<td>3.4</td>
<td>Draft interpretation note</td>
<td>26</td>
</tr>
<tr>
<td>3.5</td>
<td>Tax Administration Act</td>
<td>28</td>
</tr>
<tr>
<td>3.6</td>
<td>Tax Return</td>
<td>29</td>
</tr>
<tr>
<td>3.7</td>
<td>Davis Tax Committee’s view</td>
<td>31</td>
</tr>
<tr>
<td>3.8</td>
<td>Conclusion</td>
<td>33</td>
</tr>
<tr>
<td>Chapter 4</td>
<td>Value creation: Intangibles</td>
<td>36</td>
</tr>
<tr>
<td>4.1</td>
<td>Introduction</td>
<td>36</td>
</tr>
<tr>
<td>4.2</td>
<td>OECD Revision to chapter VI of Transfer Pricing Guidelines</td>
<td>37</td>
</tr>
<tr>
<td>4.3</td>
<td>Intangibles and its South African risk</td>
<td>38</td>
</tr>
<tr>
<td>4.4</td>
<td>Section 23I of the Act</td>
<td>40</td>
</tr>
<tr>
<td>4.5</td>
<td>The DTC’s comments on intangibles in South Africa</td>
<td>43</td>
</tr>
<tr>
<td>4.6</td>
<td>Conclusion</td>
<td>44</td>
</tr>
<tr>
<td>Chapter 5</td>
<td>Section 31 of Act</td>
<td>45</td>
</tr>
<tr>
<td>5.1</td>
<td>Introduction</td>
<td>45</td>
</tr>
<tr>
<td>5.2</td>
<td>Thin Capitalisation</td>
<td>46</td>
</tr>
<tr>
<td>5.3</td>
<td>Primary adjustment</td>
<td>49</td>
</tr>
<tr>
<td>5.4</td>
<td>Secondary adjustments</td>
<td>49</td>
</tr>
<tr>
<td>5.5</td>
<td>Conclusion</td>
<td>53</td>
</tr>
<tr>
<td>Chapter 6</td>
<td>Risks of non-compliance</td>
<td>54</td>
</tr>
<tr>
<td>6.1</td>
<td>Introduction</td>
<td>54</td>
</tr>
<tr>
<td>6.2</td>
<td>Risks of non-compliance</td>
<td>54</td>
</tr>
<tr>
<td>Section</td>
<td>Page</td>
<td></td>
</tr>
<tr>
<td>------------------------------</td>
<td>------</td>
<td></td>
</tr>
<tr>
<td>6.3 Conclusion</td>
<td>56</td>
<td></td>
</tr>
<tr>
<td>Chapter 7 Conclusion</td>
<td>58</td>
<td></td>
</tr>
<tr>
<td>7.1 Introduction</td>
<td>58</td>
<td></td>
</tr>
<tr>
<td>7.2 Documentation</td>
<td>58</td>
<td></td>
</tr>
<tr>
<td>7.3 Intangibles</td>
<td>60</td>
<td></td>
</tr>
<tr>
<td>7.4 Overall</td>
<td>61</td>
<td></td>
</tr>
<tr>
<td>References</td>
<td>64</td>
<td></td>
</tr>
</tbody>
</table>
## GLOSSARY

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>BEPS</td>
<td>Base Erosion and Profit Shifting</td>
</tr>
<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
</tr>
<tr>
<td>G20</td>
<td>An international forum for the governments and central bank governors from 20 major economies.</td>
</tr>
<tr>
<td>MNE</td>
<td>Multinational Enterprise</td>
</tr>
<tr>
<td>DTC</td>
<td>Davis Tax Committee</td>
</tr>
<tr>
<td>SARS</td>
<td>South African Revenue Service</td>
</tr>
<tr>
<td>CFC</td>
<td>Controlled Foreign Company</td>
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<td>PE</td>
<td>Permanent Establishment</td>
</tr>
</tbody>
</table>
SUMMARY

Transfer pricing has become a very popular term in South Africa over the last few years, even more so since July 2013 when the Base Erosion and Profit Shifting (BEPS) Action plan was issued by the Organisation for Economic Co-operation and Development (OECD) and G20 (an international forum for the governments and central bank governors from 20 major economies). The OECD and G20 has issued the plan to address the perceived flaws in international tax rules, giving rise to profit shifting.

Subsequently, the OECD has issued numerous reports and as a result has updated its 2010 Transfer Pricing Guidelines. Many countries have adopted these guidelines. However as South Africa is not an OECD member, there is no certainty that it will be adopted.

The question is therefore: has the South African Tax legislation met the OECD guidelines and addressed the BEPS issue? Therefore, the objective of the research is to understand whether the current South African tax legislation is in line with the OECD Transfer Pricing Guidelines and BEPS Action Plan. The South African tax legislation provides South African taxpayers with no guidance as to how the OECD Transfer Pricing Guidelines needs to be implemented and interpreted. However, even though not legislation, the SARS practice note 7 and draft interpretation note on thin capitalisation provides taxpayers with a good basis of understanding the OECD Transfer Pricing Guidelines, as these documents provided by SARS is similar to that of the guidance in the OECD Transfer Pricing Guidelines, specifically relating to transfer pricing documentation.

The issue that may result where the South African tax legislation is not in line with the OECD guidelines and the BEPS Action Plan is that Multinational Enterprises (MNEs) may use South Africa as the country to shift its profits to or from, thus effectively resulting in a loss to the Fiscus.
KEY WORDS

Arm’s length, transfer pricing documentation, intangibles (intellectual property), thin capitalisation, primary and secondary adjustments.
Chapter 1 Introduction and Research goals

1.1 Introduction

South Africa is one of the many non-members of the OECD. However South Africa has a working relationship with the OECD. South Africa’s policy makers gain access to the expertise and good policy practices of the OECD, and the OECD in turn, benefits from the exposure1.

“Cross-border transactions have become extremely popular over the last decade. The free movement of capital and labour, the shift of manufacturing bases from high-cost to low-cost locations, the gradual removal of trade barriers, technological and telecommunication developments, and the ever-increasing importance of managing risks and of developing, protecting and exploiting intellectual property, have had an important impact on the way cross-border activities take place”2.

The OECD has published Transfer Pricing Guidelines and a BEPS Action Plan in order to address the issue of BEPS. BEPS may be among the most important global economic debates of all time. Some businesses are worth millions but pay minimal to no taxes in the jurisdictions where they operate. This is simply because the tax systems are not up to scratch with taxing of profits made within the digital economy. Furthermore, businesses also avoid paying taxes through BEPS. This affects governments’ tax bases, and therefore governments increase the taxes to everyone else. Therefore, by implementing the BEPS Action plan it “will for example stop the abuse of transfer pricing by ensuring that taxable profits can’t be artificially shifted through the transfer of patents, copyright or other intangibles away from countries where the value is created, and it will oblige taxpayers to report their aggressive tax planning arrangements.”3

Wikipedia\textsuperscript{4} defines the term BEPS as follows:

“Base Erosion and Profit Shifting (BEPS) is a technical term referring to the negative effect of multinational companies' tax avoidance strategies on national tax bases. BEPS can be achieved through the use of transfer pricing, or, more correctly, "transfer mispricing". BEPS is used in a project headed by the OECD which produced detailed reports in September 2014 in response to seven actions agreed previously. BEPS is said to be an "attempt by the world’s major economies to try to rewrite the rules on corporate taxation to address the widespread perception that the [corporations] don’t pay their fair share of taxes".”

Furthermore, the BEPS Action Plan\textsuperscript{5}, published by the OECD in July 2013, states that BEPS relates chiefly to instances where the interaction of different tax rules leads to double non-taxation or less than single taxation. It also relates to arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place.

The BEPS Action Plan\textsuperscript{6} is a fifteen point action plan, with a timeline spanning a period of 2 years. A summary of the fifteen action points in terms of the BEPS Action Plan\textsuperscript{7} are:

1. Address the tax challenges of the digital economy.
2. Neutralise the effects of hybrid mismatch arrangements.
3. Strengthen controlled foreign company (CFC) rules.
4. Limit base erosion via interest deductions and other financial payments.
5. Counter harmful tax practices more effectively, taking into account transparency and substance.
7. Prevent the artificial avoidance of permanent establishment (PE) status.

\textsuperscript{6}Ibid.
\textsuperscript{7}Ibid.
8. Assure that transfer pricing outcomes are in line with value creation: Intangibles.
9. Assure that transfer pricing outcomes are in line with value creation: Risks and Capital.
10. Assure that transfer pricing outcomes are in line with value creation: Risk transactions.
11. Establish methodologies to collect and analyse data on BEPS and the actions to address it.
12. Require taxpayers to disclose their aggressive tax planning arrangements.
13. Re-examine transfer pricing documentation.
14. Make dispute resolution mechanisms more effective.
15. Develop a multilateral instrument.

The actions of specific reference to this research are points 8 (Assure that transfer pricing outcomes are in line with value creation: Intangibles), and 13 (Re-examine transfer pricing documentation).

Many comments and discussion papers have been issued by the OECD and the public on the abovementioned actions. The Davis Tax Committee (DTC) has also issued comments on how the Plan should be incorporated into South African legislation.

1.2 Research objectives and method

The question is therefore: has the South African Tax legislation met the OECD guidelines and addressed the BEPS issue? The objective of the research is to understand whether the current South African tax legislation is in line with the OECD Transfer Pricing Guidelines and BEPS Action Plan.

The research also addresses the possible changes that may occur to the South African tax legislation in the near future as a result of the ongoing changes being made to the OECD Transfer Pricing Guidelines to address the issue of BEPS.
In addition the treatise examines the changes that have been made to the South African tax legislation as a result of the OECD Transfer Pricing Guidelines with specific reference to section 31 of the Income Tax Act\(^8\) on and after 1 January 2015.

The research study answers the following specific questions relating to the objective above:

- Is the current income tax legislation in line with the OECD Transfer Pricing Guidelines? (See Chapter 2, 3 and 4)
- What changes have been made to the tax legislation, since the BEPS Action Plan was published on July 2013, in order to bring the tax legislation in line with the OECD view? (See Chapter 3 and 5)
- What are the issues that arise as a result of these changes? (See Chapter 5)
- What are the possible changes that can be made to the legislation to ensure that it is in line with the OECD Transfer Pricing Guidelines and the BEPS Action Plan? (See Chapter 4)

The approach of this treatise is as follows

- This chapter – Introduction to the treatise, objectives and methodology.
- Chapter 2 – Transfer Pricing: To explain transfer pricing with specific reference to the arm’s length principle and the transfer pricing methods that are acceptable to the South African Revenue Service (SARS).
- Chapter 3 – Documentation: To give an overview of the OECD and DTC commentary regarding Action 13 and to determine whether the current tax legislation is in terms of the OECD guideline.
- Chapter 4 – Value creation: Intangibles, risks and capital, and risk transactions: To give an overview of the OECD and DTC commentary regarding Action 8 and to determine whether the current tax legislation is in terms of the updated OECD guideline.

\(^8\)Income Tax Act No. 58 of 1962.
Chapter 5 – Section 31: To give an overview of section 31 of the Act on and after 1 January 2015.

Chapter 6 – Risks of non-compliance: To give an overview of the possible risks of non-compliance.

Chapter 7 - Summary, conclusions and recommendations.

In order to achieve the research objectives, books, online resources, tax journals and tax cases were scrutinized for relevant information. The information extracted was analysed in accordance with its relevance in relation to this treatise. Emphasis was placed on factual documents published and comments issued by the Davis Tax Committee and OECD in the form of reports and articles.
Chapter 2 Transfer pricing

2.1 Introduction

According to the Tax Justice Network⁹, transfer pricing happens whenever two companies that are part of the same multinational group trade with each other: when a US-based subsidiary of Coca-Cola, for example, buys something from a French-based subsidiary of Coca-Cola. When the parties establish a price for the transaction, this is transfer pricing. Transfer pricing is not, in itself, illegal or necessarily abusive. What is illegal or abusive is transfer mispricing, also known as transfer pricing manipulation or abusive transfer pricing. (Transfer mispricing is a form of a more general phenomenon known as trade mispricing, which includes trade between unrelated or apparently unrelated parties …)

SARS set out their view of transfer pricing in Practice Note 7, dated 6 August 1999 (PN7), namely that “the term transfer pricing describes the process by which entities set the prices at which they transfer goods or services between each other. The transfer prices adopted by a multinational have a direct bearing on the proportional profit it derives in each country in which it operates. If a non-market value (inadequate or excessive consideration) is paid for the transfer of goods or services between the members of a multinational, the income calculated for each of those members will be inconsistent with their relative economic contributions. This distortion will impact on the tax revenues of the relevant tax jurisdictions in which they operate.” For example, if a member of an Irish multinational sells to a connected person resident in South Africa at a price which exceeds the market price, the profit which the multinational earns in South Africa is reduced. Similarly if the member of an Irish multinational sells to a connected person resident in South Africa at a reduced price, the profit the multinational earns in South Africa is increased.

Therefore, in summary the term transfer pricing is the price at which goods or services are charged between related parties across an international border.

An example to illustrate transfer pricing and its effects on the different tax jurisdictions follows:

Parts and spares used in the automotive industry are manufactured by a parent company in Ireland and sold to a subsidiary in South Africa for distribution to third parties. The Ireland company sells part X to the South African subsidiary at R90 per part, the cost of making a part is R35. The South African Subsidiary sells the part to third parties in South Africa at R100 per part. The corporate tax rate in Ireland is 12.5%\(^{10}\), and the tax rate in South Africa is 28%\(^{11}\). The profit and tax payable on this transaction in the different jurisdictions are:

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<th>Ireland</th>
<th>South Africa</th>
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<tbody>
<tr>
<td>Sale</td>
<td>R90</td>
<td>R100</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>R35</td>
<td>R90</td>
</tr>
<tr>
<td>Profit</td>
<td>R55</td>
<td>R10</td>
</tr>
<tr>
<td>Tax payable</td>
<td>R6.84</td>
<td>R2.80</td>
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</tbody>
</table>

The aim of the pricing is to ensure that the maximum profit is made in Ireland, thus resulting in most of the profits being taxed at the lower rate of 12.5% instead of the 28% rate in South Africa.

As a result of the effects of transfer pricing, SARS adopted the internationally accepted arm’s length principle (see below) for taxation purposes as the basis for ensuring that the South African fiscus receives its fair share of tax.

### 2.2 Arm’s length principle

According to the Tax Justice Network\(^{12}\), if two unrelated companies trade with each other, a market price for the transaction will generally result. This is known as “arms-

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length” trading, because it is the product of genuine negotiation in a market. This arm’s length price is usually considered to be acceptable for tax purposes.

Paragraph 1 of Article 9 of the OECD Model Tax Convention\(^{13}\) deals with the arm’s length principle as follows:

“[When] conditions are made or imposed between … two [associated] enterprises in their commercial or financial relations which differ from those which would have been 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.”

PN7 states that “the problem to be resolved is how a multinational should determine what price would have arisen if transactions between its members were subject to market forces. The solution advanced by the arm’s length principle is that a comparable transaction between independent parties (an uncontrolled transaction) should be used as a benchmark against which to appraise the multinational’s prices (the controlled transaction). Any difference between the two transactions can then be identified and adjusted. An arm’s length price that will reflect the economic contributions made by the parties to the transaction can be determined for the controlled transaction.”\(^{14}\)

Overall, an arm’s length price is the price charged of goods or services between third party persons. The issue that occurs in South Africa is that we have a lack of local comparables, there are no databases that provide for South Africa comparables. Taxpayers are placing great reliance on foreign databases to establish an arm’s length price, however, this can cause further issues to taxpayers as they are then required to make further adjustments to ensure that the transfer prices fairly reflect an arm’s length price. In terms of PN7, SARS will accept the use of foreign country comparables in taxpayers' transfer pricing analyses\(^{15}\).

\(^{13}\)OECD 2014, Model Convention with respect to taxes on income and on capital, Accessed: 12 September 2015.

\(^{14}\)SARS, Practice Note 7, at 8.

\(^{15}\)SARS, Practice Note 7, at 25.
The Australian Taxation Office (Taxation Ruling 98/11, Chapter 5) has designed a four-step approach as a useful tool for taxpayers to develop the methodology and documentation needed to support the evaluation of their transfer prices. The Commissioner of SARS endorses the four-step process as a useful tool. In annexure B of PN7, the Commissioner provides the four-step approach, which is as follows:

“Step 1: Understand the cross-border dealings between connected parties in the context of the business” i.e. A functional risk analysis report should be compiled;
“Step 2: Select the pricing method or methods”;
“Step 3: Application of the pricing method or methods”;
Finally “Step 4: Arriving at the arm’s length amount and introducing processes to support the chosen method”.

A functional risk analysis is a report of all the functions performed by the tested party, locally and abroad. It also provides a general understanding of the business of the tested party. Furthermore, it sets out the risks that are borne by the tested party for e.g. market risks, foreign exchange risks etc. The functional risk analysis is the most important step of the solution as it will identify if there are any internal comparables that may be used as a transfer pricing method.

The OECD issued a document to all its member states, *Transfer Pricing – Suggested Approach*, published in June 2011. With this document the OECD provides its member states with a suggested approach to its transfer pricing legislation. It further states that if a country implements transfer pricing legislation where it embodies the arm’s length principle, the country will be “protecting their tax base while not creating double taxation or uncertainties that could hamper foreign direct investment and cross-border trade.”

South Africa is not an OECD member state, but it is submitted that there are many advantages to the country if it aligns its transfer pricing legislation with that of the
internationally accepted principles that are set out in the OECD Transfer Pricing guidelines. These advantages and benefits include but are not limited to:

- “Provide countries with the tools they need to fight artificial shifting of profits out of their jurisdiction by MNEs;
- Provide MNEs with some certainty of treatment in the country concerned;
- Reduce the risk of economic double taxation;
- Provide a level playing field between countries, which is less likely to distort the pattern of international trade and investment; and
- Provide a level playing field between MNEs and independent enterprises doing business within a country.”

In summary, South Africa’s legislation does refer to the OECD transfer pricing guidelines and the arm’s length principle. Even though PN7 refers to the old legislation and is not updated to reflect the changes that were made to the OECD transfer pricing guidelines, it still provides the MNE’s with a guideline as to what the acceptable methods are that may be applied in determining an arm’s length price.

2.3 Transfer pricing methods

The OECD Transfer Pricing Guidelines issued in 2010 set out five methods to analyse the arm’s length nature of inter-company transactions. SARS is in agreement with these methods as they are stated in PN7. The methods are split between traditional transaction methods and transactional profit methods. The five methods that are approved by SARS are:

**Traditional transaction methods**

1. Comparable uncontrolled price method (CUP method) internal vs external (e.g. listed)

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“A transfer pricing method that compares the price for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.” 18

2 Resale price method (RP method)

“A transfer pricing method based on the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. The resale price is reduced by the resale price margin. What is left after subtracting the resale price margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. custom duties), as an arm’s length price of the original transfer of property between the associated enterprises.” 19

3 Cost plus method (CP method)

“A transfer pricing method using the costs incurred by the supplier of property (or services) in a controlled transaction. An appropriate cost plus mark-up is added to this cost, to make an appropriate profit in light of the functions performed (taking into account assets used and risks assumed) and the market conditions. What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm’s length price of the original controlled transaction.” 20

Transactional Profit Methods

4 Profit Split Method

“A transactional profit method that identifies the combined profit to be split for the associated enterprises from a controlled transaction and then splits those profits between the associated enterprises based upon an economically valid basis that approximates the

19Ibid, at 28.
division of profits that would have been anticipated and reflected in an agreement made at arm’s length.” 21

5 Transactional Net Margin Method

“A transactional profit method that examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realises from a controlled transaction.” 22

The Commissioner for SARS endorses the abovementioned methods as acceptable transfer pricing methods, the most appropriate of these depending on the particular situation and the extent of reliable data to enable its proper application.23 The OECD provides for other methods if the standard methods do not provide an arm’s length result, however these methods are not approved by SARS.

The method that will be used will be based on the facts and circumstances of the transaction. The OECD Transfer Pricing Guidelines states that the most appropriate method is based on the following considerations:

- “…the respective strengths and weaknesses of the OECD recognised methods;
- The appropriateness of the method considered in view of the nature of the controlled transaction, determined in particular through a functional analysis;
- The availability of reliable information (in particular on uncontrolled comparables) needed to apply the selected method and/or other methods;
- The degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate material differences between them.” 24

21Ibid, at 28.
23Refer to paragraph 9.2.4 of the Practice Note.
24OECD Transfer Pricing Guidelines, at 59, point 2.2.
Certain of the methods may provide a more reliable result than the others. Therefore, some may be preferred above the others. However, the most reliable method will be the one that requires the least amount of adjustments.

Of the three traditional transaction methods (the CUP method, the RP method and the CP method), the CUP method is preferred, as it looks directly to the product or services transferred, and is relatively insensitive to the specific functions that are performed by the entities being compared. However, the RP method and CP method can be said to be ranked second as these methods examine gross margins, from which operating expenses are excluded. Therefore, the impact of relative cost structures should not be material for these two methods.

2.4 Conclusion

The question still remains, is the current income tax legislation in line with the OECD Transfer Pricing Guidelines?

No, the South African tax legislation does not even refer to the OECD transfer pricing guidelines and does not provide guidance on how to apply the arm’s length principle. Even though PN7 refers to old legislation and is not updated to reflect the changes that were made to the OECD transfer pricing guidelines, it still provides MNE’s with a guidance as to what the acceptable methods are that may be applied in determining an arm’s length price.

Even though South Africa is not an OECD member, it does however understand that it will be to the countries benefit to adhere to the guidelines provided by the OECD. Therefore, the country should try and adopt as much as it possibly can of the OECD guidelines.
Chapter 3 Documentation

3.1 Introduction

In the BEPS action plan, the OECD and G20 realised that there is a need for transparency to the tax administration in regards to the documentation of transfer pricing. The BEPS action 13 which deals with the re-examination of transfer pricing documentation states: “Develop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that MNE’s provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template.”

Subsequent to the action plan that was issued in July 2013, the OECD has issued an interim report and a final report on action 13 in September 2014 and 5 October 2015, respectively. In the final report, “Transfer Pricing Documentation and Country-by-Country Reporting”25 (TP report), the final report will replace the current chapter V of the OECD Transfer Pricing guidelines.

The TP report prescribes a three-tiered standardised approach to transfer pricing documentation. This standard consists of:

(i) “a master file containing standardised information relevant for all MNE group members;

(ii) a local file referring specifically to material transactions of the local taxpayer; and

(iii) a Country-by-Country Report containing certain information relating to the global allocation of the MNE group’s income and taxes paid together with certain indicators of the location of economic activity within the MNE group.”26

3.2 Three-tiered standardised approach

The TP report provides a detailed list of what is required to be included in the three reports. The aim of the reports are to provide standardisation so that transfer pricing compliance is more straightforward and more consistent among countries while at the same time providing tax administrations with more focused and useful information for transfer pricing risk assessments and audits.

**Master File**

The master file should provide an overview of the MNE group business, including the nature of its global business operations, its overall transfer pricing policies, and its global allocation of income and economic activity in order to assist tax administrations in evaluating the presence of significant transfer pricing risk. In general, the master file is intended to provide a high-level overview in order to place the MNE group’s transfer pricing practices in their global economic, legal, financial and tax context. It is not intended to require exhaustive listings of minutiae (e.g. a listing of every patent owned by members of the MNE group) as this would be both unnecessarily burdensome and inconsistent with the objectives of the master file.27

The information required in the master file provides a “blueprint” of the MNE group and contains relevant information that can be grouped in five categories:

a) the MNE group’s organisational structure;

b) a description of the MNE’s business or businesses;

c) the MNE’s intangibles;

d) the MNE’s intercompany financial activities; and

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(e) the MNE’s financial and tax positions.

Taxpayers should present the information in the master file for the MNE as a whole.\(^\text{28}\) The master file must be filed to the local tax authorities and its purpose is to provide an overall perspective of the business. Therefore, taxpayers are not required to provide lengthy information regarding the description of its business. The file will assist taxpayers in understanding their processes for compiling their transfer pricing documentation.

PN7 states that in order for a taxpayer to determine that its pricing is at arm’s length, one of the requirements is that the taxpayer needs to complete a functional risk analysis which should provide a quick overview of the organisation for those evaluating the transfer pricing policy of the multinational, to assist them in familiarising themselves with the general operations of the multinational. Secondly, the functional analysis should seek to identify the functions performed by each member of the multinational and assess the importance of each function to the overall operations of the multinational. Furthermore, one of the steps in determining transfer prices is “… understand the cross-border dealings between connected parties in the context of the business …”\(^\text{29}\) (which in effect is the functional risk analysis) and in this step the taxpayer is required to explain a) how the international connected-party dealings of the enterprise are undertaken; b) the purpose or object of the dealings; c) what the taxpayer obtains from its participation in the dealings (for example products, services or strategic relationships); and d) the significance of the dealings to the taxpayer's overall business activities and to those of the multinational.

Therefore, even though practice notes do not form part of the South African legislation, the practice note does provide guidance which is similar to that required by the OECD.


\(^{29}\)SARS, Practice Note 7, at 39.
However, the transfer pricing document does not have to be filed with any tax authorities. The transfer pricing document should merely be kept readily available should the tax authorities request it.

**Local File**

The local file provides more detailed information relating to specific intercompany transactions. The information required in the local file supplements the master file and helps to meet the objective of assuring that the taxpayer has complied with the arm’s length principle in its material transfer pricing positions affecting a specific jurisdiction. The local file focuses on information relevant to the transfer pricing analysis related to transactions taking place between a local country affiliate and associated enterprises in different countries and which are material in the context of the local country’s tax system. Such information would include relevant financial information regarding those specific transactions, a comparability analysis, and the selection and application of the most appropriate transfer pricing method. Where a requirement of the local file can be fully satisfied by a specific cross-reference to information contained in the master file, such a cross-reference should suffice.30

As the master file provides a high-level overview, in contrast, the local file provides more detailed information relating to specific material intercompany transactions. The information required in the local file should supplement the master file and assist in assessing whether the taxpayer has complied with the arm’s length principle in its material transfer pricing positions affecting a specific jurisdiction.

In PN7’s four step approach to determine arm’s length pricing, the taxpayer needs to introduce processes to support the chosen method at arriving at the arm's length pricing. The taxpayer will be required to document and demonstrate how its data has been used

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in the application of its chosen pricing method to determine an arm's length amount. Furthermore, the taxpayer will need to document the choice and resultant application of its transfer pricing methods for calculating an arm's length price. The document should have regard to a) the degree of comparability between the uncontrolled transactions used for comparison and the controlled transactions of the taxpayer; b) the completeness and accuracy of the data relied on; c) the reliability of all assumptions; and d) the sensitivity of any results to possible deficiencies in the data and assumptions. Therefore the requirements of the local file is very similar to that of a taxpayer’s normal transfer pricing documentation.

PN7 does provide guidance which is similar to that required by the OECD. However the transfer pricing document does not have to be filed with the any tax authorities. The transfer pricing document should merely be kept readily available should the tax authorities request it.

**Country-by-country report**

“The country-by-country report requires aggregate tax jurisdiction wide information relating to the global allocation of the income, the taxes paid, and certain indicators of the location of economic activity among tax jurisdictions in which the MNE group operates. The report also requires a listing of all the Constituent Entities for which financial information is reported, including the tax jurisdiction of incorporation, where different from the tax jurisdiction of residence, as well as the nature of the main business activities carried out by that Constituent Entity.

The country-by-country report will be helpful for high-level transfer pricing risk assessment purposes. It may also be used by tax administrations in evaluating other BEPS related risks and where appropriate for economic and statistical analysis. However, the information in the country-by-country report should not be used as a substitute for a detailed transfer pricing analysis of individual transactions and prices based on a full functional analysis and a full comparability analysis. The information in
the country-by-country report on its own does not constitute conclusive evidence that transfer prices are or are not appropriate. It should not be used by tax administrations to propose transfer pricing adjustments based on a global formulary apportionment of income.31"

The country-by-country reporting template is designed to provide tax authorities with specific information relating to the members of a multinational group (such as revenue, profit or loss before income tax, capital, number of employees, activities etc.). The information needs to be filed by the ultimate parent of the multinational group in its jurisdiction of residence, and the report needs to be updated every 12 months. The tax authorities in that jurisdiction will distribute the report directly to all the other tax authorities in the jurisdictions mentioned in the report. An exemption applies to multinational groups with an annual consolidated group revenue in the immediately preceding fiscal year of less than Euro 750 million. The filing will be required in respect of years of assessment commencing on or after 1 January 2016 and, therefore, the reports need to be filed on or after 31 December 2017.

The issue that may arise as a result of the sharing of information across the tax authorities is the fact that the subsidiary in the other jurisdiction is unaware of the amounts and transactions that are included in the country-by-country report, unless the report is shared by the ultimate holding company that prepared it – the subsidiary may contradict the country-by-country report when it issues its local file to the local tax authorities. The contradiction may be as a result of incorrect disclosure made by either of the parties and different interpretation by the parties.

Furthermore, MNE’s may be concerned about the confidentiality issues that may arise as a result of sharing of its information to the different tax authorities. In an article written by Kara Boatman, Doreen Liu and Ian Novos from KPMG LLP32, they state that “It is unclear just how information provided will be used and to whom it will be

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provided. Even at this stage, governments have expressed concern about confidentiality and information exchange issues. Thus, companies may be somewhat cautious, at least initially, about revealing information unnecessarily. A trade-off probably will need to be evaluated between turning over more information at the risk of having it revealed more widely—even potentially publicly—and having some tax authorities cherry-pick that information to make a transfer pricing adjustment; and revealing less information and possibly facing aggressive audits because the company is suspected of concealing relevant information.”

Therefore, due to confidentiality issues MNE’s will find it difficult to provide the tax authorities with full disclosure on these reports. However, the country-by-country report should not be used as a substitute for a detailed transfer pricing analysis of individual transactions and prices based on a full functional analysis and comparability analysis. Where the country-by-country report is provided to other tax authorities in other jurisdictions, the country-by-country report can only be used as a high level risk assessment and therefore cannot be used as a basis to audit an entity. The other tax authorities are also not allowed to make any transfer pricing adjustments based on the report33.

The annexures in the TP report provide examples of the information that should be contained in these three documents.

“Taken together, these three documents (master file, local file and country-by-country report) will:

- require taxpayers to articulate consistent transfer pricing positions,
- provide tax administrations with useful information to assess transfer pricing risks,
- make determinations about where audit resources can most effectively be deployed, and

• in the event audit are asked for, provide information to commence and target audit enquiries.”

In terms of the TP report, the advantages of transfer pricing documentation is threefold:
1. “To ensure that taxpayers give appropriate consideration to transfer pricing requirements in establishing prices and other conditions for transactions between associated enterprises and in reporting the income derived from such transactions in their tax returns;
2. To provide tax administrations with the information necessary to conduct an informed transfer pricing risk assessment; and
3. To provide tax administrations with useful information to employ in conducting an appropriately thorough audit of the transfer pricing practices of entities subject to tax in their jurisdiction, although it may be necessary to supplement the documentation with additional information as the audit progresses.”

3.3 The South African position

The aim of the research is to determine whether the South African Tax legislation is in line with the terms of the OECD transfer pricing guidelines.

In terms of the South African tax legislation it is not mandatory to prepare transfer pricing documentation. Although there is clearly no statutory or other requirement to prepare and maintain transfer pricing documentation, it is in the taxpayer’s best interests to document how transfer prices have been arrived at since this is the best method to demonstrate that transfer prices are consistent with the arm’s length principle. Taxpayers electing not to prepare transfer pricing documentation are exposed on two accounts. Firstly, it is more likely that the Commissioner will examine a taxpayer’s

transfer pricing in greater detail if proper documentation has not been prepared. Secondly, if the Commissioner substitutes an alternative arm’s length amount to that adopted by the taxpayer, the lack of adequate documentation will make it difficult for the taxpayer to rebut that substitution.

The burden of proof regarding transfer pricing adjustments have changed numerous times over the years. Currently, section 31 of the Act requires that where a foreign connected transaction has occurred and it has not occurred at an arm’s length basis, an adjustment is required. So in effect, should the taxpayer know that its foreign connected transactions are not at arm’s length the taxpayer has the responsibility to adjust its taxable income accordingly to thus ensure that the transaction is at arm’s length.

PN7 deals with the “Determination of the taxable income of certain persons from international transactions: transfer pricing” and in respect of transfer pricing documentation it states that as a general rule the Commissioner considers that taxpayers should contemporaneously document the process they have followed and their analysis in determining transfer prices, in their efforts to comply with the arm’s length principle. The Commissioner will rely as much as possible on documentation that should be created in the ordinary course of business and of setting a transfer price. This documentation (according to PN 7) will generally address the following:

- Identification of transactions in terms of international agreements entered into with connected persons and the extent of any other commercial or financial relations with connected persons which fall within the scope of Section 31;
- Copies of the international agreements entered into with connected persons;
- A description of the nature and terms (including prices) of all the relevant transactions (including a series of transactions and any relevant off-setting transactions);
- The method that has been used to arrive at the nature and terms of the relevant transactions (including the functional analysis undertaken and an appraisal of potential comparables);
• The reasons why the choice of method was considered to be the most appropriate to the relevant transactions and to the particular circumstances;
• An explanation of the process used to select and apply the method used to establish the transfer prices and why it is considered to provide a result that is consistent with the arm's length principle;
• Information relied on in arriving at the arm’s length terms such as commercial agreements with third parties, financial information, budgets, forecasts etc.
• Details of any special circumstances that have influenced the price set by the taxpayer.
This should include some justification of why those transfer prices are considered to be consistent with the arm's length principle.

Again, although not law, PN7 does provide taxpayers with guidance and indicates SARS approach to the issue. However, since it was issued in 1999 it refers to the old OECD transfer pricing guidelines that were updated in 1995 and old South African tax legislation. Taxpayers may use the practice note to provide some guidance, but need to bear in mind that it is outdated.

3.4 Draft interpretation note

As a result of the changes made to section 31 of the Act, and specifically the introduction of the definition of an “affected transaction”, the amended section applies to all years of assessment commencing on or after 1 April 2012. SARS issued a draft interpretation note36 on thin capitalisation (thin capitalisation is discussed in more detail in chapter 5). The draft interpretation note states the following on documentation:
“The documentation a taxpayer will need to support its arm’s length amount of debt and, if applicable, thin capitalisation adjustment, will vary depending upon the facts and

circumstances of the particular case including its’ size and complexity. However, as a guideline SARS considers that, as appropriate to the particular facts and circumstances, taxpayers should retain the following documentation on their capitalisation position:

- A description of the funding structure which has been or is in the process of being put in place, including the dates of transactions, a clear statement of the source of the funds (immediate and ultimate), reasons for obtaining the funds, how the funds were or will be applied (the purpose of the funding) and the repayment terms.
- A description of the business (including the type of business, details of the specific business, details regarding the management team and external market conditions) and the plans of the principal trading operations (including the business strategy).
- Copies of relevant funding agreements and other relevant documents, for example, board minutes relevant to the funding, South African Reserve Bank applications and approvals, copies of related funding applications (for example, where part of the funding is received from an offshore bank).
- An analysis of the financial strategy of the business, including how capital is allocated and the relationship between capital and cash flows from operations and any changes relating to the funding transactions; and details regarding principal cash flows and the sources of repayment of debt.
- A group structure covering all relevant companies and clearly setting out any changes to the structure taking place over the course of the funding transactions.
- Copies of the financial statements or management accounts just before the point in time the funding is obtained and after the funding transactions.
- An analysis supporting the borrower’s view of the extent to which the connected party (or supported) debt is considered to be arm’s length.”

The information required per the draft interpretation note has certain elements of the master file (as defined above) in the sense that the interpretation note requires the taxpayer to disclose a description of its business and its group structure. However, the interpretation note is quite focused on the funding and debt of a taxpayer. It does not

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37SARS, Draft interpretation note on thin capitalisation, at 12.
refer to any other foreign intercompany transactions as required in the local file. There is also no reference to the disclosure of the revenue, profit or loss before income tax, capital, and number of employees of the members within the multinational group.

Most of the information required to be disclosed per the draft interpretation note is also required in terms of PN7. Therefore should the draft interpretation note be issued as final, the taxpayer will not be required to gather a lot of additional information.

Even though South Africa is not an OECD member state, they are a member of the G20, which had tasked the OECD to propose measures to tackle perceived BEPS, and therefore it is widely expected that South Africa will follow the recommendations by the OECD.

3.5 Tax Administration Act

The Tax Administration Act\(^\text{38}\) (TAA) implemented with effect from 1 October 2012, governs the administration of the different tax Acts, including the Income Tax Act. The Act governs, inter alia, disputes, appeals, assessments, interest, penalties, documentation and record keeping. Section 40 of the TAA states that SARS may select a person for inspection, verification or audit on the basis of any consideration relevant for the proper administration of a tax Act, including on a random or a risk assessment basis. Section 46 further states that SARS may, for the purposes of the administration of a tax Act require the taxpayer or another person to, within a reasonable period, submit relevant material (whether orally or in writing) that SARS requires. A request by SARS for relevant material from a person other than the taxpayer is limited to relevant information related to the records maintained or that should reasonably be maintained by the person in relation to the taxpayer.

\(^{38}\text{Tax Administration Act, No 28 of 2011.}\)
Therefore, the TAA provides SARS with the right to request transfer pricing documentation, including from a third party, should it be reasonable to expect that third party to maintain that information.

In terms of section 31 of the Act, the onus is on the taxpayer to prove to the Commissioner that its transactions are at arm’s length. The Act merely states that the adjustment to taxable income must be made where the transaction is not at arm’s length, hence if the Commissioner is of the view that it is not at arm’s length it is the taxpayer’s onus to prove otherwise. Therefore, the burden of proof is on the taxpayer to prove the Commissioner wrong. If a taxpayer has not maintained appropriate records, the process of checking compliance with the arm’s length principle becomes far more difficult and the Commissioner’s officials are forced to rely on less documentary evidence in applying a transfer pricing method, thus requiring a greater degree of judgment by the SARS officials.

3.6 Tax Return

Even though the South African tax legislation does not provide for any specific transfer pricing documentation to be retained by the taxpayer, the South African corporate tax return (ITR14) requires a taxpayer to supply certain specific information regarding cross-border transactions entered into between connected persons. It further requires the taxpayer to indicate whether or not transfer pricing documentation in respect of the relevant year of assessment is in place. A small business (where the gross income (sales/turnover plus other income) does not exceed R14 million and total assets (current and non-current) does not exceed R10 million) is not required to complete the new questions. With effect from 4 May 2013, the ITR14\(^{39}\) was amended to include the following:

**Some of the new questions included are:**

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\(^{39}\)An extract of a Medium to Large business ITR14 on E-filing, Annexure D of the Comprehensive guide to the ITR14 for companies issued by SARS.
“Did the company receive or earn any foreign income or incur any foreign expenditure or pay any royalties, interest, dividends or consulting fees to a non-resident?

“For years of assessments on or after 1 April 2012, did the company enter into an “affected transaction” as defined in s31(1)(a), where the company: Received/earned foreign income?

“For years of assessments on or after 1 April 2012, did the company enter into an “affected transaction” as defined in s31(1)(a), where the company: Incurred foreign expenditure?”

If any of the above answers are yes, then the following supporting questions will need to be answered:

• “Does the company have transfer pricing documentation that supports the pricing policy applied to each transaction between the company and the foreign connected person during the year of assessment as being at arm’s length?
• “Did the company conduct any outbound transaction, operation, scheme, agreement for no consideration with a connected person that is tax resident outside South Africa?
• “Did the company transact with a connected person that is tax resident in a tax haven/low tax jurisdiction?
• “Did the company make a year-end adjustment to achieve a guaranteed profit margin?”

The new disclosure requirements also require companies to breakdown the following items into local, foreign connected and foreign non-connected, if certain questions listed above are answered yes:

• Received/Receivable and Paid/Payable
  ➢ Sale of goods/ Purchases of goods
  ➢ Commission
  ➢ Interest
- Royalties or licence fees
- Administration, management, secretarial fees, rentals
- Guarantee fees
- Insurance premiums
- Other finance charges
- Research and development fees
- Other income/other expenses

It also requires companies to calculate and disclose its debt-to-earnings before interest, tax depreciation and amortisation, interest cover (EBITDA) and debt-to-equity ratios. Although the safe harbour rule for thin capitalisation (see chapter 5) has been removed from the South African tax legislation, SARS is still of the view that a greater thin capitalisation risk exists if the debt to EBITDA ratio of a South African taxpayer exceeds three to one. Therefore, the relevance of the ratios would be to provide SARS with a risk assessment of the debt.

The ITR14 provides a summary of a taxpayer’s foreign connected person transactions. It provides SARS with a very high level risk assessment. It cannot be used as a full functional risk analysis. However, should the taxpayer answer the question regarding whether its transactions are at “arm’s length”, the taxpayer is required to have the necessary documentation in place to support it.

3.7 Davis Tax Committee’s view

The Davis Tax Committee (DTC) set up in July 2013 with the objective to assess South Africa’s tax policy framework and its role in supporting the objectives of inclusive growth, employment, development and fiscal sustainability, reviewed the OECD report ‘Guidance on Transfer Pricing Documentation and Country-by-Country Reporting Guidance’ issued in September 2014, and issued a report named “Addressing Base Erosion and Profit Shifting in South Africa, Davis Tax Committee Interim Report,
Action 13: Re-examine Transfer Pricing Documentation” and as a result has issued the following recommendations\(^{40}\) to South Africa:

- Practice Note 7 must be revised and updated to be in line with the OECD revised TP Documentation Guidelines and the finalisation of the draft Interpretation Note must be prioritised.
- The OECD’s recommendation that countries should adopt a standardised approach to transfer pricing documentation that follows a three-tiered structure consisting of a master file, a local file and country-by-country reporting should also be adopted in South Africa.
- The three-tiered structure should however, only be compulsory for large multinational businesses with a group turnover of over 1 billion rand, instead of the Euro 750 million exemption provided by the OECD.
- SARS should balance requests for transfer pricing documentation against the expected cost and administrative burden to the taxpayer of creating it.
- The country-by-country report for South Africa should contain additional transactional data regarding related party interest payments, royalty payments and especially related party service fees so that SARS may perform risk assessments where it is difficult to obtain information on the operations of a multinational group.
- In respect of the timing for each of the three reports, SARS should set out what its expectations are, as the OECD recommends that the local file should be finalised no later than the due date for the filing of the tax return; the master file should be updated by the tax return due date for the ultimate parent of the group; and the country-by-country report, should be submitted when the final statutory financial statements are finalised.
- The master file, the local file and the country-by-country report should be reviewed and updated annually and database searches for comparables should be updated every three years.

SARS should start to build a database of comparable information as the OECD recommends that the most reliable information is usually local comparables.

SARS needs to establish a highly skilled transfer pricing team to include not only lawyers and accountants but also business analysts and economists, to ensure an understanding of commercial operations. This will require that measures are taken to identify, employ and retain skilled personnel especially in the regions.

- Information required from corporates via the ITR14 submissions needs to be improved so that timely decisions can be made on the tax assessment of companies.
- The collection and sharing of data should be extended to include other holders of vital information such as exchange control information about capital outflows collected by the South African Reserve Bank.

Based on the comments made by the DTC, the implementation of the three-tiered documentation structure is welcomed, but the DTC is of the view that SARS needs to consider certain setbacks should the reports be required to be submitted annually. SARS should ensure that they have the necessary resources, skills and expertise to ensure that the risk assessment is done timeously.

In conclusion, the South African tax legislation does not require any form of documentation to be prepared and/or submitted to the Commissioner. However, in terms of section 31 of the Act, the taxpayer is required to provide support to its foreign connected person pricing and the burden of proof that pricing is at arm’s length is effectively on the taxpayer.

**3.8 Conclusion**

It is submitted that the South African transfer pricing legislation is expected to reflect the OECD transfer pricing guidelines within the next year. Even though it’s not mandatory in terms of the current legislation, the Commissioner may call on documentation to support the taxpayers’ pricing in terms of the TAA. If the taxpayer fails to provide the Commissioner with the relevant material requested in terms of section 46 of the TAA and section 31 of the Act, the taxpayer may be held non-
compliant and may be subjected to penalties and transfer pricing adjustments in terms of section 31 of the Act.

Therefore, the South African legislation should be updated to reflect that required by the OECD in terms of transfer pricing documentation. However it is submitted that there are additional considerations to be taken into account:

- SARS should update or delete PN 7, as it is outdated.
- SARS should update and issue the interpretation to reflect the new legislation and the changes to the OECD transfer pricing guidelines.
- SARS needs to consider, as noted in the DTC report, whether they have the necessary skills, information and resources to be able to ensure that they are interpreting the reports correctly.
- SARS needs to consider that South Africa lacks sufficient and/or suitable local comparable data. As a result of the lack of local comparable data, foreign comparable data needs to be appropriately adjusted for.
- In certain instances where SARS audits taxpayers SARS requests taxpayers to complete a transfer pricing questionnaire. The questionnaire provides SARS with a further risk assessment. SARS needs to assess whether the questionnaire is in line with the OECD transfer pricing guidelines.
- Involve the South African Reserve Bank, where the bank does not allow the flow of cash across the borders where no transfer pricing documentation is in place. The South African Reserve Bank should request transfer pricing documentation where payments are made to entities within low tax jurisdictions, the South African Reserve Bank can even request transfer pricing documentation where payments flow across the borders that exceed a certain amount.

As the DTC has recommended that the OECD BEPS related proposals should be adopted, South African members of multinational groups should start preparing for the new reporting requirements to come. In order to start preparing for the new requirements the MNE’s may do the following:
• The taxpayer needs to understand the reports and understand what type of information is required.
• The availability and format of data needs to be assessed, as the taxpayer may need to adjust its systems to ensure that the data is easily accessible.
• The taxpayer should attempt a “dry-run” to determine if there are any other issues when preparing the reports. The issues may be resolved prior to the preparation of the actual reports.
• Reporting responsibilities should be assigned to personnel, thus ensuring that personnel can take ownership of the reports.
• Reporting deadlines should be assessed and planned timeously as it is more than likely that transfer pricing documentation will be required to be submitted alongside the tax return and will therefore become part of the annual tax compliance cycle.

With effect from the date that the BEPS Action Plan was published in July 2013 there have been no changes to the South African tax legislation in respect of transfer pricing documentation to align the tax legislation to that issued by the OECD in its BEPS reports.

The guidance in PN7 provides a lot of similarity to that of the local file and master file that is required by the OECD, therefore significant changes to the tax legislation are not expected in this regard. However the South African legislation does not have any requirements for country-by-country reporting. As a result of the fact that it has been welcomed by the DTC, SARS may very likely bring the requirement of the country-by-country reporting into the tax legislation. Should these requirements be legislated, SARS should ensure that their systems are upgraded and are able to handle the storage of the reports. Furthermore, SARS should ensure that it has the resources and skills required to interpret the reports, specifically the country-by-country report.
Chapter 4 Value creation: Intangibles

4.1 Introduction

The BEPS Action Plan was implemented to direct the OECD to address a number of transfer pricing issues, of specific reference to intangibles, it states as follows: “Develop rules to prevent BEPS by moving intangibles among group members. This will involve (i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation; (iii) developing transfer pricing rules or special measures for transfers of hard to value intangibles; and (iv) updating the guidance on cost contribution arrangements.” 41

The OECD has in the past done extensive work on the transfer pricing of intangibles which are in line with Action Plan 8. In Action Plan 8, the OECD recommends that countries develop rules to prevent BEPS by moving intangibles among MNE group companies. The OECD issued its final report on Aligning Transfer Pricing Outcomes with Value Creation on the 5 October 2015, the report deals with Actions 8, 9 and 10 and it replaces and adds to the Transfer Pricing Guidelines.

The aim of the BEPS report on intangibles, inter alia, is to provide guidance to countries by providing countries with transfer pricing rules for transfers of hard-to-value intangibles, allocation of intangible returns and emphasis of the importance of substance and functions performed in allocating intangible related returns. The guidance states that legal ownership and contractual arrangements are the key starting point for the transfer pricing analysis of intangibles.

4.2 OECD Revision to chapter VI of Transfer Pricing Guidelines

The revision to chapter VI of Transfer Pricing Guidelines states that it provides guidance and addresses the opportunities for BEPS resulting from the transfer of intangibles amongst members of an MNE group. As a result of this guidance, members of the MNE group are to be compensated based on the value they create through functions performed, assets used and risks assumed in the development, enhancement, maintenance, protection and exploitation of intangibles. In analysing the risks assumed depends on a very specific and meaningful control requirement, which takes into account both the capability to perform relevant decision-making functions together with the actual performance of such functions.

If a company contractually assuming a specific risk does not exercise control over that risk nor has the financial capacity to assume the risk, then the guidance in the revised chapter determines that the risk will be allocated to another member of the MNE group that does exercise such control and has the financial capacity to assume the risk. The control requirement is used in this chapter to determine which parties assume risks in relation to intangibles, but also for assessing which member of the MNE group in fact controls the performance of outsourced functions in relation to the development, enhancement, maintenance, protection and exploitation of the intangible.

In the nutshell report called “The October 2015 BEPS Deliverables” 42 prepared by KPMG, the OECD deliverables issued thus far were looked at, and as a result, key guidance points were summarised. In summary the report states that the legal ownership of an intangible does not in itself provide a right to all (or even any) of the return generated from its exploitation. Instead those returns accrue to the entities which carry out the functions of development, enhancement, management, protection and exploitation in relation to that intangible. The new guidelines emphasises:

the need to accurately delineate a transaction so that the conduct of parties will replace contractual arrangements where they are incomplete or out of line with the conduct. Transactions can be disregarded for transfer pricing purposes where they lack commercial rationality.

Return for risk is allocated to the party which controls it and has the financial capacity to assume it. An entity only providing capital will be entitled to no more than a risk free return.

Enhanced rules on how to apply the CUP (comparable uncontrolled price) methodology to commodity transactions.

A safe harbour for low value adding services recommended, with a light touch benefits test and prescribed net cost plus margins of between 2% and 5%.

Changes to the rules on Cost Contribution Arrangements to align them with the other TP outcomes.

These guidelines cement the importance of underlying substance and value creation over legal ownership/funding.

4.3 Intangibles and its South African risk

The South African tax legislation does not define the term intangible, but it broadly defines the term ‘intellectual property’ in section 23I of the Act. In terms of the Act, Intellectual property means any patent or application for a patent as defined in the Patents Act, a design as defined in the Designs Act, a trade mark as defined in the Trade Marks Act, a copyright as defined in the Copyright Act, any of the above defined or described in any similar law in a country other than the Republic, property or similar right to those defined above and any knowledge connected with the use of any of the above.

The transfer pricing issue that arises as a result of intangibles amongst MNE group companies are that the MNE group will recognise the intangible asset in the company that is in the lowest tax jurisdiction. For example, a MNE group which consist of three
companies, the holding company and its two wholly owned subsidiaries. The holding company is incorporated in Germany, the one subsidiary in Australia and the other in South Africa. For the South African company it would be to its advantage to have the holding company recognise the intellectual property such as brands, trademarks, licences etc. The South African company would in exchange for use of the intellectual property pay the German company a fee, also known as a royalty. The South African company would generally claim a deduction for the royalty payments, subject to certain limitations. However, the South African company will be subject to withholding tax at a rate of 15% in terms of section 49B of the Act, where the royalties are seen as a source within the Republic in terms of section 9(2) of the Act.

However, the withholding tax is reduced to zero in terms of article 9 of the double tax treaty between South Africa and Germany. 43

Had the Australian subsidiary company held the intangible, the double tax treaty between South Africa and Australia merely reduces the withholding tax on royalties to 10%. However, in both cases the South African entity may still get the deduction of the royalty payment. And with little to no taxes being paid to either of the other two jurisdictions.

With the new chapter VI of the Transfer Pricing guidelines, there are a few factors that need to be taken into account to determine which company in an MNE group actually owns the intangible. One should assess which company contractually assumes the risk relating to the intangible. The company should also have the capacity to exercise control over that risk and have the financial capacity to assume the risk. Based on the example above, should the German holding company contractually own the intangible, but does not actually control the rights relating to the intangible and it does not have the financial capacity to assume the risks associated to the intangible then the guidance in the revised

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chapter determines that the risk will be allocated to another member of the MNE group that does exercise such control and has the financial capacity to assume the risk.

4.4 Section 23I of the Act

Section 23I of the Act is an anti-avoidance section which in broad terms seeks to disallow as a deduction any expenditure incurred for the use of certain intellectual property, where the intellectual property was previously owned by a South African entity and transferred to a non-South African entity or was developed in South Africa. Silke\textsuperscript{44} deals with section 23I of the Act and states that the principle underlying section 23I is that, where intellectual property was previously owned by a taxable person\textsuperscript{45} (in other words, a person falling within the South African tax net), no tax arbitrage should result from the payment of royalties by that taxable person to a non-taxable person. (This discussion excludes any payments to Controlled Foreign Companies.)

The opportunity for arbitrage arises where expenditure incurred in the development of intellectual property is often fully deductible. The payer of royalties is usually entitled to a deduction for those royalty payments, and the receipt or accrual of royalties forms part of gross income if the payer or recipient is a taxable entity falling within the South African tax net.

The concern of SARS was that the scheme of the Act lacked effective mechanisms to prevent tax arbitrage where a taxpayer assigned South African intellectual property to an entity with a lower effective tax rate, and then licensed the same intellectual property to fully taxable South African taxpayers. From that juncture, the licensee would make deductible payments to the holder of the intellectual property rights who operated wholly or partly outside the South African tax net. In many instances, the royalty payments are simply returned to the licensee (payer) in the form of dividends, whilst the

\textsuperscript{44}Silke, Silke on South African Tax, Lexis Nexis, 2015, chapter 7.48.
\textsuperscript{45}In essence a taxable person defined in section 23I of the Act is a person who was or is a South African resident.
tax deductions for payments made by the licensee might be so large as to reduce the latter’s taxable income to little or nothing. These considerations led to the enactment of section 23I of the Act.

Section 23I targets ‘tainted intellectual property’ and seeks to deny a deduction of expenditure incurred where the taxpayer is contractually obligated to pay the expense, if it is determined with reference to expenditure for the use or right of use of the tainted intellectual property.

The definition of ‘tainted intellectual property’ in s 23I(1) has two aspects. First, the property in question must qualify as ‘intellectual property’, a term widely defined. Secondly, the intellectual property must be ‘tainted intellectual property’, which is defined as meaning, intellectual property which falls into one of the following categories, namely intellectual property:

- “[W]hich was the property of the end user or of a taxable person that is or was a connected person…” (defined in section 31(4) of the Act) to the end user. A connected person in relation to another company is where the one company holds 20% or more of the shares or voting rights, even if the majority voting rights are held by another shareholder.

- “[W]hich is now the property of a taxable person”.

- In respect of which “a material part … was used by a taxable person in carrying on a business while that property was the property of a taxable person and the end user of that intellectual property acquired that business or a material part thereof as a going concern”.

- “[W]hich was discovered, devised, developed, created or produced by the end user of that [intellectual] property, or by a taxable person that is a connected person … in relation to the end user,…” where that end user “… together with a taxable person … holds at least 20% of the participation rights …”.
However, an override comes into play where the royalty payment is subject to withholding tax (after the application of a double tax agreement). In such a case, part of the royalty may be claimed as a tax deduction if the royalty is subject to the withholding tax on royalties. Where the company is subject to withholding tax of 15% in terms of subsections 49A to 49G, the licensee will be permitted to deduct an amount equal to 50% of the royalty expenses. Where a double tax agreement reduces the royalty withholding tax rate in respect of royalties to 10%, the taxpayer will be entitled to the one-third deduction as long as the rate is not reduced below 10% in terms of the specific treaty.

For example\(^{46}\), where a South African company sells intellectual property that it owns, to a non-resident company in Germany. The German company licenses the intellectual property to the South African company for an arm’s length royalty. The South African company was the original creator of the intellectual property and is now the end user therefore the royalty payment by the South African company is not deductible.

However, should the German company be replaced with an Australian company, bear in mind the facts remain the same. Section 23I of the Act is still applicable as the South African company is the creator and end user of the intellectual property. However, the double tax agreement between South Africa and Australia reduces the withholding tax rate to 10%, therefore the South African company would be eligible to a deduction of one-third of the royalty payments. Section 23I of the Act, provides the South African fiscus with a good basis to prevent value shifting out of South Africa to low or no tax jurisdictions.

\(^{46}\)Phillip Haupt, An example adapted from Notes on South African Income Tax, Huxham and Haupt, 2015.
4.5 The DTC’s comments on intangibles in South Africa

The DTC reiterates that transfer pricing is a key focus area for SARS and that the South African Reserve Bank has been approached to assist in determining the magnitude of BEPS relating to transfer pricing\textsuperscript{47}.

The BEPS concern in relation to South African owned intellectual property is the possibility that MNEs may transfer valuable intellectual property to low tax or tax free jurisdictions to ensure a flow of royalty income to that jurisdiction. In assessing this concern, the DTC, amongst others, considered the South African exchange control rules which prohibits the export of South African developed intellectual property and requires South African based owners of intellectual property, which make the intellectual property available to foreign related parties, to charge an appropriate royalty for the intellectual property.

The DTC came to the conclusion that Action Plan 8 may not require major legislative attention in South Africa at this stage. The DTC is of the opinion that the exchange control restrictions, the punitive tax consequences in terms of section 23I of the Act for the payments of royalties by South African taxpayers which previously used to own the relevant intellectual property, amongst others, readily prevent transfer pricing of intangibles in South Africa\textsuperscript{48}.

The DTC further cautions that care should be taken in developing tax legislation on transferring of intangibles that is too restrictive and that limits the development of intellectual property in South Africa. This will reduce the investments in South Africa in relation to intangibles\textsuperscript{49}.

\textsuperscript{47}Davis Tax Committee, Action 8: Assure Transfer Pricing Outcomes are in line with value creation with regards to intangibles, At 16, Accessed: 6 September 2015.

\textsuperscript{48}Ibid, at 21.

\textsuperscript{49}Ibid, at 22.
4.6 Conclusion

The new chapter VI of the Transfer Pricing guidelines developed rules to prevent BEPS by moving intangibles among group members. In order to achieve this, the new chapter adopted a broad and clearly delineated definition of intangibles; ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with value creation; developing transfer pricing rules or special measures for transfers of hard to value intangibles; and updated the guidance on cost contribution arrangements.

Thus, based on the above chapter, does the South African legislation in respect of intangibles have adequate rules in place to prevent BEPS by moving intangibles among group members?

It is submitted that in parts it does. The strict exchange control restrictions and the anti-avoidance section, section 23I of the Act, with its punitive tax consequences for the payments of royalties by South African taxpayers which previously used to own the relevant intellectual property, prevents the easy transfer of intangibles among MNEs group members.

However, perhaps SARS needs to look into adapting the broad and clearly delineated definition of intangibles, since there is no definition in the Act or perhaps align the definition of intellectual property in section 23I of the Act to the broad definition of intangibles per the new chapter.
Chapter 5 Section 31 of Act

5.1 Introduction

Section 31 was introduced into the Act with effect from 19 July 1995 to counter transfer pricing in South Africa. The section has been amended numerous times since then. Nyasha Musviba did an analysis of section 31 in an article called ‘Transfer Pricing – Income Tax Act 58 of 1962 section 31 further analysis’ 50. Musviba stated that the old section 31 provided the Commissioner with the right to adjust the consideration in respect of the transaction to reflect an arm’s length price for the goods or services. As a result, taxpayers were not obliged to make the adjustments on their tax returns for transactions even if such transactions were not conducted on an arm’s length basis. Taxpayers could therefore file tax returns with excessive deductions, and then sit and wait and hope for the best – which would be that the Commissioner did not pick up these excessive deductions. In the old section, a lot of reliance were placed on the Commissioner. Therefore, had the Commissioner not made any adjustments, the taxpayer would not make any adjustments in its tax return.

However, for years of assessment commencing on or after 1 April 2012 the ITA enables the Commissioner to adjust the price payable in respect of a supply or acquisition of goods or service in terms of an “affected transaction” 51. In terms of section 31(1) of the Act an affected transaction means any transaction, operation, scheme, agreement or understanding which is undertaken directly or indirectly between:

- “a person that is a resident and any other person that is not a resident”;
- “a person that is not a resident and 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”;


51 Section 31(1) of the ITA defines an “affected transaction”.
• “a person that is a resident and 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
• “a person that is not a resident and any other person that is a controlled foreign company in relation to any resident, and those persons are connected persons in relation to one another”.

In addition to the above, the terms and pricing of this transaction, operation, scheme, agreement or understanding must also not be at arm’s length, to be an “affected transaction”.

“The two key changes affecting financial assistance arrangements have also been incorporated under the new legislation. The first is the inclusion of finance arrangements between South African branches of foreign companies and another foreign company within the group. The second, perhaps a more radical change, is the move from a debt to equity ratio test, for assessing thin capitalisation, to an arm’s length test in determining an appropriate funding position.”52

5.2 Thin Capitalisation

In line with the OECD's views, SARS has stated that it views the issue of thin capitalisation as part of the transfer pricing mandate. Thin capitalisation provisions are applied to limit the deductibility of interest where there is a disproportionate ratio between the loan capital and equity employed in a company.

The previous section 31(3), that is the section before 1 April 2012, which allows the Commissioner to disallow the deduction of interest by a taxpayer where financial assistance has been provided and where the Commissioner regards such financial assistance as excessive in relation to the fixed capital of the taxpayer, was deleted when the new transfer pricing rules come into force on 1 April 2012.

The new thin capitalisation rules require that the arm's length principle be applied to financial assistance in the same way it is applied to any other transaction, operation, scheme, agreement or understanding. In practice, this will have the result that a taxpayer will have to determine what amounts it would have been able to borrow in the open market, on what overall terms and conditions, and at what price. (SAICA Article – New Rules) 53

The new rules place more onus on the taxpayer to ensure that its transactions are at arm’s length. It also results in confusion to the taxpayer as PN2 that governs the SARS interpretation of thin capitalisation and that refers to the 3:1 debt to equity ratio has not been withdrawn. With the deletion of the specific thin capitalisation provision, the 3:1 debt to equity ratio safe harbour provided in PN2 ought to disappear.

The thin capitalisation rules were further complicated by the introduction of debt restriction rules effective for interest incurred on and after 1 January 2015. Section 23M of the Act effectively limits the deduction for interest paid between connected persons where the interest is not taxed in the hands of the recipient. Briefly stated, the interest deduction allowed is calculated as interest received plus an amount calculated with reference to a formula, about 40% of EBITDA minus taxable interest incurred in respect of other parties. The confusion created with the inclusion of the new section is that these new rules and the thin capitalisation rules appear to stand separate. The further difficulty arising as a result of the new section is to understand the hierarchy of how the sections will correlate. Even though the limitation of interest deductions in terms of section 23M could have the same effect as a thin capitalisation adjustment, the interaction between section 23M and the thin capitalisation rules within section 31 is not clear.

The draft IN states that from an audit risk perspective, SARS will consider a debt denominated in rand to be of higher risk if the rate of the inbound loan exceeds the weighted average of the South African Johannesburg Interbank Agreed Rate plus 2%. Furthermore, debt denominated in a foreign currency will be considered to be of higher risk if the rate applied to the pricing of the inbound exceeds the weighted average of the base rate of the country of denomination plus 2%. However, the draft IN states that this is not a safe harbour rule and it does not preclude SARS from auditing a taxpayer where the interest rate does not exceed the rates mentioned above. The interest is merely indicative of the level of risk set by SARS for the purpose of selecting cases for audit.

It seems that based on the guidance available, the new capitalisation rules are a subjective test. By allowing the thin capitalisation rules to be subjective, SARS broadens the test and therefore it does not restrict the test to specific taxpayers.

The draft IN provides limited guidance regarding the appropriate indicators of arm's length debt levels. However, the note does state that a Debt: EBITDA ratio that exceeds 3:1 will be viewed as resulting in a high thin capitalisation risk.

Furthermore, the draft IN states that in addition to the debt to EBITDA ratio, SARS will consider a taxpayer to be thinly capitalised if, amongst other factors, some or all of the following circumstances exist:

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

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55Ibid.
56Ibid.
5.3 Primary adjustment

The 2010 OECD transfer pricing guidelines categorize a primary adjustment as “an adjustment that a tax administration in a first jurisdiction makes to a company’s taxable profits as a result of applying the arm’s length principle to transactions involving an associated enterprise in a second tax jurisdiction” 57.

In the current South African transfer pricing legislation, a primary adjustment results where terms and pricing of a transaction, operation, scheme, agreement or understanding is not at arm’s length, and meets the definition of an “affected transaction” in terms of section 31 of the Act. The primary adjustment is as a result of a tax benefit that arose as a result of non-arm’s length transaction between a South African taxpayer and its foreign connected persons. The non-arm’s length portion of the transaction will be disallowed in determining the taxpayer’s taxable income.

5.4 Secondary adjustments

A secondary adjustment is defined as “an adjustment that arises from imposing tax on a secondary transaction.” 58 However, it is submitted that a secondary adjustment is a penalty that is levied on a taxpayer for not carrying out its foreign connected transactions at an arm’s length price.

With effect from 1 January 2015 the secondary adjustment in terms of section 31 of the Act is as follows:

- Where the taxpayer is a company, the secondary adjustment is deemed to be a dividend of an asset in specie declared by the taxpayer and thus may be subject to dividends tax at a rate of 15%, or
- Where the taxpayer is not a company, the secondary adjustment is deemed to be a donation and thus may be subject to donations tax.

The date of the deemed dividend or donation is six months after the end of the tax year in respect of which the primary adjustment was made.

Prior to 1 January 2015, the secondary adjustment was in the form of a deemed loan as a result of the primary adjustments. The secondary adjustment would be the arm’s length interest accruing on the deemed loan that would be taxable.

However, keeping track of secondary adjustments in the form of a deemed loan proved to be a significant administrative burden both for the taxpayer and SARS. In practice, there was no legal basis for the foreign company to repay the deemed loan and the deemed interest because there were no contractual legal obligations supporting the settlement of the loan. It also created difficulties in relation to the accounting treatment of the deemed loan and the relevant currency of the deemed loan and deemed interest.\(^{59}\)

The secondary adjustments as a result of the deemed loan were impractical and resulted in notional interest ‘accruing’ on a loan that contractually did not exist. The taxpayer was responsible to manually preserve its calculations of the loan and interest. Furthermore, in the 2014 explanatory memorandum\(^{60}\) to the Bill, SARS states that the deemed loan mechanism is problematic because in practice it is simply never repaid. The reason for this is that a) there are no contracts setting out the repayment terms because it is a deemed loan and not an actual loan; and b) there may be exchange control restrictions that prevent the repayment of a deemed loan due to exchange control restrictions in the country of the connected person it may be impossible to repatriate the funds resulting in an ongoing interest charge for tax purposes. The administrative burden of the deemed loan was too significant, therefore the change of the secondary adjustment to a deemed dividend in specie with effect from 1 January 2015 was welcomed.


Furthermore, where a deemed loan arose before 1 January 2015, any amount still outstanding on 1 January 2015 is treated as a dividend or donation, as the case may be, on that date.

The DTC acknowledged that the elimination of the deemed loan mechanism is welcomed. However, it is difficult to understand the reasoning behind suggesting that the secondary adjustment may, in certain circumstances (presumably where the foreign counter-party is a subsidiary rather than a shareholder) be treated as a capital contribution.

The issue that arises as a result of the deemed dividend is whether there is tax treaty relief to the 15% withholding tax. The OECD Model Convention with respect to taxes on income and capital (Model Convention), Article 10 dealing with dividends states that where dividends are “… paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State. However, dividends paid by a company which is a resident of a Contracting State may also be taxed in that State according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:

a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;

b) 15 per cent of the gross amount of the dividends in all other cases.”

In summary, the OECD’s intention is that where a dividend is paid by a South African resident company to a resident of the United States (US), the dividend may be taxed in the US. However, the dividend may also be taxed in South Africa, and if so, the tax charged by South Africa cannot exceed 5 percent where the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends or 15 percent in all other cases. As 15 percent is the rate payable in South Africa per the tax legislation, there is no relief. The
5 percent rule would provide some kind of relief but it can only be used where the beneficial owner is a company which holds at least 25 percent. A beneficial owner is not defined in the Model Convention. However, section 64D of the Act defines a beneficial owner as a person entitled to the benefit of the dividend attaching to a share.

The interpretation issue that results here is that even though the secondary adjustment results in a deemed dividend in specie, the dividend will not be subject to tax treaty relief where the dividend was merely a result of a transaction entered between the South African resident and its foreign connected persons where the foreign person does not hold the benefit of the dividend as a result of a share (of which it must hold 25 percent of the share).

The DTC alludes to the view that the secondary adjustment is merely a form of penalty and therefore no tax treaty relief should be available. The DTC stated that the secondary adjustment is seen as more of a penalty than an actual dividend, and therefore to provide treaty relief would defeat the intention of the legislation. The DTC stated that this transfer of economic value results in depletion in the asset base of the South African taxpayer and a resultant potential loss of future taxable income for the Fiscus. Therefore, it is suggested that transfer pricing adjustments are economically similar to outbound payments of dividends to foreign related parties since they represent a distribution of value from a South African to the foreign company.\(^{61}\)

Therefore the secondary adjustment mechanism should result in a tax equivalent to the proposed 15% withholding tax. It would be a tax levied on the South African company rather than on the foreign related party, and therefore no tax treaty relief would be available.\(^{62}\)


\(^{62}\)Ibid.
5.5 Conclusion

One of the research objectives is to determine whether there were any changes that have been made to the South African tax legislation, since the publishing of the BEPS Action Plan in July 2013, in order to bring the South African tax legislation in line with the OECD view.

The significant changes that were made to the Act, were the inclusion of section 23M Section 23M of the Act effectively limits the deduction for interest paid between connected persons where the interest is not taxed in the hands of the recipient, the section however is only effective from 1 January, 2016 and is applicable in respect of amounts of interest incurred on or after that date. The section will reduce the shifting of profits to low tax jurisdictions where little or no taxes are paid on interest.

The issue or confusion created with the inclusion of the new section is that these new rules and the thin capitalisation rules appear to stand separate. The further difficulty arising as a result of the new section is to understand the hierarchy of how the sections will correlate. Even though the limitation of interest deductions in terms of section 23M could have the same effect as a thin capitalisation adjustment, the interaction between section 23M and the thin capitalisation rules within section 31 is not clear.

The secondary adjustment in section 31 of the Act was slightly changed with effect from 1 January 2015. This change however does not necessarily align the South African tax legislation with the requirements of BEPS or the OECD transfer pricing guidelines. In effect, the change to section 31 of the Act allows the secondary adjustment to be that of a deemed dividend or a donation, based on certain requirements. This change does however present certain interpretation issues, such as whether the secondary adjustment resulting in a deemed dividend may be subject to tax treaty relief.
Chapter 6 Risks of non-compliance

6.1 Introduction

If a taxpayer has not maintained appropriate records, the process of checking compliance with the arm’s length principle becomes far more difficult and the Commissioner’s officials are forced to rely on less documentary evidence in applying a transfer pricing method, thus requiring a greater degree of judgment by the Commissioner’s officials.

If a taxpayer elects not to prepare transfer pricing documentation, it leaves itself exposed on two counts. Firstly, it is more likely that the Commissioner will examine a taxpayer’s transfer pricing in detail if the taxpayer has not prepared proper documentation. Secondly, if the Commissioner, as a result of this examination, substitutes an alternative arm’s length amount for the one adopted by the taxpayer, the lack of adequate documentation will make it difficult for the taxpayer to rebut that substitution, either directly to the Commissioner or in the Courts.

6.2 Risks of non-compliance

It is submitted that taxpayers in general are trying to fly under SARS’s radar and avoid the compilation of transfer pricing documentation. It is further submitted that some transfer pricing risks are as follows:

- No transfer pricing documentation to demonstrate arm’s length pricing;
- Incorrect or outdated transfer pricing documentation and policies;
- Taxpayer does not ensure that arm’s length pricing is correctly implemented;
- No or insufficient transfer pricing agreements;
- South African transfer pricing documentation does not tie up with group documentation;
- Profit margins achieved by local company differ from group;
- Consistent losses incurred as a result of transfer pricing;
• Income tax adjustment to reflect arm’s length price, also referred to as a primary adjustment;
• Secondary adjustment (e.g. deemed dividend discussed in chapter 5);
• Penalties up to 200% of the adjustments where SARS is of the view that it’s a repeat case and as a result of tax evasion;
• Interest;
• Open to further investigations by tax authorities; and
• Negative publicity or reputational risk.

Example:

The German holding company charges R25 million service costs to a South African company. Assume that the German company overcharges the South African company by 10%, and assume all requirements in terms of section 31 of the Act are met. The penalties and additional taxes are illustrated in the table below:

<table>
<thead>
<tr>
<th>Description</th>
<th>Calculation</th>
<th>Tax effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Primary transfer pricing adjustment</td>
<td>R2 500 000 x 28% = R700 000</td>
<td>R700 000</td>
</tr>
<tr>
<td>Secondary transfer pricing adjustment i.e. Deemed dividend</td>
<td>R2 500 000 x 15% = R375 000</td>
<td>R375 000</td>
</tr>
<tr>
<td>Penalties</td>
<td>Between 5% - 200%. On the presumption that this is a standard case(^63), it will be 25% Primary adjustment: R700 000 x 25% = R175 000 Secondary adjustment: R375 000 x 25%</td>
<td>R175 000   R93 750</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>R1 343 750</strong></td>
<td><strong>R1 343 750</strong></td>
</tr>
</tbody>
</table>

\(^63\) Assumed that SARS levied an understatement penalty per section 223 of the TAA. SARS deemed the adjustment to be a standard case where reasonable care was not taken in completing the taxpayer’s annual income tax return.
Therefore as a result of the 10% overcharge on its service costs, the South African MNE is subject to additional taxes and penalties of R1 343 750.

6.3 Conclusion

The taxes due as a result of non-compliance may not be an issue for a MNE, as they may have excess cash to pay transfer pricing adjustments, penalties and interest. However, as a result of non-compliance a MNE is subject to reputational risk and public perception. The public perception is influenced by what is reported in the media. Even though in certain instances the MNE may avoid tax, which in effect is not illegal, the public perception may as well deem it to be illegal as the public may have the perception that the MNE is not paying its fair share of taxes. Therefore, the reputation impact has a lasting effect and cannot be fixed by merely making a payment to the tax authorities. In the 2013 year Google, Starbucks and Amazon were under fire for avoiding tax and as a result the public boycotted the brands, indicating that they are tired of companies that are not paying their fair share of taxes.  

In the article “Google brand damaged by tax row” by Christopher Williams, he states that “Google’s reputation in Britain has taken a heavy blow as a result of criticism over its avoidance of taxes, a major survey of consumer attitudes suggests. The search engine has tumbled over the last year in rankings of brands compiled from a survey of 12,000 consumers by Clear, M&C Saatchi’s branding agency. Google was named the fifth-most-desirable brand by Britons in the same survey in 2012, but new figures due to be published next week reveal it has fallen out of the top 20.”

Where an MNE has damaged its brand, it may take years to correct and re-build customer loyalty. In the article “Transfer pricing and Managing your reputational risk” it is stated that to manage reputational risk, it is critical to seek the assistance of a trusted advisor

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with the ability to help drive the success of your business in the international market. The trusted advisor should have the taxpayer's reputation and best interests in mind when it comes to advising on international tax and transfer pricing matters.
Chapter 7 Conclusion

7.1 Introduction

The purpose of the treatise was to critically analyse the transfer pricing legislation in South Africa in light of the recent global discussions regarding BEPS specifically aiming at transfer pricing documentation and value creation with reference to intangibles.

7.2 Documentation

The final Action 13 report and the new Chapter VI of the OECD transfer pricing guidelines describe a three-tiered standardized approach for transfer pricing documentation. This standard consists of:

- a master file containing standardized information relevant for all group members,
- local files referring specifically to transactions of the local taxpayer and
- a country-by-country report containing information on the global allocation of the group's income and taxes paid as well as other group data.

The guidance in PN7 provides a great deal of similarity to that of the local file and master file that is required by the OECD, therefore significant changes to the tax legislation are not expected in this regard.

The South African tax legislation does not have any requirements for country-by-country reporting. South African transfer pricing experts were anticipating significant changes in respect of the country-by-country reporting to be brought into tax legislation in the 2015 year. The OECD only issued its final report on the 5 October 2015 on transfer pricing documentation and updated transfer pricing guidelines. As a result it is expected that South African legislation to bring in these OECD guidelines will only be amended in the 2016 year.
Many tax authorities are asking for transfer pricing documentation to be submitted alongside tax returns. Transfer pricing documentation will become part of the annual tax compliance cycle, therefore initial planning is imperative and will assist the taxpayer to ensure that compliance deadlines are not missed.

The following countries have announced the implementation of the country-by-country reporting:

- United States;
- United Kingdom (UK);
- Australia;
- Spain; and
- Poland.

Canada has proposed rules for country-by-country reporting and has reaffirmed its commitment to the BEPS project.

Even though there are no specific requirements for transfer pricing documentation in the South African tax legislation, taxpayers are urged to start planning for the initial preparation of the master file, report and local files to be done simultaneously with the country-by-country report in order to ensure consistency of the data provided. Furthermore, taxpayers will be required to defend their transfer pricing policies in light of the new documentary requirements.

Due to the fact that the country-by-country report will be shared with all the tax jurisdictions in which an MNE has subsidiaries and with which it transacts, the South Africa revenue service may be in the possession of crucial and confidential information. Therefore, if a company is part of a United Kingdom MNE group and it transacts with the UK company, the UK company will be required to complete and submit its country-

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68 Ibid.
by-country report to the UK tax authorities who in turn will pass it on to the South African tax authority.

The intention of sending on the information to the South African tax authority is not so that the tax authority may audit the South African company based on the information contained in the country-by-country report. It is to provide the South African authority with a basis to determine the risk profile of the South African entity.

In all honesty, will SARS only use it as a risk assessment? How can a taxpayer be assured that the tax authorities will not abuse the information provided to them? It is submitted that to ensure that they do not abuse the country-by-country report for their own benefit, the UK tax authority, in this case, must be strict and indicate that should the other tax authorities abuse the country-by-country report, they will no longer supply it to them. The UK company may even indicate that they will not comply with the regulation should the report be abused by the other authorities.

7.3 Intangibles

The new chapter VI of the Transfer Pricing guidelines developed rules to prevent BEPS by moving intangibles among group members. In order to achieve this, the new chapter adopted a broad and clearly delineated definition of intangibles; ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with value creation; developing transfer pricing rules or special measures for transfers of hard to value intangibles; and updated the guidance on cost contribution arrangements.

The guidance focusses on who controls the intangible and who assumes the risks associated to the intangible, not necessarily the legal owner of the intangible. However a company may contractually own the asset but may not be able to exercise the control over that risk nor has the financial capacity to assume the risk. In that case the guidance in the revised chapter determines that the risk will be allocated to another member of the
MNE group that does exercise such control and has the financial capacity to assume the risk. The control requirement is used in this chapter to determine which parties assume risks in relation to intangibles, but also for assessing which member of the MNE group in fact controls the performance of outsourced functions in relation to the development, enhancement, maintenance, protection and exploitation of the intangible.

Section 23I of the Act, the anti-avoidance section, in broad terms seeks to disallow as a deduction any expenditure incurred for the use of certain intellectual property, where the intellectual property was previously owned by a South African entity and transferred to a non-South African entity or was developed in South Africa.

The punitive tax consequences in section 23I of the Act does provide a very good platform to prevent instances of BEPS using intangibles. However, perhaps SARS needs to look into adapting the broad and clearly delineated definition of intangibles, since there is no definition in the Act, or perhaps align the definition of intellectual property in section 23I of the Act to the broad definition of intangibles per the new chapter. This will ensure that the company actually controlling the intangible, not only contractually but financially, will assume the risk that is associated to the intangible.

7.4 Overall

Chapter 1 introduced the treatise and set out the objective and aims thereof. In chapter 2 transfer pricing was explained with specific reference to the arm’s length principle and the transfer pricing methods that are acceptable to SARS was discussed and it was shown that South Africa only partly complies with the OECD model guidelines as the South African tax legislation does not specifically provide guidance to the arm’s length principal and the transfer pricing methods, however, PN7 (bear in mind this in not legislation) provides guidance to the acceptability of certain transfer pricing methods by SARS. It also provides guidance to the arm’s length principal.
Chapter 3 discussed the OECD guidelines on transfer pricing documentation, it further gave an overview of the DTC commentary regarding Action 13. Once again, the South African tax legislation provides no guidance as to the requirements of transfer pricing documentation. However, the guidance in PN7 provides a lot of similarity to that of the local file and master file that is required by the OECD. However the South African legislation does not have any requirements for country-by-country reporting. South Africa has not made any changes to its tax legislation in light of the OECD report of transfer pricing documentation.

Chapter 4 discusses value creation in respect of intangibles, risks and capital, and risk transactions and therefore gives an overview of the DTC commentary regarding Action 8 and to determine whether the current tax legislation is in terms of the updated OECD guideline. It was discussed that in part the South African tax legislation is in line with the OECD Transfer pricing guidelines in the sense that it response to BEPS. The strict exchange control restrictions and the anti-avoidance section, section 23I of the Act, with its punitive tax consequences for the payments of royalties by South African taxpayers which previously used to own the relevant intellectual property, prevents the easy transfer of intangibles among MNEs group members. However, the possible change that can be made to the legislation to ensure that it is fully in line with the OECD Transfer Pricing Guidelines and the BEPS Action Plan, perhaps is that SARS needs to look into adapting the broad and clearly delineated definition of intangibles, seeing that there is no definition in the Act or perhaps align the definition of intellectual property in section 23I of the Act to the broad definition of intangibles per the new chapter.

Chapter 5 gave overview of section 31 of the Act on and after 1 January 2015. The significant changes that were made to the Act, were the inclusion of section 23M of the Act. Section 23M of the Act Act effectively limits the deduction for interest paid between connected persons where the interest is not taxed in the hands of the recipient, the section however is only effective from 1 January, 2016 and is applicable in respect of amounts of interest incurred on or after that date. The section will reduce the shifting
of profits to low tax jurisdictions where little or no taxes are paid on interest. The issue or confusion created with the inclusion of the new section is that these new rules and the thin capitalisation rules appear to stand separate. The further difficulty arising as a result of the new section is to understand the hierarchy of how the sections will correlate. Even though the limitation of interest deductions in terms of section 23M could have the same effect as a thin capitalisation adjustment, the interaction between section 23M and the thin capitalisation rules within section 31 is not clear.

Chapter 6 discussed the risks of non-compliance, both financially and the impact to an MNE’s reputation.
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