UNITED NATIONS PRACTICAL MANUAL ON TRANSFER PRICING FOR DEVELOPING COUNTRIES

D.5. SOUTH AFRICA - COUNTRY PERSPECTIVE

D.5.1. Introduction

Over the last few years transfer pricing has been and still is a strategic focus area for the South African Revenue Service (SARS) forming an integral part of SARS's Compliance Programme. International developments around the transfer pricing practices of large multinationals that have been made public together with the G20/OECD BEPS Project have resulted in transfer pricing having a heightened focus not only for SARS and South Africa's National Treasury but also at the highest levels of government. Labour unrest in the extractive sector saw NGOs and civil society, together with some political parties, attributing the inability of corporates to pay fair wages to be the direct result of transfer mispricing and profit shifting.

D.5.2. South African Transfer Pricing Law

By way of background, South Africa's transfer pricing legislation (set out in section 31 of Income Tax Act 58 of 1962) came into effect on 1 July 1995 followed by Practice Note 2 (published on 14 May 1996) and Practice Note 7 (published on 6 August 1999) which served to provide taxpayers with guidance on how SARS interpreted the legislation. Practice Note 2 covered thin capitalisation whilst Practice Note 7 dealt with transfer pricing. With effect from 1 April 2012 several legislative amendments to the transfer pricing rules became effective. However, the fundamental principle underpinning the South African transfer pricing legislation, since inception, has been the arm's length principle as set out in Article 9 of both the United Nations Model Double Taxation Convention between Developed and Developing Countries and the OECD Model Tax Convention on Income and on Capital, as well as the UN Practical Manual on Transfer Pricing for Developing Countries and the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Transfer Pricing Guidelines). It is the stated intention of SARS to review Practice Note 2 and Practice Note 7 to take into account the legislative amendments mentioned above.

Given the strategic importance of transfer pricing to SARS, there has been significant progress in refining and improving the administration of transfer pricing and the application of the arm's length principle. Whilst resourcing and skills challenges remain, active measures are being taken by SARS to build capacity in the transfer pricing unit.

This country experience's is not an affirmation of SARS' approach to all transactions as this remains circumstance and fact specific.

D.5.3. Recent Transfer Pricing Developments in South Africa

D.5.3.1. The Davis Tax Committee

South Africa's Minister of Finance announced in February 2013, that the government would initiate a tax review to assess South Africa's tax policy framework and its role in supporting the objectives of inclusive growth, employment, development and fiscal sustainability. A nine member committee known as the "Davis Tax Committee" (DTC) was inaugurated and the Committee's Terms of Reference were announced in July 2015.

In September 2013 the G20/OECD BEPS Project was launched with South Africa participating as an equal partner. As a result, the DTC set up a BEPS Sub-Committee to address its concerns around base erosion and profit shifting and formulate the DTC's position in this regard. The DTC consulted with various stakeholders from business representatives, trade unions, civil society organisations, tax practitioners, SARS, National Treasury, the South African Reserve Bank, members of international bodies and academics, in releasing its "BEPS First Interim Report" for public comment by 31 March 2015.

In this release, the DTC made recommendations for South Africa regarding transfer pricing in general and recommendations in relation to Actions 8 and 13 of the G20/OECD BEPS Project around intangibles and documentation.

a) General Recommendations

The general recommendations included the following:

- formal adoption of the OECD Transfer Pricing Guidelines through a Binding General Ruling, as provided for in section 89 of the Tax Administration Act of 2011;
- the suggested Binding General Ruling should include a set of principles reflecting the South African reality;
- SARS must increase its enforcement capability within the transfer pricing unit; and
- SARS must ensure that there is sufficient transfer pricing training and capacity building in its transfer pricing unit.

b) Action 8 – Intangibles

With regards to intangibles the recommendations of the DTC focussed on:

- the transfer pricing implications associated with foreign owned intellectual property (IP) which is licensed to South African related parties, and;
- the transfer pricing implications associated with South African owned IP which is made available to foreign related parties.

The DTC acknowledged the role of the South African Exchange Control (governing sales and transfers of South African owned and developed IP and outbound royalty payments), the Department of Trade and Industry (which regulates royalty rates for IP associated with a process of manufacture) and the South African Reserve Bank (governing all other royalty payments). The DTC also analysed situations involving IP that, despite governance, controls and specific anti-avoidance regulations, could nonetheless, lead to base erosion and profit shifting through business restructurings, treaties and artificial creation of substance. Against this backdrop the DTC made the following observations/recommendations:

- No immediate need for South Africa to enact legislation to prevent transfer pricing of intangibles since the current exchange controls restrict the outbound movement of intangibles and royalty payments;
- That careful consideration should be given in the event of any future developments or relaxation of the exchange control rules for IP. The DTC suggested that any policy development in this area should be informed by tax and specifically the transfer pricing considerations;

- Given that South African developed IP cannot be readily exported without the necessary regulatory approvals, the DTC recommended that:

  - The South African CFC rules exclude intangibles from the CFC exemption benefits;
  - The transfer pricing rules or even the general anti-avoidance provisions of the Income Tax Act be applied to challenge the limited remuneration of a South African entity involved in the IP development process;
  - Use should be made of section 23I of the Income Tax Act (an anti-avoidance provision) which prohibits the claiming of an income tax deduction in respect of "tainted IP".
  - The "beneficial ownership" in terms of the royalty article 12 of DTAs can also be applied to deny the reduced withholding tax treaty rate if the recipient lacks substance.

Overall, whilst the DTC remained concerned regarding tax structuring around IP and its potential for base erosion and profit shifting, the DTC also included some cautionary language that:

"Care should be taken, when developing tax legislation on transferring of intangibles, to ensure that the legislation is not so restrictive that it limits South Africa's ambitions to be a global player in the development of IP".

c) Action 13 – Documentation

The DTC made the following recommendations:

- SARS should prioritise updating Practice Note 7 in line with the OECD transfer pricing documentation guidelines and provide taxpayers with much more specific guidance on what information is actually required;
- preparation of a local file, a master file and country by country (CbC) reporting should be a compulsory requirement for South African groups with turnover in excess of R1 billion;
- a strengthening of the confidentiality provisions of the Tax Administration Act;
- SARS must balance requests for documentation against the expected cost and compliance burden to the taxpayer of creating it;
- SARS should clarify its expectations with respect to the timing of preparation and filing of the master file, local file and CbC Report;
- it is not necessary for SARS to provide additional requirements with respect to the general retention of documents except to the extent that it is considered necessary to have rules which are specific to transfer pricing documentation;
- SARS should implement the OECD's recommendation that the master file, the local file and the country-by-country report should be reviewed and updated annually and that database searches for comparables be updated every 3 years;
- SARS should consider an incentive programme to encourage compliance with transfer pricing documentation requirements;
- SARS should build a database of comparable information;
- SARS should 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;
- SARS should improve the corporate income tax return;
- 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.

In conclusion, after review and evaluation, SARS has implemented certain of the DTC recommendations relating to documentation, tax returns and building capacity in the transfer pricing division.

D.5.4. The G20/OECD BEPS Project

South Africa is not a member of the OECD but has the status of being a participant in the Committee on Fiscal Affairs. However, as part of the G20/OECD BEPS Project, South Africa was an associate on equal footing alongside OECD countries.

For South Africa, the BEPS Project was a welcome initiative and created a platform for many developing countries to bring to the fore their challenges with the positive prospect of solutions. The BEPS Project raised areas of improvement for South Africa, especially that of asymmetry of information, resulting in legislative and administrative changes.

D.5.5. Legislative and Administrative Amendments and Proposals

The following significant changes have been made to the Tax Administration Act, 2011, in South Africa. At a glance these relate to:

a) Filing of CbC reports;
b) Access to information;
c) Extension of the statute of limitations to audit certain classes of BEPS related transactions, including transfer pricing; and
d) Expanding the corporate tax return to improve and increase disclosure requirements of transfer pricing and other BEPS related transactions.

D.5.5.1. Country-by-Country Reporting

Following final outcomes contained in the OECD CbC report, South Africa remains committed to adhere to the agreed framework of the CbC report. Legislation has been passed to ensure the filing and sharing of CbC reports.

1D.5.5.2. Access to Information

One of the key challenges in any transfer pricing analysis is access to information. This is a widespread problem not unique to South Africa and indeed was also acknowledged in the BEPS project. Over the past two years SARS has been challenged on a number of fronts regarding its information requests including, *inter alia*:

- SARS's right to certain categories of information. Taxpayers have argued for the non-submission of information on the basis that such information is commercially sensitive, irrelevant and out of scope, not accessible, or legally privileged;
- Taxpayers requesting numerous extensions of time within which to comply with a SARS information request to the point that the statute of limitation runs out for SARS or that it becomes almost impossible for SARS to review such information before the statute of limitations runs out; and
- Taxpayers have challenged SARS's powers to interview persons and personnel that may have information relevant to the transaction under audit.

To address these challenges, the following legislative amendments have been effected to the Tax Administration Act:

a) The overarching provisions of section 46 clarify the information gathering powers of SARS to be that SARS can request information that is relevant or foreseeably relevant. There is no onus on SARS to explain or justify information requests. However, it was acknowledged that legal professional privilege was an exceptional situation. For this reason section 42A was introduced clarifying the ***requirements*** to be met by taxpayers failing to submit relevant information to SARS on the basis of legal professional privilege and the ***process*** to be followed to resolve the issue;

b) Amendment to section 46 with respect to access to foreign based information and to ensure that where a matter progresses to dispute resolution taxpayers are held to any assertions that they were unable to access information located offshore. Where a taxpayer makes such an assertion, the taxpayer may, under certain circumstances, be prohibited from submitting such information at a later stage;

c) Amendment to section 47 clarifying persons who may be interviewed or called upon to provide information on a taxpayer/company/entity under

audit. Important to this amendment is the existing requirement in terms of section 49 of the TAA, that allows SARS to request such persons to be interviewed under oath or solemn declaration; and

d) A record keeping notice in terms of section 29 of the Tax Administration Act was issued on [?? October 2016[1] - *to be updated when final notice is published*], requiring specified persons to keep and retain the records, books of account or documents prescribed in the schedule to the notice. That public notice sets out additional record-keeping requirements for transfer pricing transactions.

D.5.5.3. Extension of Prescription

Previously there was a general 3 year statute of limitation for assessments by SARS to execute and conclude any audit, including audits relating to transfer pricing. In response to taxpayers requiring continuous extensions of time that impinge on the statute of limitation period together with the recognition of the need for taxpayers to have sufficient time to collate information, amendments to section 99 of the TAA were made extending the prescription period by the period of delay by the taxpayer in responding to a request for information by SARS, and a further 3 years where an audit or investigation relate to transfer pricing, the application of substance over form, the general anti-avoidance rule or the taxation of hybrid entities or hybrid instruments.

D.5.6. Comparability

The main challenge that South Africa has in determining arm's length profits has to be the lack of domestic comparables. It is thus accepted that the *most reliable* comparables will suffice. The problem in South Africa is that this compromise is extended even further given that there are no databases containing South African specific or for that matter, Africa specific, comparable data. As a result, both the tax administration and taxpayers rely on European databases to establish arm's length levels of profitability.

[1] http://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-49%20-%20Draft%20Notice%20in%20terms%20of%20section%2029%20of%20Tax%20Administration%20Act%20Second%20Round.pdf

The obvious problem this gives rise to has no simple or definitive solution. Instituting comparability adjustments to account for geographical differences (for example, market, economic and political differences) in order to improve the degree of reliability of the comparable data, is often extremely complex and can in some instances have the reverse effect, i.e. where the comparable data is no longer comparable.

In practice, SARS has attempted to make comparability adjustments, for example country risk adjustments based on publicly available country risk ratings and government bond rates (sometimes referred to as the risk free rate). However, these have been applied with caution and in specific circumstances.

Whilst South Africa may be worse off than some countries for not having any domestic comparable data, many other countries are likely to be in a similar position. As multinationals become more and more complex in their business models and as more widespread industry consolidation is achieved, finding comparable data and achieving reliability may not be South Africa's problem alone. It is perhaps already true that for certain types of large scale manufacturing and distribution activities, for example, in the automotive industry there is no independent comparable data available anywhere.

It is for this reason, amongst others, that SARS favours a more holistic approach to establishing whether or not the arm's length principle has been complied with. By seeking to understand the business model of taxpayers across the whole value chain, gaining an in-depth understanding of the commercial sensibilities and rationalities governing intra-group transactions and agreements it is evident that SARS does not look to comparable data alone or in isolation from other relevant economic factors in determining whether or not the appropriate or arm's length level of profit has been achieved.

An important development in the BEPS Project was the undertaking by the OECD to develop toolkits for developing countries. One of them relates to further work to be done in the area of comparability. SARS is working with the OECD work groups in this regard in the hope that meaningful solutions may be found. In the interim SARS continues to work with service providers of comparable databases to develop possible solutions to address the challenge

D.5.7. Services

As a result of an increase in globalisation, in order to achieve economies of scale and optimise efficiencies, it is becoming commonplace for multinationals to centralise the provision of certain services in a single entity, generally in a tax favourable jurisdiction.

The challenge in establishing whether or not payment for a service is arm's length goes further than the two step approach set out in Chapter 7 of the OECD Guidelines. Whilst Chapter 7 was covered in the BEPS Project, it has largely remained the same with the exception of the introduction of a simplification measure relating to low value adding services. Overall, there were no significant developments to address the BEPS challenge that service payments present for developing countries.

South Africa has consistently stated that it will not be applying the simplified approach to low value adding services, as outlined in the final BEPS report.

In essence, Chapter 7 continues with the approach that in establishing the arm's length nature of intra-group services, the test is twofold. Firstly, it must be determined if a service has been rendered and secondly it must be determined if the charge for such service is arm's length (paragraph 7.5 of the OECD Transfer Pricing Guidelines). As relates to the first part of the test, the approach followed is to determine if the services:

- Provide the recipient with economic and commercial benefit (now called the "Benefits Test" in the revision to Chapter 7);
- Are not services that the recipient is already performing for itself (duplicate service test); and
- Are not shareholder services.

As regards the second part of the test, the audit approach seeks to confirm the following:

- That the cost base is appropriate to the services provided;
- That the mark-up is arm's length; and
- That the allocation keys applied are commensurate to the services provided.

In particular paragraph 7.29 of the OECD Transfer Pricing Guidelines states that in determining the arm's length price for intra-group services, the matter should be

considered from the perspective of the service provider and the recipient. Relevant considerations include the value of the service to the recipient as well as the costs to the service provider.

With regard to the determination of whether or not a service has provided the recipient with economic and commercial benefit, demonstration of adherence to the arm's length principle becomes difficult. In practice this is becoming more and more subjective. The economic benefit of services cannot always be measured in actual monetary or other quantifiable terms and as such it is often becoming more the "say so" of the taxpayer rather than a matter of fact. It is often reiterated that transfer pricing is not an exact science and tax administrations are encouraged to take into account the taxpayer's commercial judgement as well as their own. This becomes difficult when that judgement has the potential to translate into a significant tax adjustment for taxpayers. A possible solution is for a tax administration to clearly set out its documentation and burden of proof requirements. However, this is likely to meet with resistance from taxpayers claiming that this places an increased compliance cost burden on them. SARS is currently taking a pragmatic but firm approach to evaluating payments for intra-group services and where clear commercial justification or reasonableness for those payments is lacking, the payments are disallowed.

1. D.5.8. Contract Risk Shifting - Year-End Adjustments

There appears to be an increasing tendency for parent companies of South African subsidiaries to shift profits via a year-end adjustment to either the cost of goods imported by the South African subsidiary or directly to the operating margin, to bring the South African subsidiary in line with "comparable companies". What occurs is usually a global policy change by the parent company aimed at limiting the return of its subsidiaries (including those based in South Africa) to a guaranteed return (determined by way of a comparable search). The change in policy is often followed by an introduction of year-end transfer pricing adjustments to ensure that South African entities achieve the often low targeted net margin while the residual profit is returned to the parent or holding company.

There is little or no regard for the drivers of higher profits attained in South Africa when comparing them to comparable companies in foreign markets (given there are no local comparables for South Africa) or consideration for the actual functional and risk profile of the South African subsidiary. South African subsidiaries of multinational companies

are frequently classified as limited risk distributors or limited risk manufacturers when in actual fact they assume much more than just limited risk. Furthermore, there are many instances where unique dynamics exist within the South African market that enable South African subsidiaries to realise higher profits than their related party counterparts in other parts of the world or than is evidenced by comparable data obtained from foreign databases. For instance, the South African pharmaceutical and manufacturing industries are still unsaturated and offer ample opportunities for multinational companies to increase their profits. The increased participation and spending power of the middle class segment in the economy also offers a new market opportunity for certain industries.

Building on the practice followed in India and China, SARS is currently considering its approach to location savings, location specific advantages and market premiums within certain industries and those factors will be addressed when conducting audits.

D.5.9. Intangibles

As intangibles are "unique" in nature they raise unique transfer pricing challenges for both multinationals and tax administrations. Disputes which arise in South Africa relate to the existence of local marketing intangibles, issues of economic versus legal ownership and the valuation of intangibles. The revised guidance in Chapter 6 of the OECD Transfer Pricing Guidelines as a result of the BEPS Project was welcome and provides helpful guidance for developing countries.

In the South African experience, the sale of South African developed intangibles presents a somewhat exceptional situation compared to the rest of the world, as exchange control regulations prohibit the relicensing of that intangible property back into South Africa. Once the intangible property is sold to an offshore related party, usually in a low tax jurisdiction, the related party becomes the legal owner of the intangible property. This related party then licences out the intangible property worldwide (excluding South Africa) earning royalties. In addition, terms and conditions of the original sale may dictate that the South African entity will continue to perform certain functions toward the enhancement and further development of the intangible property for which it earns a cost plus return. The related party, that is now the legal owner, in essence merely carries out activities relating to registration and maintenance of the intangible property and earns an intangible related return (in the form of

royalties). Furthermore, if such intangible property were ever sold outside of the group, the South African entity would have no participation in any profits that may be realised.

In this regard the SARS will be applying the guidance arising from Action 8 of the BEPS Project.

D.5.10. Safe harbours and Advance Pricing Agreements (APAs)

In SARS the view is held that the use of safe harbours and APAs should be considered with caution. For developing countries the introduction of safe harbours is perhaps best considered when the tax authorities have established a high degree of understanding of certain transaction types with low risk. Most often, the benefits of safe harbours are considered to include ease of audit administration, without due consideration to the resultant quantum of the possible tax leakage that can arise from the application of safe harbours. For this reason, it is important that countries give careful consideration to what they will be sanctioning when introducing safe harbours.

With respect to an APA program, despite its obvious benefits such as co-operative compliance and resolution, there are also significant pitfalls. For any tax regime considering an APA regime there must be a balance between providing certainty to taxpayers and ensuring effective administration and tax collection by the tax administration. An important consideration in the light of scarcity of resources is whether to build audit or APA capacity. For developing countries with fledgling transfer pricing regimes, there need to be safeguards against offering APAs without having developed key knowledge of how transfer mispricing occurs in certain industries, transaction types or countries. Given that practically an APA consideration is similar to an audit approach, it stands to reason that a country with little audit capability should not be entering into APAs.

The key message is that whilst safe harbours and APAs have their respective benefits, they should be equally beneficial for the tax administration and taxpayers.

D.5.11. Conclusion

The arm’s length principle presents several challenges in terms of application. The hypothesis required to approximate transactions between related parties to what would

have transpired had they been independent can be difficult and as stated, finding reliable comparables and making comparability adjustments is easier said than done.

For now there is no disagreement that the arm's length standard is the most workable solution despite some of its limitations which can be overcome. In the South African context, whilst taxpayers may seek to exploit the limitations of the arm's length principle to their advantage, SARS remains undeterred. The arm's length principle does not ignore basic principles such as the perspective of the prudent business man, commercial rationale and good business practice. It is with this understanding that SARS applies the arm's length principle.