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Africa Regional[1]

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South Africa, Republic Of[2]

Introduction

Transfer pricing legislation has been in South African law since 1995; however, it has only been in recent years that the South African Revenue Service (SARS) has focused on this area. The rules require those subject to tax in South Africa to follow arm's-length principles in their dealings with inter alia connected persons who are not tax residents of South Africa and were overhauled in 2010[3] and apply to years of assessment commencing on or after 1 October 2011. The changes were introduced to focus on profit objectives rather than isolated transactions, to align with treaty wording referring to adjustments to profits rather than adjustments to price, and to de-emphasise the SARS' concentration on the comparable uncontrolled price (CUP) method.

While exchange control regulations continue to regulate the flow of funds from South Africa, the gradual relaxation of the exchange control rules have provided greater flexibility and freedom for the movement of funds offshore. As such, the authorities are becoming more reliant on the successful monitoring of transfer pricing rules. We have seen increased activity by the specialist Transfer Pricing unit within the SARS, with growing focus on industry sectors, notably automotive, pharmaceutical, and retail.

The years open to question by the SARS depend on whether assessments (in respect of the years in which the relevant transactions took place) have prescribed[4] (generally speaking, assessments prescribe three years after the date of assessment) and whether the SARS can argue that non-disclosure has taken place, in which case, earlier years of assessment can be reopened. The SARS has raised assessments in respect of transfer pricing adjustments where the tax years are close to prescription, or reopened assessments for earlier years on the basis of non-disclosure. The SARS is applying current knowledge and practice with a degree of hindsight, which contradicts the Practice Note and the OECD Guidelines.

The South African government has indicated that it wants South Africa to become the "gateway" into Africa, and it is looking into incentives to make South Africa more attractive as a hub for investments into Africa. The 2010 introduction of a headquarters company regime is part of this drive. Such companies are not subject to South African transfer pricing or thin capitalisation rules for the receipt and provision of financial assistance (subject to certain requirements).

[1] Updated by David Lermer and Kate Noakes (PwC South Africa).
[2] Updated by David Lermer and Kate Noakes (PwC South Africa).
[3] New transfer pricing and thin capitalisation legislation was enacted as part of the 2010 Taxation Laws Amendment Act (the 2010 TLAA).
[4] Prescription in the South African statute of limitations.

Africa Regional

Statutory rules

Section 31 of the South African Income Tax Act 58 of 1962 (Income Tax Act) covers transfer pricing and thin capitalisation measures. Section 31(2) gives the commissioner the power to adjust the consideration of a transaction to an arm's-length price for the purposes of computing the South African taxable income of a taxpayer. This rule applies to goods and services, both terms being defined in section 31(1), as well as to direct and indirect financial assistance. Section 31 is a discretionary section, which means that while the taxpayer can place some reliance on the fact that the commissioner must have applied due care and reasonableness in raising a transfer pricing adjustment, the onus of proof for rebutting such an adjustment rests with the taxpayer.

Under the 2010 Taxation Laws Amendment Act (TLAA), taxpayers are required to determine the taxable income, if different from that reported, that would arise from arm's-length transactions. This places emphasis on self-assessment of the terms and results of the transactions with related parties and has implications for prescription and non-disclosure. It also allows the SARS to recharacterise transactions for transfer pricing purposes and apply a whole-of-entity approach.

In terms of section 64C(2)(e), the SARS may, in certain circumstances, also deem an adjusted amount to be a dividend on which Secondary Tax on Companies (STC) is payable (currently 10%). STC is payable even if the company has an assessed loss. STC is to be abolished in favour of a dividend withholding tax, known as Dividend Tax, with effect from 1 April 2012. The deemed dividend legislation is also being replaced with a new value extraction tax. An unresolved contention remains regarding the application of the current STC charge on adjustments made voluntarily by taxpayers, as in practice this acts as a disincentive for taxpayers to rectify non-arm's-length pricing. It is thought that future transfer pricing and thin capitalisation adjustments are to be excluded from value extraction tax, but this may be an omission to be corrected as the legislation is finalised.

Additional to tax on transfer pricing adjustments are interest and penalties. Section 89 covers interest on underpaid tax and Section 76l covers penalties which may be as much as 200% of the underpaid taxes.

Although the Income Tax Act contains no explicit transfer pricing documentation requirements, the SARS may (in terms of section 74 read with section 74A) require a taxpayer to furnish "information, documents or things as the commissioner may require for the administration of the Income Tax Act". In practice, the SARS may require detailed transfer pricing information to be supplied within 14 days from the date of request.

What is of interest is the requirement (introduced in 2004 and clarified in the addendum to the Practice Note) to furnish the transfer pricing documentation with the tax return if held. It is arguable that this introduces a requirement to complete documentation, although SARS maintains there is no statutory requirement to do so. What is critical is that where such documentation has been prepared, it must adequately reflect the current transfer pricing policies being implemented and be up to date. Otherwise, erroneous, out-of-date or incorrect documentation could and has been argued to represent incomplete disclosure, resulting in prescription not applying to those years. This represents a significant risk to taxpayers who could remain open to a transfer pricing review from the SARS for indefinite periods back to 1995. The SARS have started to enter into agreements with taxpayers to extend the period within which an assessment prescribes — if agreed to by the taxpayer, this effectively provides the SARS additional time to raise queries or assessments.

The income-tax return requires a taxpayer to indicate whether it has cross-border transactions with connected persons and whether the taxpayer has prepared transfer pricing documentation. Specifically, the 2010 corporate income-tax return form requires taxpayers to answer yes or no to the following questions:

- Does the company have a transfer pricing policy document in support of the transfer pricing applied in the current year in relation to the transactions as defined in section 31?, and
- Has the company provided goods and services[5] or anything of value (including transactions on capital account) to a non-resident party?

To answer these questions accurately and prevent non-disclosure issues, some form of documentation or transfer pricing study needs to be undertaken.

In terms of current SARS' practice (specifically in the event that a taxpayer makes use of SARS e-filing), the system does not allow for the submission of transfer pricing documentation with the corporate income-tax return, rather it must be available upon request from the SARS. Uncertainty exists as to how this impacts taxpayers' obligations to provide full disclosure to the SARS. Generally speaking, in the event that there is non-disclosure in a taxpayer's income-tax return, the assessment in respect of the specific year does not prescribe. Furthermore, bearing in mind the focused questionnaires that the SARS sends to taxpayers, it is not necessarily advisable to submit transfer pricing documentation when the tax return is filed. Given the current uncertainty as to whether a taxpayer must submit transfer pricing documentation and the possible impact of non-disclosure, taxpayers are advised to keep abreast of developments and seek advice before deciding not to prepare contemporaneous documentation or file supporting documentation.

In the event that transfer pricing documentation is available and a taxpayer does not submit it on request from SARS, failure to submit the documentation could arguably lead to prosecution under section 75 of the Income Tax Act.

Section 31(3) is specifically aimed at thin capitalisation and is discussed in more detail below.

South Africa does not have transfer pricing rules in respect of domestic transactions, with the exception of gross sales for Mineral and Petroleum Resources Royalty Act purposes (from 1 March 2010). Given South Africa's mining country status, this is a significant development.

Controlled foreign companies

The Income Tax Act deems any transaction undertaken between a controlled foreign company (CFC) and any connected person a transaction to which the transfer pricing provisions contained in section 31 apply. CFCs are non-resident companies in which more than 50% of the total participation or voting rights are held directly or indirectly by one or more South African residents. The result is that the Act deems the CFC party to the transaction to be a South African resident for transfer pricing purposes.

[5] Goods and services included loans.

This is increasingly becoming an area of scrutiny for SARS, as many multinationals based in South Africa do not identify the potential risk in transactions between CFCs. One of the stringent anti-diversionary rules requires that the transactions between CFCs and residents are conducted at arm's length before the specific business establishment exemption from CFC imputation can apply to these transactions.

Other regulations

The SARS issues Practice Notes that provide guidance on its interpretation and application of the Income Tax Act. Practise Notes are not law and their contents cannot be relied upon formally. They are intended to provide guidance on the SARS' views and be used by taxpayers to defend their filing positions.

Practice Note 2 was issued in May 1996 and focuses on the interaction of the thin capitalisation rules and the transfer pricing rules. Practice Note 2 relates to the provision of financial assistance given by an overseas-connected party to a South African resident, but not vice versa. The Practice Note helps taxpayers identify levels of excessive loan debt under the thin capitalisation rules, as well as excessive interest rates under the transfer pricing rules. Financial assistance and thin capitalisation is a current focus area for the SARS.

The Practice Note applies only to inbound financial assistance, and taxpayers need to be wary if relying on this in evaluating outbound financial assistance. It is our understanding that the SARS is currently in the process of preparing an updated Practice Note dealing with financial assistance and thin capitalisation — the anticipated date of release is not known.

Practice Note 7 was issued in 1999 and provides guidance on transfer pricing. It is comprehensive and follows the approaches of the Australian and New Zealand guidance.

Under accounting statement IAS 24 (AC126) (and the new IFRS requirements), companies are required to disclose all transactions with related parties. We understand that, due to amendments to IAS 24, additional related party information may need to be disclosed in future. Due to the rather wide definition of related parties, financial statements will now provide information to the SARS on cross-border transactions with connected persons. Also, the requirements under the accounting standards must be able to support any statement made in the financial statements. Consequently, if a statement is made that all related party transactions are conducted at arm's length, the auditor needs to be confident that this can be supported. In the current climate of risk averseness, this places a greater onus on auditors and, in turn, greater pressure on multinationals to ensure their transfer pricing is in order. If a general statement is made that a related party transaction takes place at arm's length and this is not in fact the case, the SARS could claim that the taxpayer made a fraudulent misrepresentation, resulting in prescription not applying to the relevant years.

The introduction of legislation regarding reportable irregularities for auditors and tax practitioners also places strain on transfer pricing compliance. Transfer pricing in South Africa is discretionary and, therefore, identifying the existence of a transfer pricing exposure and quantifying this, without undertaking extensive analysis, is problematic and raises concerns for auditors, tax practitioners and taxpayers.

The SARS has yet to release any new Practice Notes on the 2010 TLAA or to reflect the 2010 update to the OECD Guidelines. These are expected before 1 October 2011, the date on which the 2010 TLAA amendments take effect.

Legal cases

As yet, no court cases have been brought in South Africa on transfer pricing. As a result of the increased focus of the SARS, various transfer pricing assessments have been issued in which adjustments have been made. Some of these adjustments have been appealed against and are likely to be tested through the courts.

Under the South African constitution, the courts are bound to follow international precedent (i.e. foreign case law) in the event that no local precedent is available. Currently, SARS is open to entering into settlement agreements rather than going to court. This is a positive development and does not infringe on the taxpayer's right to object and appeal (if the taxpayer is not satisfied with the SARS' position).

Given the lack of court cases on transfer pricing, few advocates and judges have knowledge of transfer pricing. For this reason, taxpayers sometimes prefer to settle cases with the SARS rather than going to court, or where available under the relevant treaty, to initiate competent authority claims.

Burden of proof

Section 31 is a discretionary section; therefore, in making any transfer pricing adjustment, SARS must demonstrate that it has paid due care and attention to the issue. Notwithstanding, the burden of proof lies with the taxpayer to demonstrate that the transfer pricing policy complies with the relevant rules and that the transactions have been conducted in accordance with the arm's-length standard.

Tax audit procedures

In the 2010/11 budget speech, the South African Minister of Finance indicated that transfer pricing is one of SARS' key focus areas.

SARS follows the OECD Guidelines in conducting transfer pricing investigations and all multinationals are potential targets — inbound investors as well as South African-based groups. Companies that fall within the provisions of section 31 should take transfer pricing seriously and develop and maintain properly documented and defensible transfer pricing policies. Such documentation must be contemporaneous and regularly updated. Previously, the SARS' practice was to accept that documents can be updated only every three years, or for changes in the operations. Currently, we recommend that benchmarking for non-core services be updated at least every three years. Furthermore, on the basis that tax is viewed as an annual event, taxpayers need to ensure the documentation is reviewed annually. At a minimum, financial analysis must be completed on an annual basis given that the SARS performs its calculations annually rather than on a weighted-average basis.

The SARS also prefers the South African taxpayer to be the tested party, even though it may not be the least complex party to the transaction. The transfer pricing document must list every cross-border transaction entered into by the taxpayer, even though the transfer pricing document may not deal with a specific transaction in detail. This ensures that the taxpayer satisfies the requirement for full disclosure in its transfer pricing documentation.

The SARS is actively auditing taxpayers on their transfer pricing and has indicated that it will place greater scrutiny on multinationals that have connected-party entities situated in low-tax jurisdictions. This line of enquiry tends to combine a challenge on residence of the low-taxed foreign entity, together with questions on the transfer pricing. We have also seen the SARS issue transfer pricing questionnaires to multinationals to obtain information regarding their transfer prices. The focus of these is on comparability and characterisation of transactions.

The SARS, as in South Africa generally, is experiencing a resource issue, which means many of the audits commenced take a long time to conclude. In addition, where transactions are with African countries that do not have a transfer pricing regime, solutions through the normal channels of mutual agreement procedures (MAPs) are unlikely to be successful.

Resources available to the tax authorities

A specialist unit within SARS conducts transfer pricing audits. This unit comprises highly skilled individuals who have previously been employed by professional firms. To help train personnel in the unit, SARS has sought advice and training from Revenue specialists in the United States, the United Kingdom and Australia. Over the last year, SARS has also recruited personnel (on a secondment basis) from other tax authorities (e.g. from the United Kingdom and Australia), and cooperation between SARS and overseas tax authorities has increased. The SARS' transfer pricing representatives also regularly attend OECD conferences and training sessions.

Use and availability of comparable information

Use

The OECD Guidelines on transfer pricing are the basis for determining an acceptable transfer pricing methodology. Within the context of these guidelines, therefore, any information gained on the performance of similar companies would be acceptable in defending a transfer pricing policy.

Availability

Information on the performance of public companies in South Africa is available only in the form of published interim and annual financial statements. More detailed information on public companies and information concerning private companies is generally not available, which makes the search for comparables in South Africa difficult.

SARS has indicated that it will accept the use of financial databases used elsewhere in the world, but all comparables must be adjusted for the South African market. Our understanding is that SARS uses Amadeus to conduct comparable studies, relying largely on European companies for comparability. SARS would prefer to see emerging country comparables, to the extent these are available, and may consider the relevance of country risk adjustments.

We have seen limited evidence of the SARS relying on secret comparable information (i.e. information of competitors) it has access to when determining adjustments under audit. Although such supporting evidence could never be used in a court of law and this practice would not be confirmed publically, it places emphasis on the need for multinationals to have robust benchmarking to support related party transactions in order to rebut any proposed adjustments.

Risk transactions or industries

The SARS' audit activity focuses on industry areas. It has demonstrated its ability to research an industry and is being selective in targeting audits. We have seen increased activity in the automotive, pharmaceutical, fast-moving consumer goods and retail sectors. In addition, the SARS stated in its 2007 budget that intellectual property (IP) is a focus area. Since then a number of IP-related queries have been issued, which we expect to increase.

South African companies that have related companies situated in lower-tax jurisdictions remain at a high risk of investigation. Such investigation is often two-pronged, testing residency together with transfer pricing. The SARS has a stricter requirement for documentation and supporting evidence than many other countries. For instance, global documentation prepared by a group and rolled out throughout that group is not acceptable in South Africa without a sufficient level of localisation. The SARS' focus until the 2010 changes has been at the transactional level and it has preferred to accept analyses undertaken on a whole-of-entity basis, commonly adopted in the United States and Australia, only as a method of last resort. Further, the SARS is at odds with the OECD in some respects, notably on the use of multiple-year data. The SARS views tax as an annual event and adjustments for transfer pricing are viewed on a year-by-year basis, irrespective of the longer-term picture.

The SARS does not look favourably upon transfer pricing adjustments (i.e. year-end adjustments, targeted returns or situations where a payment is made in respect of the indirect assumption of risk by a non-resident-connected person without the corresponding transfer of or change in functions performed by the South African entity). The SARS views such adjustments as a profit-stripping mechanism and, as such, any transfer pricing adjustments raise a "red flag" for the SARS to raise queries or perform an audit. It is therefore important that appropriate legal agreements are in place to support pricing adjustments. The SARS also states that the taxpayer cannot use hindsight and that year-end transfer pricing adjustments are arguably based on hindsight. This is a question of fact, depending on the legal agreements and related obligations.

The use of entrepreneur and limited-risk models in the African continent is not straight forward, as delivery and cost-saving mechanisms are not easy to implement. The SARS is likely to focus on the functional profile of the taxpayer and whether any real risk has been moved from South Africa. Business model changes need to be implemented carefully with robust documentation of the pre- and post-factual reality of the business.

Competent authority

Little information is available on the process for competent authority claims. Experience suggests that competent authority has not been widely used in South Africa. The lack of experience coupled with potentially difficult administrations in the rest of the continent mean that reliance on MAP to resolve disputes is problematic.

However, for transactions involving countries with a well-established MAP, its use provides a valuable defence mechanism against double taxation.

Advance pricing agreements

No procedures are in place by which a taxpayer might achieve advance agreement to its transfer pricing policy, and none are expected for some time. In Practice Note 7, the SARS specifically states that it is not in favour of adopting advance pricing agreements

(APAs). Although it is understood that this initial view is starting to change at SARS, there are few available resources and therefore the introduction of an APA process in South Africa is likely to be some way off. SARS will not be bound by unilateral APAs that a taxpayer's connected parties may have agreed with other tax authorities.

Anticipated developments in law and practice

Law

The current requirements regarding the filing of transfer pricing documentation are not clear. Taxpayers are advised to submit the information requested in the brochure to the income-tax return form. If this cannot be done via e-filing, taxpayers are advised to make a separate manual submission to the SARS.

Practice Notes 2 and 7 are being updated and should be issued later in 2011.

Practice

The SARS has continued its drive to implement the transfer pricing legislation, and all multinational companies remain the focus of the authorities' attention. The SARS is not restricting its focus to larger groups, but is taking a much wider view. For this reason, it is important for multinational companies to formulate and document transfer pricing policies in line with OECD Guidelines and the Practice Notes as soon as possible.

In the 2007 budget, the SARS acknowledged the potential economic value locked in intellectual property and the tendency of multinationals to shift this value offshore. In response, the SARS intends to impose measures to correct this. While South Africa is not a member of the OECD, it is an enhanced engagement country. SARS plays an active role at the OECD and has been involved significantly with the new releases on the attribution of profits to permanent establishments and conversion matters. The transfer pricing rules do not capture transactions between a branch and its head office, but the SARS focuses on this area and using transfer pricing principles to review such transactions.

It is anticipated that guarantee fees may become a focus area for the SARS.

Liaison with other authorities

Although customs and income tax authorities are under the same authoritative body, and generally speaking, no information is shared between the two authorities, there is clear evidence of more cooperation between the two tax departments, particularly in terms of the SARS' "integrated audit", which seeks to apply a more holistic approach to tax compliance. Recent questionnaires circulated by the customs authorities include specific questions regarding transfer pricing. As a general point, the SARS is improving its systems, and better cooperation between the various authorities is expected in the near future.

We have observed increased cooperation between the SARS and the Reserve Bank. A South African resident needs Reserve Bank approval to remit funds from South Africa. The extent of the approval and vigilance of the banks depends on the nature of the payments. Cross-border payments to connected parties will first be reviewed and cleared by the Reserve Bank. There is a marked increase in Reserve Bank requests to review applicants' transfer pricing documentation in support of such transactions before approval is granted. In this regard, the SARS has provided a "working handbook" to the Reserve Bank to assist it with transfer-pricing-related matters.

The Reserve Bank has also set up a working committee (PwC is represented on this committee) to discuss transfer-pricing-related matters in the exchange control context. The Reserve Bank follows a more commercial approach when approving payments. Where approval is required, it is given on a case-by-case basis.

Payment for the use of intellectual property and inbound services has always been a focus, and the Reserve Bank now requests a transfer pricing review by the auditors to ensure any payments are in accordance with the arm's-length principle. In recent years, two notable changes have been introduced: (1) the requirement to demonstrate a benefit not only to the recipient of an inbound service, but also to South Africa as a whole; and (2) a recent move to ensure that inbound as well as outbound licence fees for intellectual property are arm's length.

It is important that exchange controls are considered together with transfer pricing given that, in a South African context, these two matters effectively go hand in hand. There may be certain instances where policies or pricing may be considered arm's length from a transfer pricing perspective, but the Reserve Bank would either not allow the payment without specific approval, for example, manufacturing royalties can be capped at 6%, or it would not allow the transaction at all in the first instance, such as the sale of intellectual property from South Africa. Debt set-offs can also breach exchange control regulations, be voidable and even criminal offenses.

The 2010 TLAA introduced a Voluntary Disclosure Programme (1 November 2010 to 31 October 2011) to enable companies and individuals to regularise their tax and exchange control affairs with relief in the form of reduced penalties and interest.

OECD issues

South Africa is not a member of the OECD, but it is an enhanced engagement country. South Africa actively participates in and provides input to OECD discussions and discussion papers. South Africa follows the OECD Guidelines and the 2010 changes to the guidelines issued by the OECD are being applied by the SARS in their transfer pricing audits.

Joint investigations

It is possible for the South African tax authorities to join with the authorities of another country to jointly investigate a multinational group or share information from a South African audit with an overseas tax authority. Practically, we have started to see closer cooperation between the SARS and other overseas revenue authorities.

Thin capitalisation

Thin capitalisation is dealt with primarily by section 31(3). Guidance on thin capitalisation and the charging of excessive interest is provided in Practice Note 2 issued 14 May 1996.

Thin capitalisation rules apply where financial assistance is granted, directly or indirectly, by a non-resident to one of the following:

a. (a) Any connected person who is a resident; and
b. (b) Any person (in whom the non-resident has a direct or indirect interest) other than a natural person who is a resident, where the non-resident is entitled to 25% or more of the company's profits, dividends or capital, or is entitled to exercise, directly or indirectly, 25% or more of the voting rights of the recipient.

Per the 2010 TLAA, under which transfer pricing provisions (including thin capitalisation) become effective on 1 October 2011, these shareholdings are reduced to 20%.

Back-to-back loans are included in the financial assistance provisions and there remains uncertainty as to whether this results in unintentional domestic transfer pricing.

Practice Note 2 of 1996 provides for an acceptable debt-to-equity ratio of 3:1, within which the Commissioner does not generally apply thin capitalisation restrictions. This 3:1 safe harbour reflects the previous approach adopted by the Exchange Control Authorities. It is not a statutory ratio and taxpayers are free to apply to the Commissioner for relaxation from the ratio (preferable in the year when the company becomes thinly capitalised) where sound commercial reasons for variance exist. Taxpayers who comply with the safe harbour ratio are not required to justify shareholder loans, but are still required to supply information as requested on the annual tax return.

In determining the interest rates applicable for Rand denominated loans, an interest rate of the weighted average of South African prime rate plus 2% is accepted as arm's length. For foreign-denominated loans, an interest rate of the weighted average of the relevant interbank rate plus 2% is considered as arm's length. This provides a safe harbour for determining arm's-length interest rates to be applied to inbound cross-border loans.

Subject to clearance (see below), interest charged on that part of the loan which exceeds the permissible ratio of 3:1 is not deductible for tax purposes and is deemed to be a dividend under section 64C(2)(e)) of the Income Tax Act. STC is payable on the excessive amount. The 2010 TLAA formally introduces an arm's-length lender test for thin capitalisation. It is expected that the current 3:1 safe harbour will be discontinued. Further details on this are expected with the revised Practice Note.

The new rules apply to financial assistance provided to South African branches. It is thought that this will be applied by measuring the foreign equity versus the outstanding debt of the foreign subsidiary, as opposed to measuring at the South African branch level.

The 2010 TLAA introduced a new withholding tax on interest, with a domestic rate of 10% with effect from 1 January 2013. The government is negotiating tax treaties to ensure that South Africa can collect this, at perhaps a treaty rate of 5%, although these negotiations are ongoing.

The safe harbour provisions apply only to inbound financial assistance and not financial assistance provided by a South African entity. Reliance on these provisions for outbound financial assistance is not appropriate and a robust arm's-length analysis is required.

A literal interpretation of section 31 would lead to the conclusion that the concept of financial assistance would extend beyond interest-bearing loans to interest-free loans. However, the purpose of section 31(3) is to enable the Commissioner to determine an acceptable debt-to-equity ratio in order to disallow a tax deduction for interest paid in relation to any excessive part of the debt. Consequently, the application of section 31(3) is limited, in practice, to interest-bearing debt only.