

Chapter 10.4. South Africa Country practices

THE ARM'S LENGTH PRINCIPLE: A COUNTRY PERSPECTIVE

10.4.1. Introduction

10.4.1.1. South Africa's transfer pricing legislation (set out in Section 31 of the Income Tax Act 58 of 1962) came into effect on 01 July 1995 followed by Practice Note 2 (introduced 14 May 1996) and Practice Note 7 (introduced 6 August 1999) which served to provide taxpayers with guidance on how the South African Revenue Services ("the SARS") intended to apply the legislation. Practice Note 2 covered thin capitalisation whilst Practice Note 7 dealt with transfer pricing. As of 01 April 2012 the SARS made several amendments to its transfer pricing rules.

10.4.1.2. 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 Capital as well as the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("the OECD Guidelines"). It is the stated intention of the SARS to provide an update to Practice Note 2 and Practice Note 7, following the amendments to the legislation, however at the time of this publication these had not been released.

10.4.1.3. South Africa is still in its infancy with respect to auditing related party cross-border transactions, even though it can be considered that transfer pricing has been in existence in for some time. SARS has only in the last few years begun to aggressively audit transfer pricing owing mainly to a lack of resources and skills challenges. Equally, South African companies of multinational groups are also starting to focus on their transfer pricing compliance.

10.4.1.4. Whilst the OECD Guidelines have been particularly useful in providing a conceptual understanding of *what* is the nature of the arm's length principle, there are instances when the Guidelines fail to address the more practical aspects of *how* to apply the principle. This contribution shares South Africa's experience in applying the arm's length principle and shows how South Africa attempts to work around some of the practical shortcomings. Attention will be given to some broad themes as well as to some specific areas of challenge experienced in South Africa with respect to the application of the arm's length principle. This article is not an affirmation of SARS' approach to all

transactions as such approach remains specific to the facts and circumstances. The issues raised merely convey some of the challenges and experiences of the SARS in transfer pricing.

10.4.2. Comparability

10.4.2.1. The main challenge that South Africa encounters in determining arm's length profits is the lack of domestic comparables. The pursuit of the perfect comparable remains an elusive and almost unattainable feat. 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 African specific, comparable data. As a result, both the tax administration and taxpayer rely on European databases to establish arm's length prices or levels of profitability.

10.4.2.2. The obvious problem to which this gives rise has no simple or definitive solution. Instituting comparability adjustments to account for geographical differences (for example, market, economic, political differences etc.) 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 after adjustment the comparable data is no longer comparable to the controlled transaction.

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

10.4.2.4. Whilst South Africa may be worse off than many other 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 anywhere.

10.4.2.5. It is for this reason, amongst others, that the SARS favours a more holistic approach to establishing whether or not the arm's length principle has been upheld. 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 etc, it is evident that the SARS does not look to comparable data alone or in isolation from other relevant economic factors in determining whether or not the appropriate price or arm's length level of profit has been achieved.

10.4.3. Management Services

10.4.3.1. 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. In the South African context there seem to be some favoured destinations such as Singapore, Hong Kong and the Netherlands.

10.4.3.2. The challenge in establishing whether or not payment for a service is at arm's length goes further than the two step approach set out in Chapter 7 of the OECD Guidelines. Chapter 7 states 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 (para 7.5 of the OECD Guidelines). As regards the first test, the approach followed is to determine if the services:

- Provide the recipient with economic and commercial benefit;
- 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;
- That the allocation keys applied are commensurate to the services provided.

10.4.3.3. In particular para. 7.29 of the OECD Guidelines states that in determining the arm's length prices 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.

10.4.3.4. With regards to the determination of whether or not a service has provided the recipient with economic and commercial benefit, a 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 such quantifiable terms and as such it is often demonstrated by the assertion of the taxpayer rather than being 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 such judgement has the potential to translate into a significant tax adjustment for taxpayers.

10.4.3.5. A possible solution is for a tax administration to clearly set out its requirements for documentation and burden of proof. However this is likely to meet with resistance from taxpayers who will claim that this places an increased compliance cost burden on them. The SARS is currently taking a pragmatic but firm approach to evaluating payments for intra-group services and where clear commercial justification or evidence of reasonableness for such payments are lacking, such payments are disallowed.

10.4.4. Contract Risk Shifting - Year-End Adjustments

10.4.4.1. 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.

10.4.4.2. There is often little or no regard for the drivers of higher profits attained in South Africa when taxpayers compare them to comparable companies in foreign markets (given that 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 are often much more than just limited risk entities. Furthermore, there are many instances where unique

dynamics exist within the South African market enabling South African subsidiaries to realise higher profits than their related party counterparts in other parts of the world, or than are 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.

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

10.4.5. Intangibles

10.4.5.1. 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.

10.4.5.2. In the South African experience, the sale of intangibles developed in South Africa presents a somewhat exceptional situation compared to the rest of the world, as exchange control regulations prohibit the relicensing of such intangible property back into South Africa. Once such 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, the 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 the group the South African entity would have no participation in any profits that may be realised.

10.4.5.3. The question that arises is whether or not such terms and conditions would have been agreed to at arm’s length and more importantly whilst legal ownership may have been transferred, can the South African entity be considered to have economic ownership?

10.4.5.4. From a SARS perspective there is merit in the argument that economically the ownership resides with the South African entity and as such the entity should be earning an intangible related return. Given the true functional and risk profile of the related party, the related party should be compensated as a service provider for registration and maintenance of the intangible property.

10.4.5.5. There is no one size fits all approach to these issues and it is the approach of SARS to adopt a case by case stance depending on the facts and circumstances.

10.4.6. Access to Information

10.4.6.1. Another major challenge faced by the SARS when conducting transfer pricing audits is that posed by the creative tactics adopted by taxpayers to circumvent responding to SARS questions and providing the information requested. This approach often leads to long and drawn out audits. Taxpayers prefer the use of costly advisors and advocates to find ways of not responding to a SARS audit rather than providing relevant information or arguing the technical points raised by the SARS.

10.4.6.2. In addition, it is also fairly common for taxpayers to present arguments they themselves cannot substantiate or to make disclosures to the SARS and subsequently retract them. Taxpayers can often illustrate what was done however they can seldom explain *why*. Such interactions make it difficult for the SARS to reach reliable audit findings.

10.4.7. Conclusion

10.4.7.1. 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. It is however the most workable solution at this current time and its limitations 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 the 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 the SARS applies the arm's length principle.