Section 31 – Transfer Pricing and Thin Capitalisation

Being a technical report submitted by

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ABSTRACT

The aim of this technical report is to provide a detailed and informative understanding of transfer pricing and thin capitalisation.

The South African Act that is the subject of this technical report is the Income Tax Act, No.58 of 1962.

The principal South African taxes dealt with in this technical report are as follows:

- Normal Tax
- Secondary tax on companies

DECLARATION

I hereby declare that this report is entirely my own work.

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TABLE OF CONTENTS

Chapter 1

Introduction

Advice offered in isolation is not enough when fundamental elements have an impact on every multinational business transaction. A single transaction may be subject to multiple taxes, both direct and indirect, at country and regional levels. Competing tax jurisdictions and conflicting regulations can also challenge success. Key issues affecting multinational businesses today are the topics of transfer pricing and thin capitalisation.

The level of international tax planning by South African businesses has significantly increased over the last few years. This is in direct response to the increasing worldwide trend towards globalisation and South Africa's regained acceptability in the international community. The trend is, therefore, expected to continue and this is not surprising when one considers the potential international tax planning has for boosting a company's[1] bottom line or enabling it to increase market share through a lower pricing policy funded by global tax savings.

It follows that the implications of international taxation should be considered whenever a business transaction involves parties or activities in more than one country. The manner in which different countries' tax systems interact poses both tax opportunities and pitfalls for the taxpayer entering into cross-border transactions. It is, therefore, important to be aware of the business decisions that are being made and to focus on the potential tax implications so that the decisions may be put in place in the most tax efficient way.

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[1] For this report, 'company' includes all forms of business entities.

This report deals with transfer pricing and thin capitalisation. These issues often affect the same entities. Following the introduction of the new s 31 of the Income Tax Act (referred to as the Act), which became effective as from 19 July 1995, entities involved in international transactions with connected persons should be aware of the threat posed by this legislation which relates to transfer pricing and thin capitalisation.

The aim of this report is

- to make one aware of the legislation,
- to highlight the key issues relating to transfer pricing and thin capitalisation, and
- to share ideas on how entities should develop strategies and implement procedures to assist in countering challenges from the Commissioner.

Chapter 2

What is Transfer Pricing

The following statement gives a description of transfer pricing:[2]

> 'A transfer price is the price put on a transaction between parts of a single organisation or between members of a group of companies. The term is a way of indicating that it is a price arranged within a group, and not arrived at in the open market. The term is often used in condemnation because of a suspicion that prices within an organisation are readily manipulated to avoid tax or to achieve some other ulterior motive.'

Multinational enterprises (referred to as MNEs) would generally consist of a number of subsidiaries that operate in different countries but report or take their instructions from the parent company. There are various reasons for being involved in transfer pricing. The most common reason would be to minimise the overall tax burden of the group. Transfer pricing is also used frequently to divert taxable income from high tax paying countries to subsidiaries in tax haven countries.

MNEs may achieve significant benefits by taking advantage of differences between the tax laws in various countries in the areas of

- corporate tax,
- tax incentives, and
- customs and excise duties.

[2] Pieter Malan 'Transfer Pricing', February 1996 at 6.

The non-tax reasons for setting artificial prices would be to repatriate capital or profits, and to support poor performing entities. Transfer pricing affects a wide variety of transactions,

- including the purchase and sale of goods,
- the provision of services,
- the letting of property,
- the granting of loans and credit facilities, and
- the use of intangible assets.

Section 31 of the Act requires prices charged to related parties to be determined on an arm's length basis.

There is no definition given to transfer pricing in the Act. A general definition for this term would be that it refers to arrangements in which goods or services are transferred at an artificial price as a means of effectively transferring income or an expense from one entity in the group to an another.

Section 31 gives the Commissioner the power to adjust prices where he thinks that the price is artificially high or low.

Section 31(2) states that

- where goods or services
- are supplied or acquired
- in terms of an international agreement
- *and* the acquirer is a connected person in relation to the supplier

- *and* the price of the goods or services is not an arm's length price (that is market value in the circumstances),

the Commissioner may adjust the price to an arm's length price in calculating the taxable income of the acquirer or supplier. This discretion is subject to objection and appeal.

Transfer pricing has always been an important subject. It attracts scrutiny from the legislature, tax administrators and taxpayers. The reason is obvious, transfer pricing rules and practices determine the allocation of income among tax jurisdictions arising from related party transactions. The subject has come under even more scrutiny in recent years.

This additional focus is attributable to two causes:

- First, the increasing pressure to raise revenue in this country and elsewhere. This scrutiny is appropriate, since each country has a right to expect its taxpayers to pay their fair share of taxes.
- Secondly, the fact that the system has not been working as well as it should.

From the government's perspective, two flaws can be seen:

- First, there is insufficient self-compliance by taxpayers.
- Second, the legal framework does not offer taxpayers, tax administrators and courts adequate guidance in cases in which the traditional transfer pricing methods are inadequate.

Chapter 3

What is Thin Capitalisation

When MNEs makes cross-border investments, whether by setting up an entirely new operation or by acquiring the whole or a part of an existing operation, one of the fundamental questions that arises is whether to finance the investment by way of debt or by way of share capital (also called equity capital).

The tax treatment of interest-bearing debt usually differs from that of equity capital, the return on which normally takes the form of dividends.

In particular, carrying interest-bearing debt usually yields tax advantages in the country in which the investment is located. This has resulted in the tax authorities of a growing number of countries, concerned about the loss of tax revenue through the repatriation of profits from their countries to other countries by way of interest rather than dividends, paying close attention to methods of financing, that is, to the question of thin capitalisation.

The problems relating to thin capitalisation arise because under most tax systems debt and equity are treated differently. In particular, interest on debt is treated differently from dividends on equity capital.

The differences in treatment give rise to the possibility that characterising equity as debt (or vice versa), deliberately or otherwise, may result in tax advantages (or disadvantages) to particular companies in corporate groupings. In some countries, this may be of considerable relevance in purely domestic situations.

Thin capitalisation may affect many aspects of doing business, but this report is primarily concerned with thin capitalisation and related issues as they affect cross-border financing, especially the provision by a company of capital to a subsidiary or associated company located in another country.

In most countries, when a company receives capital from a foreign parent company or other foreign associate by way of a debt bearing a commercial rate of interest, the interest on the debt would often (although not always) be allowed as a deduction for corporate normal tax purposes in the borrowing company's hands.

Although the payment of interest to a foreign parent company or associate may potentially be subject to withholding taxes, in practice these taxes are often eliminated or substantially reduced by the terms of a double tax treaty between the two countries concerned.

When, however, capital is provided by way of share capital rather than debt, the return on the share capital would normally be in the form of dividend distributions. In most cases, dividend distributions would not be allowed as a deduction against the corporate profits of the paying company. Dividend distributions to a foreign parent company or associate are also often subject to a withholding tax, but commonly at a higher rate than that applicable to interest payments.

Therefore, if a corporate group decides to provide funds from a parent company in one country to a subsidiary in another country almost entirely by way of a debt bearing a commercial rate of interest, the subsidiary company's tax liability may be substantially reduced, in the absence of special provisions to the contrary, compared with the situation had similar funds been provided as share capital. There would be even greater tax advantage for the subsidiary if interest paid to the parent company (or associate) is not subject to any withholding tax on payment or if a double tax treaty eliminates any potential withholding tax on interest payments to a foreign parent company.

The provisions of capital as debt or as equity also have an important tax effect on the parent company. It is normally more advantageous to the parent company to provide capital by way of equity rather than debt, the reverse of the subsidiary's position. If capital were provided to the subsidiary by way of equity, the return on capital would normally be by way of a dividend. Often, this dividend is either exempt from tax in the parent company's hands or may qualify for a substantial reduction in tax by virtue of a foreign tax credit allowed for underlying corporate taxes on the profits out of which the dividend is paid. When, alternatively, capital is provided to the subsidiary as interest-bearing debt, interest received on the debt would generally be fully taxable in that parent company's hands.

Because of the difference between the tax treatment of debt and the tax treatment of equity, a number of countries have included thin capitalisation provisions in their tax laws. These thin capitalisation provisions, known as debt-to-equity provisions may allow debt to be recharacterised as equity (sometimes vice versa) or allow interest and dividends to be reclassified when the debt or equity capital from which that income is derived appears to have been artificially established.

A number of countries have comprehensive provisions allowing the recharacterisation of debt as equity or equity as debt. The approach most commonly adopted in thin capitalisation provisions is to focus on subsidiary companies provided with what is essentially equity capital in the form of debt and to seek to deny a tax deduction for excessive interest paid. The classic thin capitalisation case is one in which the financing provided by the parent company represents a high ratio of debt-to-equity capital.

The following chapters that follow deal with questions relating to debt-to-equity problems and indicates how interest on debt provided by a foreign investor may be paid out of a country in the most tax-efficient manner.

Section 31(3) states that where a non-resident (referred to as the investor) has granted financial assistance (directly or indirectly) to:

- any 'connected person' (in the Republic) in relation to him; or
- any other person (in whom he has a (25% or more) direct or indirect interest) (*other than a natural person*) who is managed *or* controlled in the Republic (the 'recipient') and the Commissioner is (having regard to the circumstances) of the opinion that the total value of financial assistance given by the 'investor' is excessive in relation to the fixed capital of the South African borrower (the 'connected person' or the 'recipient'), then the cost of the financial assistance (interest and finance charges) on the amount of the financial assistance which is considered excessive, would not be allowed as a tax deduction in the hands of the borrower. The interest, which is not allowed as a deduction in terms of this section, would be deemed to be a dividend for the purposes of Secondary Tax on Companies (STC) if it is paid to a shareholder or a 'recipient' as defined in s 64C.

The Commissioner's discretion is subject to objection and appeal.

Chapter 4

Definitions

The following is provided for in s 31(1) of the Act. Section 31(1) introduces definitions with regard to 'goods', 'international agreement' and 'services'. The following are the definitions:

'"goods" include any corporeal movable thing, fixed property and any real right in any such thing or fixed property.'

'"international agreement" means a transaction, operation or scheme entered into between:

(a) a person who, in the case of a natural person, is ordinarily resident in the Republic or in the case of a person other than a natural person, is managed or controlled in the Republic; and

(b) any other person who, in the case of a natural person, is ordinarily resident outside the Republic or in the case of a person other than a natural person, is managed or controlled outside the Republic.'

'"service" included anything done or to be done, including, without limiting the generality of the foregoing:

(a) the granting, assignment, cession or surrender of any right, benefit or privilege;

(b) the making available of any facility or advantage;

(c) the granting of financial assistance, including a loan, advance or debt, and the provision of any security or guarantee;

(d) the performance of any work;

(e) an agreement of insurance; or

(f) the conferring of rights to incorporeal property.'

It is important to note that para (*c*) of the definition of 'services' includes the granting of financial assistance, including a loan, advance or debt and the provision of security or a guarantee. This ensures that a scheme involving thin capitalisation could be dealt with under the provisions of s 31 of the Act.

Chapter 5

When Can the Commissioner Apply S 31(2) of the Act

A transfer pricing enquiry by the Commissioner may be expensive, time consuming, and result in significant tax adjustments, as well as potential double taxation.

The following may help in enforcing the application of s 31(2) of the Act by the Commissioner:

- The Commissioner may consider a transfer price to be unacceptable and artificially determined, despite the taxpayer believing it to be justifiable.
- The Commissioner in South Africa is tending to co-operate internationally, and he would readily exchange information with other countries regarding MNEs activities in their respective jurisdictions.
- Pricing policies that are unclear and unjustifiable from a commercial point of view.
- Documentation of pricing policies that is unclear.
- Pricing policies that are not reviewed regularly for changing economic and business conditions.
- Loose and imprecise intra-group arrangements by MNEs that are unjustified.
- Insufficient evidence supporting the commerciality of prices particularly where prices are determined on bases other than arm's length.
- Incomparable arm's length prices for similar goods in similar circumstances.

- Incomparable mark-ups used in comparable arm's length situations or by competitors.
- Quotations unavailable from independent parties.
- The effect of local conditions or particular circumstances on price cannot be justified.
- The precise nature of services rendered and their value to the recipient cannot be done, and there is insufficient proof that they have in fact been performed.
- Deviations from an arm's length price cannot be justified.
- Evidence supporting the group's pricing philosophy and policies are not consistent with information supplied to the Commissioner in the past.
- Unplanned responses given to routine enquiry letters from the Commissioner.

Chapter 6

Suggested Procedure with Regard to Enquiries from the Commissioner Relating to S 31 of the Act

- A taxpayer would generally receive a letter from the Commissioner requesting information as follows:
  - Details of sales and purchases between group companies, how the prices were determined, and how they compare to arm's length prices.
  - Details of interest-bearing financing.
  - Details of management and service fees.
  - Details of intra-group agreements affecting intangibles.
- During negotiations with the Commissioner, the taxpayer should be prepared to field manpower of equal seniority to that deployed by the Commissioner.
- The taxpayer should take a firm, but co-operative, stance and not necessarily be swayed by the Commissioner's desire to reach a negotiated settlement. An appeal, however, could produce unpredictable results, and given the time and costs involved in going to court, it would generally be in the taxpayer's interest to avoid litigation.
- The Commissioner is likely to rely heavily on historic statistics, which may not reflect the situation, which existed when the pricing policies were set. Taxpayers should be able to explain these circumstances to the Commissioner, and to rebut unfavourable statistics.
- Assume that the officials from the Commissioner are well trained and competent. Taxpayers should therefore be represented by senior

management or professional advisers during meetings with officials from the Commissioner.

- These meetings should be encouraged where a potentially significant transfer pricing challenge has been raised in order to
  - have the opportunity to explain pricing policies in detail, and to judge Commissioner's responses to them,
  - advise the officials of the Commissioner to focus on specific issues rather than general enquiries,
  - explain difficulties in supplying the information requested, and
  - point out the costs and inconvenience of the information supplied.
- Ensure that proceedings at meetings are documented to avoid misinterpretation.
- Taxpayers must be aware of all the relevant prescription dates after which they will not be able to raise objections, or after which liabilities may prescribe.

Chapter 7

Measures by the Commissioner to Counter Transfer Pricing in Particular the Establishment of an Arm's Length Price

There are several legislative provisions which could be applied to counter transfer pricing manoeuvres other than s 31 of the Act. These provisions are analysed to determine how the fiscal authorities could establish an arm's length price.

Excessive expenditure is disallowed as a deduction for tax purposes on the grounds that this expenditure is not incurred in the production of the income, in accordance with s 11(*a*) of the Act or that it is not laid out or expended for the purposes of trade, in terms of s 23(*g*).

What is then excessive expenditure?

The first requirement is that the expenditure must be incurred in the production of the income. Expenditure, however, which is not strictly necessary, may still be deductible.

In *Port Elizabeth Electric Tramway Co v CIR*, Watermeyer AJP said the following:[3]

> '[A]ll expenses attached to the performance of a business operation bona fide performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are

[3] 1936 CPD 241 8 SATC 13.

> bona fide incurred for the more efficient performance of such operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it.'

This was confirmed in ITC 735 by Thompson J who said the following:[4]

> 'The extravagant, inefficient man can deduct his expenditure even if it is more than a careful and efficient man would spend in the same circumstances so long as such expenditure is incurred in "the production of income".'

This approach seems to deviate considerably from the arm's length principle. Thompson J, however, continued to say that the amount of remuneration must have some reasonable relation to the services rendered. He confirmed his view previously expressed in ITC 569,[5] namely that the considerations, which should influence the court in determining whether expenditure is excessive, would be the following:

- That the expenditure is so grossly excessive that it could not possibly be regarded in its total amount as producing income.
- That it has been awarded for some ulterior motive, for example tax evasion, or favouritism.

Therefore, if it can be shown that the reason for the excessive expenditure was to transfer profits between companies in a multinational group, the excessive portion may be disallowed on the basis that it had been awarded for some ulterior motive.

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[4] 18 SATC 204 at 105.
[5] 13 SATC 447 at 449.

In ITC 1011[6] the court again had to decide whether a salary paid by a father's company to his son qualified as expenditure by the company in the production of the income. The expenditure was disallowed since the taxpayer could not prove that there was a *bona fide* commercial transaction between the son and the father's company.

In ITC 610[7] it was pointed out that one person may regard expenditure as being extravagant whereas another would find it reasonable. The court expressed the opinion, however, that one may reach a saturation point, that is if the expenditure passes a point of what may be regarded as extravagant, it falls for suspicion. In the court's view the expenses involved were too remarkable not to evoke criticism.

Excessive director's fees were also considered in this case. The court applied the arm's length test. The basis used by the court were

- the relationship of the salary to profits and turnover, and
- what an independent employer would pay for these services.

In the case of *Tobacco Father v COT* on the issue of whether the salary paid by a farmer to his son was excessive, Beadle J looked at what the services were worth in the open market. He concluded that the salary paid was market related and therefore not excessive. This judgment placed some uncertainty on the role of the courts in establishing arm's length prices. In this regard Beadle J said the following:[8]

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[6] 1963, 25 SATC 283.
[7] 1945 14 SATC 337.
[8] 1951 (1) SA 150 (SR), 17 SATC 395.

> 'But it does not seem to me that it is competent for the Commissioner or myself to decide what is a fair rate of wage in the tobacco industry. A rate of wage, after all, is a pure business proposition, and if the industry decides that it is an economic preposition to pay certain high wages, it is for the industry to make that decision and not for the Commissioner or for the courts to decide what is a reasonable wage in a particular industry.'

In order to prove that a portion of the expenditure is *bona fide* incurred, it would have to be shown that the price paid was a market-related price. (Note that in terms of s 82 of the Act, the burden of proof that any amount is subject to a deduction will be on the person claiming that deduction.)

It is possible that the general anti-tax avoidance provision contained in the Act, namely s 103(1), could be applied to counter transfer price abuse. Section 103(1) reads as follows:

> 'Whenever the Commissioner is satisfied that any transaction, operation or scheme (whether entered into or carried out before or after the commencement of this Act, and including a transaction, operation or scheme involving the alienation of property)
>
> *(a)* has been entered into or carried out which has the effect of avoiding or postponing liability for the payment of any tax, duty or levy imposed by this Act or any previous Income Tax Act, or of reducing the amount thereof; and
>
> *(b)* having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out
>
> (i) was entered into or carried out

(aa) in the case of a transaction, operation or scheme in the context of business in a manner which would not normally be employed for bona fide business purposes, other than the obtaining of a tax benefit; and

(bb) in the case of any other transaction, operation or scheme, being a transaction, operation or scheme not falling within the provisions of item (*aa*), by means or in a manner which would not normally be employed in the entering into or carrying out of a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; or

(ii) has created rights or obligations which would not normally be created between persons dealing at arm's length under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; and

(c) was entered into or carried out solely or mainly for the purposes of obtaining a tax benefit,

the Commissioner shall determine the liability for any tax, duty or levy imposed by this Act, and the amount thereof, as if the transaction, operation or scheme had not been entered into or carried out, or in such manner as in the circumstances of the case he deems appropriate for the prevention or diminution of such avoidance, postponement or reduction.'

Before s 103(1) can be applied, the Commissioner must be satisfied that all the requirements are present, that is, if the taxpayer can show that any one of the circumstances described above is not of application, his liability for any tax may not be determined under this section.

In *Smith v CIR*[9] it was held that 'avoiding liability for the payment of any tax' referred to anticipated liabilities for tax. It follows from this judgment, by Steyn CJ, that the alienation of any asset by or involving the taxpayer by which income which otherwise would have accrued to the taxpayer, accrues to another can be regarded as having the effect of avoiding, postponing or reducing the liability for any tax, although the taxpayer has no right and would receive no benefit from the income. Therefore, if an asset is transferred to a related party abroad for insufficient consideration, s 103(1) could be applied.

The 'business test' applied by the courts to determine whether the second requirement of s 103(1) is complied with, is reminiscent of the arm's length principle.

In *Hicklin v SIR*, Trollip JA made the following remarks:[10]

> 'When the "transaction, operation or scheme" is an agreement, as in the present case, it is important, I think, to determine first whether it is one concluded "at arm' length". That is the criterion postulated in para (ii). For "dealing at arm's length" is a useful and often easily determinable premise from which to start the enquiry. It connotes that each party is independent of the other and, in so dealing, will strive to get the utmost possible advantage out of the transaction for himself ... hence, in an arm's length agreement the rights and obligations it creates are more likely to be regarded as normal than abnormal in the sense envisaged by para (ii). And the means or manner employed in entering into it or carrying it out are also more likely to be normal than abnormal in the sense envisaged by para (ii).'

[9] 1964 (1) SA 324 (AD) 26 SATC 1.
[10] 1980 (1) SA 481 (AD) 41 SATC 179.

The criterion of 'persons dealing at arm's length' was not of easy application in *SIR v Guestyn, Forsyth and Joubert*. The case involved a conversion of a professional partnership into an unlimited liability company with the partners as shareholders. Ogilivie Thompson CJ said the following:[11]

> 'For the section enjoins the application of that criterion in relation to a transaction, operation or scheme "if the nature of the transaction, operation or scheme in question". Yet the court is in the present ex hypothesis concerned with partners who have, in the circumstances outlined above, made over their practice, not to an independent third party with whom they would ordinarily deal at "arm's length" but to an unlimited company of which they are the sole shareholders and directors, and whereof they have full and complete control.'

In *CIR v Louw*, Corbett JA said the following:[12]

> 'In such a case should the court, in applying the "normality" yardstick, take account of the special relationship between the erstwhile partners and the company which they have formed, or ignore it and apply the yardstick as though the company were a stranger? I do not see how the court can ignore this special relationship and yet give proper effect to the concluding words of s 103(1)(ii), viz "under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question". For it is of the very nature of the incorporation scheme that the company to which the practice is sold by the partners will have as its shareholders and directors the self-same partners and will be controlled by them. Those are the realities of the situation ... it was not an arrangement that would normally have been created by persons dealing at arm's length in this type of transaction.'

[11] 1971 (3) SA 567 (A) 33 SATC 113.
[12] 1983 (3) SA 551 (AD) 45 SATC 113.

The last sentence makes it quite clear that the normalcy test differs from the arm's length principle commended by the Organisation for Economic Co-operation and Development (OECD) Committee on Fiscal Affairs. On the basis of this case, it is submitted that it would be relatively easy for a member of a multinational group to show that a comparatively low price charged for goods or services transferred to another member of the group abroad, is not abnormal. To justify a low price the member could, for example, argue that it is necessary in order to keep the member abroad operational in a highly competitive market.

If a South African company of a multinational group has an assessed loss, the foreign parent company might consider it feasible to move profits to that company in South Africa to reduce the overall tax burden of the group. This could be done in one of the following two ways:

- Over-pricing goods or services purchased or rendered by the South African entity.
- Under-pricing sales of goods and services to the entity in South Africa.

Section 103(2) has been enacted to counter activities, aimed specifically at providing the Commissioner with a remedy to situations where an assessed loss in a company is utilised by the taxpayer introducing income into the company.

The section may be summarised as follows:

- Whenever the Commissioner is satisfied
- that any agreement or change in shareholding in a company or change in members interest in a close corporation
- has been effected
- and has resulted directly or indirectly in income accruing to the company
- solely or mainly for the purpose of utilising any assessed loss
- in order to avoid liability for any tax, duty or levy on income
- the set-off of any assessed loss against income would be disallowed.

In this context, however, foreign tax is avoided. Does s 103(2) in stating 'any tax, duty or levy of income' include foreign tax? It is unclear from this section of the Act.

Chapter 8

The Arm's Length Principle

The 'arm's length principle' for determining transfer prices is the standard adopted by the OECD, a view which is increasingly supported throughout the world.

According to the latest OECD report, the arm's length principle is defined as follows:

> 'Where conditions are made or imposed between two enterprises in their commercial or financial relations which differ from those which would be 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.'

This implies that MNEs would be liable for tax where inter-group or inter-company prices are at variance with the prevailing market prices. Any departure from the arm's length principle would increase the risk of double taxation. There may be genuine difficulties in determining a transfer price, which may be distorted by a number of factors. The following are some of the factors:

- Government pressures relating to customs valuations.
- Exchange and price controls.
- Cash flow requirements.
- Shareholder pressures.

- Where price determination requires an element of judgement.

The arm's length approach treats members of MNEs as separate tax entities and avoids distortions in the competitive position between them. It is difficult to apply the principle in certain specific cases, as in the case of highly specialised goods or services or unique intangibles. The OECD states that industry norms cannot be standardly applied to transactions between members of MNEs due to the variable nature of the products, services or transactions, and the unique circumstances of the markets in which the company is operating.

> 'No legitimate or realistic alternative to the arm's length principle has emerged.'[13]

[13] OECD 1994 report, para 31.

Chapter 9

Guidance for Applying the Arm's Length Principle

In paragraph 33 of the OECD report of 1994 the following statement is made:[14]

> 'The application of the arm's length principle may be administratively burdensome for the taxpayer, who will have to be able to demonstrate that the transaction was consistent with the arm's length principle (this could be alleviated by the maintenance of adequate records) and for the Commissioner who has to verify the transaction some years after it occurrence. Because this process usually involves comparing related party transactions with those entered into between uncontrolled entities, a substantial amount of additional information must be collected and retained. Such information may be difficult to obtain because of its location or its confidentiality, or it may simply not exist.
>
> 'For transactions to be comparable there must be no differences between the transactions compared, or it must be possible to make reasonably accurate adjustments to eliminate any differences. The assets employed and the risks assumed by the parties must also be taken into account.'

The guidelines highlight the following factors which determine comparability:[15]

> **'Characteristic of property or services**
>
> Differences in the specific characteristics of property or services often account for differences in their value. For example,

[14] OECD 1994 report, para 33.
[15] Deloitte & Touche – Transfer Pricing , February 1996 para 2 at page 8.

- in the case of tangible property, its physical features, quality and reliability;
- in the case of services, their availability, nature and extent; and,
- in the case of intangible, the form of the transaction (licence or sale), the type of property (patent, trademark or know-how), and the duration of the transaction.

'Function analysis

In determining whether controlled and uncontrolled transactions are comparable, analysis of the functions undertaken by the entities are necessary. This function analysis is defined as the identification and comparison of the economically significant activities and responsibilities undertaken by independent and associated enterprises respectively.

'The functions, which may need to be compared, include design, manufacturing, assembling, research and development, servicing, purchasing, distribution, marketing, advertising, transportation, financing and management. It is the economic significance of these functions, which is important when comparing independent entities with controlled entities.

'Account should be taken of the assets used and the risks assumed by the respective entities. The party's conduct is the best evidence concerning the true allocation of risk. Whether the allocation of risk claimed by the taxpayer would be rational in arm's length transactions should also be considered.

'Contractual terms

The contractual terms, whether contained in a written agreement, in correspondence, or simply deduced from the parties conduct, usually define how the responsibilities, risks and benefits are to be shared by the parties.

'These terms should form part of the functional analysis. In controlled situations the degree of adherence to the terms of the contract should be examined.

'Economic circumstances

For transactions to be comparable, the markets in which they are undertaken must be similar, or, where there are differences, appropriate adjustments must be capable of being made. The factors in determining market comparability include

- geographic location,
- size,
- competition,
- availability of substitute goods and services,
- supply and demand,
- consumer purchasing power,
- production costs,
- whether wholesale or retail,
- timing of the transactions, and
- government regulations.

'Business strategies

A market penetration strategy may dictate lower prices or higher marketing costs to expand on current market shares. These strategies need to be taken into account.'

There are various methods of applying the arm's length principle. The 1994 OECD report incorporates the following methods:

Transaction based methods

In para 91 of the 1994 OECD report it is suggested that[16]

> 'the most direct way to establish whether the conditions made or imposed between associated enterprises are arm's length is to compare the prices charged in controlled transactions undertaken between those enterprises with prices charged in comparable transactions undertaken between independent enterprises'.

The report recognises that

> 'there will not always be comparable transactions available to allow reliance on this direct approach alone, and so it may be necessary to compare other, less direct indicia, such as gross margins'.

Comparable uncontrolled price method (CUP method)

The CUP method is defined by the OECD as follows:[17]

> 'A transfer pricing method that compares the price of 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.'

[16] OECD 1994 report, para 91.
[17] OECD 1994 report, para 103.

The guidelines recommend that every effort should be made to identify and quantify the adjustments, which need to be made in order to make them comparable.

Resale price method

The resale price method is defined by the OECD as follows:[18]

> '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 an appropriate gross margin (the "resale price margin") representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit. What is left after subtracting the gross margin may be regarded, after adjustment for other costs associated with the purchase of the product (for example, custom duties), arm's length price of the original transfer of property between the associated enterprises.'

This method is commonly used when applied to marketing operations. In this regard the following comments are relevant:[19]

> 'The reliability of the resale price method might be affected if there are material differences in the ways associated enterprises and independent enterprises carry out their business.

[18] OECD 1994 report, para 105.
[19] OECD 1994 report, para 106.

> 'The resale price method also depends on comparability of functions performed ... adjustments should be made to account for such differences.
>
> ' ... where accounting practices differ from the controlled transaction to the uncontrolled transaction, appropriate adjustments should be made to the data used in calculating the resale price margin.'

Cost plus method

The cost plus method is defined by the OECD as follows:[20]

> 'A transfer pricing method using the costs incurred by the supplier of the property (or services) in a controlled transaction for property transferred or services provided to a related purchaser. An appropriate gross margin ("cost plus mark up") is then added to this cost, to make an appropriate profit in light of the functions performed 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.'

The guidelines state that this method is most appropriate when semi-finished goods are sold between related parties. The gross margin should be comparable to that earned by a supplier in comparable uncontrolled transactions.

[20] OECD 1994 report, para 115.

Chapter 10

When Can the Commissioner Apply S 31(3) of the Act

Thin capitalisation is a term used to refer to loans made to companies by 'investors', which are disproportionately large in relation to the equity of the company. Section 31 empowers the Commissioner to disallow the interest expense on the portion of a loan, as he considers excessive.

The following are extracts from SARS Income Tax Practice Manual:[21]

> 'The purpose of s 31 [of the Act] is to address tax avoidance schemes involving the manipulation of prices for goods and services under cross border transactions between connected persons. In accordance with international precedent in many developed countries, transfer pricing rules were introduced and may be applied to counter the practice of thin capitalisation.
>
> 'A company may be financed in various ways, for example, by equity capital or by debt capital or a combination of debt and equity. A company is said to be 'thinly capitalised' when its equity capital is small in comparison to its debt capital.
>
> 'Because a company and its investors may be treated differently for tax purposes, depending on whether the return to the investor originates from debt or equity financing, thin capitalisation may be used as an effective tax avoidance device.

[21] SARS Income Tax Practice Manual in para 3 at A-731 Issue 3.

'On the company side, payments of interest are generally deductible in the determination of its taxable income while dividends are not, giving a company provided with a loan a taxation advantage over a company provided with equity capital.

'In the case of a foreign investor, interest would normally fall within the ambit of s 10(1)(*h*A) of the Act and would therefore be exempt from normal tax. Several countries have introduced comprehensive provisions to counter thin capitalisation, allowing the recharacterisation of debt as equity and consequently the denial of the interest expense as a deduction if the debt/equity ratio exceeds a prescribed ratio. Such an approach, however, requires very detailed and complex provisions. Many countries on the other hand prefer to apply the arm's length principle contained in their transfer pricing legislation to counter the abusive practices.

'Section 31 of the Act includes within the ambit, the granting of financial assistance. This will enable the Commissioner to adjust the interest rate in terms of a loan which is not market related on the basis of the arm's length principle.'

The OECD recommends various approaches to the treatment of thin capitalisation, including the following:[22]

- The fixed ratio approach (if the borrower's debt exceeds a certain proportion of its equity capital, the interest on the loan, or the interest on the excess of the loan, or the interest on the excess of the loan over the approved proportion, is automatically disallowed or treated as a dividend). This method has been adopted in South Africa.

[22] Deloiite & Touche Transfer Pricing, para 8, at 24.

- The general anti-abusive approach, the arm's length principle, in general, involves looking at the terms and nature of the contribution of capital and the circumstances in which it is made in order to determine whether its real nature is debt or equity. In South Africa, the existing exchange control restrictions should also be considered in this regard.
- Double taxation agreements may have a restrictive effect on domestic thin capitalisation provisions.

Chapter 11

How Does the Commissioner Establish the Acceptable Debt Equity Ratio

On 14 May 1996 the Commissioner issued a practice note (SARS Practice Note 2) entitled 'Determination of taxable income where financial assistance has been granted by a non-resident of the Republic to a resident of the Republic'.

This practice note deals with both thin capitalisation and transfer pricing.

When a non-resident investor has lent money to a South African borrower who is a connected person or a person in whom the non-resident has a greater than 25% stake, the following two steps are necessary:

- Calculate the amount of the loan, which is acceptable in terms of the thin capitalisation rules, and disallow the interest on the excess as a deduction.
- On the deductible portion of the loan, determine if the rate of interest is excessive and disallow the excessive portion.

The following extracts from SARS Practice Note 2 are relevant:[23]

'1. *Introduction*

'1.1 In anticipation of a possible relaxation in exchange controls, the Commission of Inquiry into certain aspects of the Tax Structure of South Africa (under the chairmanship of Prof M.M. Katz) recommended in its first and second interim reports that transfer pricing provisions be introduced into the Income Tax Act, 1962 (the Act), *inter alia* to counter thin capitalisation practices which may have adverse tax implications for the South African fiscus.

[23] Tax Handbook 1997-98 at 478.

'Transfer pricing provisions are normally applied to adjust the prices of goods and services in terms of certain transactions concluded between related parties to reflect an arm's length price which would have applied had the transaction been concluded on normal commercial grounds between unrelated parties. The effect of the application of transfer pricing provisions is to neutralise the tax benefit arising from such transactions. On the other hand, thin capitalisation provisions are applied to limit the deductibility of interest where there is disproportionate ratio between the loan capital and equity employed in, for example, a company.

'In order to counter such practices, s 23 of the Income Tax Act, 1995 (Act No.21 of 1995), substituted s 31 [of the Act]. Such section consists of a combination of transfer pricing and thin capitalisation provisions, which may, for instance, be applied where financial assistance is granted in respect of international transactions.

'1.2 Measures to counter transfer-pricing schemes are in essence contained in s 31(1) and (2) [of the Act]. Although these provisions may also, in certain circumstances, be applied to combat thin capitalisation, the provisions of subsection (3) are more specifically aimed at countering thin capitalisation schemes.

'Once the excessive portion of financial assistance has been determined in accordance with the guidelines as set out in para 4 of this Practice Note, the provisions of s 31(2) [of the Act] must be applied to determine whether the interest calculated on that portion of the financial assistance falling within the 3:1 guideline provided in the aforementioned paragraph, is based on an arm's length price (interest rate). In this regard consideration should be given to the guidelines provided in para 2.2.

'On a literal interpretation of s 31 [of the Act], the concept of financial assistance would include not only interest-bearing financial assistance, but also interest-free financial assistance. As the purpose of subsection (3) is in essence to enable the Commissioner to determine an acceptable debt/equity ratio in order to disallow a deduction in respect of interest relating to the excessive portion of loan capital, the application of subsection (3) will be limited to interest-bearing financial assistance. This will, however, not have the effect that financial assistance, which is not interest bearing, will be regarded as permanent owner's capital.

'On the same basis only, interest-bearing financial assistance will be taken into account in the application of the transfer pricing provisions of subsection (2) in cases where it is applied in conjunction with the provisions of subsection (3) in order to determine whether the interest calculated on that portion of the financial assistance falling within the 3:1 guideline based on arm's length price (interest rate). Where, however, the application of the thin capitalisation provisions are unnecessary because the financial assistance granted falls within the prescribed guidelines, financial assistance may include financial assistance which is not interest-bearing in the application of the provisions of sub-section (2) ...

'4. *Determination of "disallowable interest" relating to excessive financial assistance*

'4.1 As a general guideline, the Commissioner will not apply the thin capitalisation provisions contained in s 31(3) [of the Act] where the financial assistance/fixed capital ratio does not exceed 3:1. The excessive portion of financial assistance granted by an investor will, therefore, be that portion of the financial assistance which exceeds an amount equal to three times the fixed capital of the resident or recipient of the financial assistance. This approach will ensure a degree of continuity, as it will, to some extent, correspond with the current practice of the Exchange Control Authorities. The interest (interest, finance charge or other consideration including *inter alia* a discount or premium) in relation to or in respect of financial assistance shall be apportioned between the amount of financial assistance which is considered to be acceptable and the amount of financial assistance which is regarded as excessive. In order to determine which portion of interest relates to excessive financial assistance in relation to an investor in respect of a year of assessment, the following formula will be applied.

$A = B \times (C-D) / C$

in which formula:

"A" represents the disallowable [non deductible] interest, limited to interest incurred during such year in respect of financial assistance granted on or after 19 July 1995;

"B" represents the total interest incurred during such year in respect of all financial assistance, contemplated in subsection (3), in existence during such year (whether or not such financial assistance was granted before, on or after 19 July 1995);

"C" represents the weighted average of all interest-bearing financial assistance which was in existence during such year (whether or not such financial assistance was granted before, on or after 19 July 1995); and

"D" represents the greater of:

- three times the fixed capital of the resident or recipient as at the end of the relevant year of assessment; and
- the weighted average of all interest-bearing financial assistance granted prior to 19 July 1995, which existed during such year.

'4.2 The financial assistance contemplated in s 31 [of the Act] to be used in symbol C is an amount equal to the weighted average of the financial assistance in existence during the relevant year of assessment and includes interest-bearing financial assistance only. Where no significant variation occurred in the level of financial assistance during the year of assessment, the amount of financial assistance as it exists at the end of the relevant year of assessment may be used. Trade credit, which is interest bearing, must be included in the amount of financial assistance granted as contemplated in s 31(1).

'Furthermore, where a South African company is partially owned by an investor (for example 50%) and such investor is jointly and severally, together with other shareholders, liable in terms of a security provided in respect of:

- a foreign bank overdraft of the South African company; or
- any other independent third party foreign loan to the South African company,

[part] of the overdraft or loan, *pro rata* to the investor's interest in the company, will be regarded as financial assistance granted by such investor.

'4.3 In determining the amount of fixed capital of the resident or recipient in the Republic, the following items are to be taken into account on a *pro rata* basis in accordance with the investor's interest in the South African entity:

- share capital;
- share premium;
- accumulated profits of a capital and revenue nature; and
- permanent owner's capital (excluding any financial assistance) in circumstances where there is no share capital.

'Fixed capital will be reduced by any reserves and increased by any losses' resulting from the revaluation of assets. The amount of fixed capital to be used when calculating symbol "D" of the formula is an amount equal to the fixed capital at the **end** of the relevant year of assessment. The annual net trading losses sustained, however, during the current and immediately preceding two years of assessment, limited to losses sustained for years of assessment during which the investor has granted financial assistance to the resident or recipient, may be added back to fixed capital to be used in symbol "D" of the formula.

'4.4. In determining the fixed capital relating to investors the calculation should not be done on the basis of what the investors invested, but rather on such investor's pro rata share of the total fixed capital. Furthermore, fixed capital will exclude deferred tax determined for accounting purposes.

'4.5. Where financial assistance is granted to a resident of the Republic by more than one investor as contemplated in subsection (3), the rules of s 31 [of the Act] will be applied to such investors, without reference to any persons other than an investor having an interest in the fixed capital of the resident or recipient ...

'6. Commissioner's discretion

'6.1 Notwithstanding the guideline of the 3:1 ratio and the interest rates referred to in para 2.2, with regard to the application of s 31 [of the Act], it is acknowledged that a higher level of financial assistance in contrast with the guideline ratio of financial assistance to fixed capital or a higher interest rate may be applicable as a result of transactions and agreements entered into for commercial and economic reasons rather than to obtain tax advantages.

'6.2 Where a taxpayer, therefore can justify a higher level of financial assistance in contrast with the guideline ratio of financial assistance to fixed capital or a higher interest rate under particular or special circumstance, he may approach the Commissioner, to exercise his discretion in terms of s 31 [of the Act]. This will, generally be of a temporary nature and a period may be specified within which the 3:1 ratio should be restored or the interest rate is reduced.

'6.3 Taxpayers falling within the 3:1 ratio will not be required to justify their ratio. They must, however, submit the information requested in the annual income tax return...

'7. *Financial assistance in currency other than rand*

Where financial assistance is denominated in a currency other than the currency of the Republic, the equivalent currency value of the Republic must be determined by applying the spot or relevant forward rate, as the case may be, on the date the amount of financial assistance is to be determined. Where, however, there is an increase in the rand value of the financial assistance as a result of the weakening of the rand against the relevant foreign currency, the rand value of the financial assistance may be determined with reference to the spot or relevant forward rate, as the case may be, on the following dates. In the case of a loan owing by a person, the date on which the amount payable in respect of the loan was received by such person and in the case of a debt owing by a person, the date on which the debt was actually incurred...

'8. *Back-to-back arrangements*

In the application of s 31(3) [of the Act] the terms "*financial assistance granted indirectly*" includes back-to-back arrangements through independent parties or co investors. Where a foreign parent company, therefore makes a loan to a South African bank, a foreign bank or any other person on condition that the bank or other person on-lends the funds to the South African subsidiary of the parent company, the loan will be treated as financial assistance. Where the foreign parent company provides a guarantee to a foreign bank or any other non-resident as a security for a loan to the local subsidiary, the bank debt will be treated as financial assistance. Where, however, the foreign parent company provides a guarantee to a South African bank as security for a loan to the local subsidiary, the bank loan will not be treated as financial assistance as the foreign company will not receive any interest and the recipient of the interest will be taxed thereon.'

Comments on SARS Practice Note 2

Whilst the provisions of s 31 of the Act may seem rather penal and far reaching it is important to bear in mind that their application is fairly circumscribed. In this regard the following points must be borne in mind:

Thin capitalisation provisions

- Thin capitalisation provisions may only be invoked by the Commissioner if the non-resident providing the financial assistance is either a connected person (as defined) in relation to, or holds at least a 25% interest in, the local entity to which the assistance is given. Accordingly not every loan by a non-resident shareholder is subject to these provisions.
- Thin capitalisation provisions are only applicable if the recipient of the financial assistance is 'managed or controlled' in South Africa. Generally the words 'managed and controlled' are the words used in the Act. A company is usually regarded as being managed and controlled in the country where its board of directors meet and exercise their control over its affairs.
- Any financial assistance given prior to 19 July 1995 is not subject to these provisions.
- In determining the 3:1 debt to equity ratio, the Practice Note does provide some latitude in that
    - trading losses incurred whilst financial assistance is being extended may be added back to fixed capital for a three year period, and

- when the rand value of the debt increases as a result of a devaluation of the rand, the value of the debt is taken as being the initial rand proceeds received in South Africa.

Transfer pricing provisions (excessive interest rate)

- Transfer pricing provisions may only be invoked if the borrower and lender are connected persons, that is, a loan by a shareholder with a shareholding in excess of 25% who is not a connected person, would not be subject to these rules.
- The comments above regarding the meaning of 'managed or controlled' apply equally here.
- The provisions do not apply to loans granted before 19 July 1995.
- When the non-resident connected person provides interest-free funding, that funding may be taken into account in determining the effective interest rate (provided the thin capitalisation rules have not been invoked).

General

The Practice Note makes it clear that the Commissioner has a fairly broad discretion in applying these two provisions. In this regard the following statements are relevant:

- The Practice Note states that where

> 'a taxpayer ... can justify a higher level of financial assistance in contrast with the guideline ratio of financial assistance to fixed capital or a higher interest rate under particular or special circumstances, he may approach the

> Commissioner, to exercise his discretion in terms of s 31 [of the Act]. This will generally be of a temporary nature and a period may be specified within which the 3:1 ratio should be restored or the interest rate reduced.'

It goes on to state that taxpayers falling within the 3:1 ratio would not be required to justify their ratio.

- The Practice Note indicates that even if the 3:1 ratio were exceeded, the provisions would not be invoked if the recipient is subject to South African tax on the interest received.
- All the decisions of the Commissioner are subject to objection and appeal as s 3(4) of the Income Tax Act encompasses s 31 of the Act.

Chapter 12

Tax Consequences for South African Branches with Foreign Companies

In Deloitte & Touche, Tax News the following was stated:[24]

> 'In 1995 fairly detailed transfer pricing provisions were introduced into the Act. These are designed to ensure that the pricing of goods or services flowing between residents and non-residents does not unduly undermine South Africa's tax base. For example, if a resident undercharges a non resident (who may be a connected party) for services rendered, the resident's taxable income would be "artificially" reduced to the disadvantage of the South African fiscus. Accordingly, Revenue is given the power to adjust, for income (normal) tax purposes, the price at which goods or services are supplied between "connected persons" (one of whom is resident and one of whom is non-resident) where the prices used by the parties is not an "arm's length price".
>
> 'These provisions have been extended to a situation where both parties to the transaction may be non-resident, but the goods or services are supplied to a "permanent establishment" of one of the parties in the country. For example, one group company (assume a United Kingdom company) may supply goods to the South African branch of another company in the group, which is incorporated in, assume the United States of America. As the branch's profits are likely to be taxable in South Africa, the price at which it acquires goods or services from related parties would effect its South African tax liability. Hence Revenue is now given the power to adjust the pricing where it does not reflect an arm's length price. This amendment is effective in respect of the supply of goods and the services on or after 29 June 1998.'

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[24] Tax News Issue No 4/98 at 9.

The amendment to s 31 of the Act made by the Commissioner has made South African branches of foreign owned companies subject to the transfer pricing provisions. Branches in South Africa, which are foreign owned are faced with a possible risk if they have not determined their transfer pricing on an arm's length basis to the satisfaction of the Commissioner.

The following comment made in an article that appeared in Accountancy SA indicates the tax consequences for South African branches of foreign companies:[25]

> 'Foreign companies will, in any event when completing their 1999 tax return, have to contemplate the transfer pricing questions like: "how safe is my branch in the event of a transfer pricing audit?"
>
> 'Section 31 was amended in terms of the Income Tax Act 30 of 1998 promulgated on 29 June 1998 and effective as from that date. The effect of this amendment is to include branches of foreign companies in the ambit of s 31 [of the Act]. Prior to the amendment branches escaped the net on technicality.
>
> 'Since its introduction on, 19 July 1995, s 31 [of the Act] referred to an "international agreement", which was defined as:
>
> a transaction, operation or scheme entered into between
>
> *(a)* a person who, in the case of a natural person is ordinarily resident in the Republic or in the case of a person other than a natural person, is managed or controlled in the Republic; and

[25] John Stanley, 'How safe is your branch' Accountancy SA November/December 1998, at 19.

(b) any other person who; in the case of a natural person, is ordinarily resident outside the Republic or in the case of a person other than a natural person, is managed or controlled outside the Republic.

'From this definition it is clear that the concept of management and control is a vital component in determining whether the provisions of s 31 [of the Act] can be successfully applied. In the absence of a definition of management and control, the courts have interpreted this wording to mean:

'In the leading United Kingdom case of *De Beers Consolidated Mines Ltd* v *Howe* (1905) 2 KB 612 the court came to the conclusion that a company is resident where its "central management and control actually resides". It was held that under this test, a company is consequently resident where its controlling board meets. The concept that the directors must be regarded as having the control of the company has been specifically approved in the number of South African cases. In the AD decision of *Estate Kootcher v CIR* 11 SATC 298, the court, in referring to the residence of a company in the context of its management and control, saw this as being "determined by the periodic, usual or habitual location of the directing mind". The court drew a distinction between the location of control of the company (as exercised by the "directing mind" of the company's officer's) and the place where the company's trade or business is carried on. Meaning by the phrase the actual operations, which earn a profit and not the central control of those operations.

'Given that a branch cannot have a place of management or control separate from that of its head office, it is unlikely that a branch could be seen to be managed or controlled in the Republic. In terms of the original wording of s 31 [of the Act], this branch would therefore escape the ambit of s 31. It is for this reason that s 31 [of the Act] was amended by extending the definition of "international agreement" to include the following wording:

"And

(b) Between

(i) a person who, in the case of a natural person, is ordinarily resident outside the Republic or in the case of a person other than a natural person is managed or controlled outside the Republic; and

(ii) any other person who in the case of a natural person, is ordinarily resident outside the Republic or in the case of a person other than a natural person, is managed or controlled outside the Republic.

'For the supply of goods or services:

(aa) to be utilised in the business activities or either of such persons carried on through a branch in the Republic; or

(bb) to be supplied by the business of either of such persons carried on through a branch in the Republic to any connected person in relation to either of such persons."

'Clause (*aa*) of the amendment deems the South African branch of a foreign company (the acquirer of the goods or services) to be a connected person of another foreign company (the supplier of the goods or services) in circumstances where; the foreign companies are connected persons or (*bb*) the foreign companies are connected persons and either of them is a connected party in relation to the acquirer of the goods or services from the South African branch (the supplier) of either of them ...

'It is submitted that the amendment successfully includes branches of foreign companies within the ambit of s 31 [of the Act] ...

'The amendment does not deal with the situation of companies which are managed or controlled in the Republic and operate branches outside the Republic, which transact with persons who are connected to the South African companies.

'Furthermore, s 31 [of the Act] does not counter transfer pricing between connected persons who are managed or controlled in the Republic or back to back transfer pricing between persons whom are not connected in the Republic.'

Chapter 13

Secondary Tax on Companies (STC) – What are its Implications with Regard to S 31 of the Act

The relevant extracts from s 64C read as follows:

'(1) For the purposes of this section "recipient", in relation to any company, means:

(a) any shareholder of such company;

(b) any relative of such shareholder; or

(c) any trust of which such shareholder or relative is a beneficiary.

'(2) For the purposes of s 64B any amount which is in terms of subsection (3) deemed to have been distributed by a company to a recipient, shall, subject to the provisions of subsection (4), be deemed to be a dividend declared by such company, notwithstanding the fact that such amount may have been so distributed by way of a loan or credit to the recipient or that the recipient may in consequence of such distribution have assumed any other form of obligation to make a future payment to the company.

'(3) For the purposes of subsection (2) an amount shall be deemed to have been distributed by a company to a recipient if ...

(e) such amount represents an amount which has been adjusted or disallowed in accordance with the provisions of s 31 [of the Act] ....'

Foreign companies (that is, companies with their place of effective management outside the Republic) operating in South Africa through branches or agencies in the Republic are exempt from STC to the extent that dividends declared by them are funded from profits derived from a South African branch.

The only exception is if the profits funded from the South African branch or agency are from gold mining or from the carrying on of long-term insurance business. This is in terms of s 64(5)(*h*).

SARS Practice Note 2 includes a section entitled 'Excessive and disallowable [non deductible] interest subject to secondary tax on companies (STC)'.

The relevant provision reads as follows:[26]

> 'In the case of companies the total amount of the excessive and disallowable [non deductible] interest will be deemed to be a dividend declared in terms of s 64C(3)(*e*) of the Act and STC will be payable on the excessive and disallowable [non deductible] interest. As the determination of the excessive and disallowable [non deductible] portions of interest and the exercising of the Commissioner's discretion are to be made at the time the relevant assessment is raised, the dividend cycle in respect of such deemed dividend will, for purposes of the definition of "*dividend cycle*" in s 64B(1), be regarded to end on the date of assessment in respect of the year of assessment to which the excessive and disallowable [non deductible] interest relates. [This means that the STC payable would have to be paid by the end of the month following the month in which the assessment is dated – that is, STC for an assessment dated 15 June must be paid by 31 July.] Where, however, the taxpayer has been notified in writing by the Commissioner of the amount of the excessive and disallowable [non deductible] interest prior to such date of assessment, the dividend cycle will be regarded to end on month after the date of such notification .... '

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[26] Tax Handbook 97/98 at 483.

Chapter 14

What are the Documentation Requirements for Transfer Pricing

Contemporaneous documentary evidence in respect of the pricing policies, procedures and methods applied by an entity in cross border transactions with related parties, is vital to the issue of transfer pricing.

In South Africa organisations should be examining their documentary evidence and comparing their policies, procedures and methods to those which are considered to be acceptable internationally.

When one is called upon by the Commissioner to demonstrate the arm's length nature of cross-border transfer pricing, acceptable evidence of how prices have been determined is crucial.

This evidence must be in the form of acceptable documentation with regard to the methods used to determine the prices.

MNEs must be aware of the documentation requirements, both from a South African and international perspective.

The majority of countries, including South Africa, do not have any specific statutory provisions, regulations or procedures governing documentation requirements.

Appropriate documentation is, however, essential in avoiding transfer-pricing challenges from the Commissioner, or in settling the issue favourably.

Companies have to maintain substantial additional documentation in relation to related party transactions in order to provide adequate evidence of the arm's length nature of the prices involved. Many countries rely on the OECD guidelines on transfer pricing for detailed supporting documentation with regard to transfer pricing in MNEs. South Africa is no exception in this regard.

The consequences of inadequate documentation may be serious. For example, it may prove difficult to resist a transfer pricing adjustment, or penalties may be imposed for failure to properly document transactions.

The essential issue in documentary evidence is whether the company has the onus of proving that its prices are determined on an arm's length basis, or whether the burden is on the tax authorities of proving that their proposed pricing adjustment accords with arm's length pricing.

The burden of proof varies from country to country, and clearly has important implications in producing adequate documentation in relation to the pricing method used, if the burden of proof is on the taxpayer. Documentation in relation to transfer pricing policies would have to be maintained by the taxpayer in order to substantiate its transfer prices. In South Africa the burden of proof would most likely fall on the taxpayer in terms of s 82 of the Act.

The OECD guidelines include a chapter on documentation, giving guidance on documentation rules and procedures and information relevant to a transfer pricing enquiry. These guidelines may be summarised as follows:

- The arm's length principle should be considered before the transfer price is established.
- Prudent business management principles should be applied when considering whether its transfer pricing is appropriate.
- The taxpayer should comply with reasonable requests by the Commissioner for translation of documents.
- The taxpayer may need to prepare information, which is only required for tax purposes.
- Documentation retention should be limited where pricing adjustments are time barred.
- Only information, which could reasonably have been available at the time, the transfer pricing was established should be subject to enquiry by the Commissioner.
- The Commissioner should not require the taxpayer to produce documents that are not reasonably or actually available.
- Information required in relation to foreign associated enterprises should take account of the difficulty of obtaining this information.
- The Commissioner should take care to ensure that there is no public disclosure of confidential data.
- The taxpayer must take into consideration that adequate record-keeping practices and the voluntary production of documents may improve the persuasiveness of its approach to transfer pricing.

- Documents required to be produced at the time a company files its tax return should be limited to that which is sufficient to allow the Commissioner to determine approximately which enterprises need further examination.
- The need for documents should be balanced by the costs and administrative burden, especially when this involves the creation of documents that would not otherwise have been prepared.
- Documentation requirements should not impose on the taxpayer costs and burdens disproportionate to the circumstances.
- The taxpayer should recognise that adequate record-keeping practices and voluntary production of documents facilitates examinations and the resolution of transfer pricing issues.
- The Commissioner and the taxpayer should commit themselves to a greater level of co-operation in addressing documentation issues.
- The taxpayer should be forthcoming with relevant information in its possession, and the Commissioner should recognise that it can often use exchange of information agreements as an alternative way of obtaining information.

Existence of adequate documentation?

It is essential that MNEs determine the different, formal and informal, requirements in the countries in which they operate, and that they comply with these requirements.

The fundamental objective in documenting transfer pricing is to identify the method used, and to be able to demonstrate why it is an arm's length price. In order to defend its transfer pricing policies, it may be necessary for a company to exceed the minimum requirements of the countries in which it operates.

The timing of preparation of documentation is also important, since some countries require agreements to be prepared before the transaction is entered into. An example would be, in the case of agreements for service charges and inter-company financing.

The issues, which should be addressed by MNEs, are as follows:

- Are there specific statutory documentation requirements?
- Does the Commissioner have formal documentation requirements?
- Is there a requirement to file details of related party cross-border transactions?
- Must information of foreign connected parties be disclosed?
- Do the laws of South Africa permit the Commissioner to obtain information from competitors?
- Is additional documentation of transactions with connected parties in tax haven countries required?
- What penalties may be imposed?
- Are the costs of maintaining the transfer pricing documentation tax deductible?
- Is the onus of proof in transfer pricing issues on the company, necessitating additional documentation requirements?

Chapter 15

A Global Survey on Transfer Pricing

There has been a global survey done by Ernst and Young. The following were the findings of their survey:[27]

'The explosive growth in world trade in recent years, and the resulting increase in cross-border transactions between related parties, has catapulted transfer pricing to the forefront of important international tax issues. MNEs of all sizes are finding their transfer pricing practices under increased scrutiny by tax authorities.

'In a recent survey conducted globally on transfer pricing, interesting trends were revealed, amongst which the finding that 52% of MNEs cited the inter-company provision of administrative and managerial services as the transactions they believe are most susceptible to transfer pricing disputes, especially outside the head office country. This is because subsidiaries are increasingly called upon to demonstrate the value of the service, as well as the arm's length nature of the payment.

'The survey also found that only half of all MNEs facing transfer-pricing disputes of any kind were able to defend profits to tax authorities during an examination.

'Other findings included:

- 'MNEs throughout the world regard transfer pricing as the most important international tax issue their organisations will face over the next two years.
- 'Nearly two-thirds of MNEs surveyed reported that their inter-company transactions had already been the target of a tax authority examination.

[27] Transfer Pricing – 1997 Global Survey, Ernst and Young.

- ‘Eight in ten multi-nationals expect to face a transfer pricing examination within the next two years.
- ‘Transfer pricing is viewed as a compliance exercise in some organisations, while in others it has made the move to the boardroom, where it is considered as part of corporate strategic planning.

‘The survey polled 393 MNEs in 12 major countries and 76 foreign-owned subsidiaries in Europe and the United States on issues involving transfer pricing or what multi-national affiliates charge each other when exchanging goods, property and services.

‘The survey did not encompass South Africa where, to date, transfer pricing has largely been viewed as a non-issue.’

Chapter 16

Conclusion

The accelerated phasing out of General Export Incentive Scheme (GEIS) benefits has highlighted the importance of international tax planning for boosting a company's profit. Those South African companies that explore the foreign duty and tax savings techniques open to them could well discover that these savings outweigh the loss of GEIS. In the past, foreign direct and indirect taxes have been overlooked; being regarded as fixed costs. In fact, foreign taxes, like South African taxes, may be significantly reduced and sometimes avoided with proper tax planning.

Globalisation helps companies maintain and improve profitability through the following ways:

- As double taxation treaties.
- Identifying local and regional incentives or relief.
- Making decisions about the most appropriate offshore structure for their business.

South African businesses should focus on increasing their foreign profit in a company abroad while planning to reduce taxes abroad. By effectively managing the risk undertaken by an offshore company, greater foreign profit could flow to it.

Whilst it may be said that the legislative regulation of transfer pricing is a relatively new issue in South Africa, it is likely to become more important as the level of international trade increases and as the Commissioner becomes more vigorous in enforcing the legislation.

Affected companies need to be aware not only of the transfer pricing issue, but also of the relationship between the tax and customs legislation relative to related party valuation.

In addition, those companies which excessively inflate the selling price of goods being imported into South Africa, in order to reduce South African normal tax, need to be aware of the possible adverse implications, which may include any of the following:

- An attack by the Commissioner under s 31 of the Act.
- An increase in the duties payable (including excise duty on specified products), assuming the goods are dutiable.
- An increase in the VAT payable (which is based on the customs value).
- An increase in the wharfage payable (also generally based on customs value).

Depending on the product, it is possible that additional duties, VAT and wharfage payable may exceed the normal tax saved. If an attempt is made to artificially reduce the price of the goods excessively, the company may be subject to

- an attack by the Customs and Excise department under s 66(2)(*a*), or
- an attack by local industry on the basis of 'dumping' (that is, flooding the market with a particular product).

Clearly, proper consideration of these issues is vital to avoid difficulties in future.

Transfer pricing is an art, not a science, and so easily breeds uncertainty in the fields of taxation. In this respect, the Katz Commission has recommended an advance pricing agreement procedure, which if adopted, would enable a group's transfer price to be agreed in advance with the Commissioner.

Armed with new powers under the Income Tax Act, the Commissioner has started implementing recent legislation dealing with the issues of transfer pricing and thin capitalisation. The former involves the manipulation of prices on intra-group sales to shift profits to low-tax jurisdictions. The latter describes the capitalisation of a local operation, mainly through loans from the holding company abroad, which makes it cheaper, tax wise; to take profits out as interest payments rather than dividends.

Major industrial countries have increasingly introduced anti-avoidance sections into their Acts, targeting these practices. The Commissioner has now included in the IT14 form, Part 5, question 5.30, which requires the following:

> 'Did the company enter into any international agreement with a connected person in respect of goods and/ or services as contemplated in s 31 [of the Act]?'

Should the answer be 'Yes' then the taxpayer is required to complete the following schedules, which must be submitted together with the tax return:

- Names of the contracting parties and relationship to the company.

- Details of the basis for determining the prices used.
- Details of the prices which would have been used had the transaction been between independent parties dealing at arm's length.
- Copies of the agreements between the contracting parties.

If this question is not answered correctly, the taxpayer should be aware of the fact that no prescription will apply in terms of s 79(1)(*i*). Since s 31 of the Act is applicable to all related party transactions entered into on or after 19 July 1995, the Commissioner will be able to reopen all assessments after that date, regardless of how many years have passed.

If adjustments to taxable income are made, significant amounts of interest and penalties may be incurred.

It is easy to ignore transfer pricing because it would appear that the Commissioner is generally ignoring it. Unfortunately, the situation currently favours the Commissioner. It requires information which, if not given with the necessary care, would ensure he has an unlimited period of time to go back and collect his dues, without giving the taxpayer any guidelines on how to comply.

John Stanley in an article[28] criticises the Commissioner for his simplistic yes-or-no questions in the corporate tax returns in relation to these issues.

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[28] 'Damned if you do' Financial Mail, 7 June 1996 at 49.

To be able to answer these questions, the taxpayer needs to understand some complex legal issues. It is difficult to evaluate what a price could or would have been, in the hypothetical circumstances of an arm's length transaction.

He argues there may be a dearth of comparable transactions in the open market to serve as a direct reference price. In those circumstances, companies must resort to indirect procedures (for example the determination of a resale price). Stanley explains that if the taxpayer answers 'yes' to the inquiry about transfer pricing, the taxpayer would have to submit schedules with intricate details of the transaction. This would include an explanation of the method used to determine the price and state what the price would have been if negotiated by independent parties.

An incorrect 'no', though, could be regarded by the Commissioner as a misrepresentation of the facts. The taxpayer's assessment could then be reopened even after the expiry of the normal period of prescription (three years from assessment date).

In the case of thin capitalisation, the taxpayer would be called upon to explain why the assistance received should not be regarded as excessive in relation to the fixed capital of the subsidiary. Here again, the taxpayer would have to answer questions of an intricate legal nature, possibly to its future detriment.

Debt:equity ratios over 3:1 would be challenged. Interest paid by the subsidiary, on loans regarded as excessive, would be disallowed as a deduction in the borrower's hands. It will, instead, be treated as a dividend.

The area of transfer pricing is well understood by many foreign companies, where it is often a matter of priority.

Dealing with the taxation implications of transfer pricing, however, remains a new experience in the South African financial environment. Unless clarity is forthcoming, the local provisions would serve merely to render the South African tax regime to be an additional burden for potential investors.

The need for skilled advice on these two areas is even greater in South Africa than in foreign jurisdictions where tax staff have developed experience in interpretation and in applying a complicated and subtle process, evaluating a notional price.

The South African Commissioner has not yet grasped these difficulties, how can he advise local taxpayers? The Commissioner has only recently released a practice note on thin capitalisation. No note as yet been published on transfer pricing.

In circumstances where the taxpayer is effectively asked to gather potential evidence against himself, the Commissioner should provide guidance on how to determine an arm's length price where the answer is not obvious in the market place.

The Commissioner could, for example, give a set of procedures to be followed in sequence if the first or second formula do not work. Other points that need to be emphasised are the following:

- The commercial considerations in setting pricing policies.
- The difficulties in providing conclusive external evidence (for both taxpayer and the Commissioner).
- The misleading nature of statistical data.
- Dealing with particular services; and the facts.
- Information and circumstances contributing to management decisions on pricing policies.

Though double tax treaties may provide relief in relation to the Commissioner's treatment of transfer pricing and thin capitalisation, this is not always the case.

Cecilia Potgieter in an article said the following:[29]

> 'Somewhere down the line, many a company would regret its answer to a very simple, yet loaded question that is included in [its] tax return.'

[29] Cecilia Potgiter, 'Transfer pricing: hidden danger', F&T Weekly 8 May 1998 at 26.