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FEEDBACK SUMMARY
TRANSFER PRICING MATTERS DISCUSSED WITH SARS
[26 May 2021]

GENERAL

SAICA attends various discussions and meetings on behalf of members with National Treasury ("NT"), South African Revenue Service ("SARS") and other stakeholders (internal and external). These meetings represent an opportunity for them to obtain further information on any tax matter from the public and discussions and views expressed do not represent policy or decisions. Furthermore, these discussions do not represent an undertaking by SARS, NT or other stakeholders, but merely statements of their understanding or how they perceive or anticipate a particular matter to be addressed.

The below Feedback Summary should be seen in the above context as merely attempts to inform SAICA members of the discussions and of any proposals that were made during such discussions.

FEEDBACK SUMMARY

The SAICA Transfer Pricing Committee requested a meeting with SARS to discuss various pertinent transfer pricing matters. The issues of relevance discussed at this meeting are documented below.

1. UPDATE ON DRAFT INTERPRETATION NOTE ON THIN CAPITALISATION

SAICA enquired as to the progress on the finalisation of the SARS draft Interpretation Note dealing with financial assistance related to transfer pricing issues that SARS said would be published after the OECD had released its report on Financial Transactions. The OECD released this report (Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS: Actions 4, 8-10) on 11 February 2020.

SARS responded that this draft Interpretation Note is not yet finalised. The request for safe harbors was discussed, but it appears National Treasury has decided not to have safe harbors in the legislation and SARS can only provide guidance on what is/will be in the law. SARS could not commit to a date when this will be issued, but if possible, it will be attempted to be issued by the end of this financial year. Taking into account a variety of factors, once "finalised" it is likely that the draft Interpretation Note on Thin capitalization will be re-issued as a draft to allow the public to submit final comments before finalization. SAICA has re-sent SARS its submission dated 7 August 2018 in order for it to be re-considered as part of this process.

It was also noted that Practice Note 7 is outdated in many respects as, for example, it refers to previous legislation which is no longer applicable. Going forward consideration will be given to whether it should be withdrawn and whether or not it will be replaced by a new interpretation note. Given that SARS follows OECD guidance (in the broader sense) extensively, the existing OECD guidance and Notice 1334 of Government Gazette 40375 dated 28 October 2016 may be sufficient. In terms of timing, no clear date could be provided as ongoing events and OECD updates would be awaited.

2. TRANSFER PRICING INFORMATION REQUESTS

On 19 November 2020, SAICA made a submission to SARS on various concerns regarding transfer pricing information requests made by SARS.

Duplicate/uncoordinated requests

In the submission, which specifically related to transfer pricing matters, SAICA members raised a concern that no consideration seems to be taken by SARS officials of information already provided (leading to duplicate requests) and requests that are not co-ordinated within the different SARS departments. SARS noted the concern and acknowledged the taxpayers' frustrations and stated that it has discussed this with the case selection department to see how to address these concerns that are duly noted.

A further concern raised by SAICA is the extent and format of information requested by SARS. SARS noted that it is important to distinguish between information requested before 1 October 2016 (date of the documentation retention notice) and information requested after this date.

Information kept before 1 October 2016

Prior to this date, taxpayers were not required to maintain specific information, as set out in the documentation retention public notice, but SARS believes that it can still request information where relevant. SARS will, however, consider the extent of information requested but urges taxpayers to discuss their concerns with the information requests (such as difficulty meeting deadline dates), with the relevant SARS officials to come up with a date, for instance, that would be more reasonable considering, for example, the type or location of the information requested. For example, if the taxpayer cannot meet the deadline date, this should be discussed with SARS as soon as possible and before the end of the initial deadline.

Information held on/after 1 October 2016

SARS expects this information to be retained as set out in the public notice on documentation retention, and available for SARS inspection should it be requested.

Format of information

With regard to the format of the information requested, SARS noted SAICA's concerns and urged taxpayers to approach the relevant SARS officials and agree on appropriate timing of the submission should the format be maintained or agree on an alternative format that will still provide the necessary information required by SARS.

Interviews
SARS stated that it is an audit practice that when conducting interviews these should be recorded electronically. However, the audit team will not summarise the SARS view, but copies of the electronic version of the recording can be made available to taxpayers to eliminate any factual differences/inaccuracies, on request. SAICA agreed that having the recording is valuable but did suggest that minutes should be prepared as this gives the taxpayer an opportunity to rectify incorrect interpretation of facts before a letter of audit findings is issued. SARS noted that both SARS and the taxpayer can record the interview and encouraged taxpayers to co-operate more with the SARS officials, especially during interviews.

Reasons for extension
SARS agrees that reasons should be provided to taxpayers by SARS for not allowing reasons provided by taxpayers requesting extension.

Information provided by taxpayer but no/little SARS feedback
SAICA requested that SARS provide an acknowledgement of receipt of information provided by taxpayers and that progress reports should be provided that include more detail than just the matter is in progress.

SARS stated that it is difficult to give an indication as to when a matter will be resolved considering the volume of data that has to be processed as well as the complexity of the matters at hand. SARS agrees that, as far as is practical, taxpayers should arrange regular interaction with the SARS auditors and this interaction should be open and provide context to the auditors of the information provided. SARS welcomes this sort of collaboration.

Relevance of information requested by SARS
SAICA noted that SARS information requests in recent time have improved in that they are clear and specific. However, there is still some concern about the relevance of information requested by SARS as sometimes taxpayers don't know what SARS is looking for. Accordingly, taxpayers may then not be able to provide the correct and helpful information. It would be good for SARS to tell taxpayers what the purpose of the request is so that any disputes don't need to land up in the ADR process, which process is quite adversarial. SAICA suggested that SARS should have a third party inhouse panel to evaluate matters. SARS noted the comments and suggestions made.

3. COVID-19 IMPACT ON TRANSFER PRICING

COVID-19 has had an impact on services charges, funding arrangements, comparables etc. as South Africa's lockdown was more severe than similar experience in most other countries. SAICA noted that the OECD released guidance on the transfer pricing implications of the COVID-19 pandemic, and SAICA raised the question if SARS would be issuing similar guidance. SARS noted that the tax authority does not have sufficient information on the impact of COVID-19 as tax returns covering the period are not yet due and filed. However, SARS noted that if guidance is not found in the applicable Practice Notes or Interpretation Notes, then SARS would look to the OECD guidance issued. On SARS' request, SAICA provided SARS with areas for SARS' consideration regarding the impact and implications of COVID-19 on transfer pricing, and that SARS may want to take into account when considering the issuance of guidance in this regard.

These factors included:

- **Budgeted vs Actual numbers**: Is it acceptable to consider transfer pricing on budgeted numbers (if the budget can be shown to be reasonably correct) or can actuals be used but can the months where there was no trading be carved out?
- **Reduced trading adjustments**: Where a taxpayer experienced reduced trading, can an adjustment be made in this regard and if so, how? Performing a regression analysis is complicated and may result in uncertainty, however not performing any adjustments where they would be indicated would also not be an acceptable outcome. It appears that the OECD, in its guidance, supports performing an adjustment and we would therefore assume that this would also be acceptable from a South African perspective. We would appreciate it if this could be confirmed.
- **Acceptance of loss-making entities**: Guidance / clarity on limited risk distributors and whether SARS would accept losses for limited risk entities would be appreciated. We understand that under normal circumstances SARS is of the view that limited risk entities should not incur losses but under the OECD TP COVID-19 Guidance an analysis of specific facts and circumstances may open this possibility. If SARS could provide their view on this it would be much appreciated.

Other considerations included:

- **Intra group services/charges** due to additional services required from the group owing to the impact of COVID-19 would also need to be taken into account.
- **Deviation from intra group legal agreements** due to the impact of COVID-19, eg not meeting a guaranteed profit even if a true up is done, as terms per the intra-group agreement cannot be met.
- **Interest free intra group financial assistance**.
- **Timing of retrospective adjustments**: From our discussions with SARS it is understood that the adjustments have to be made in the same year. However, companies during the time they experienced the economic COVID-19 impact period faced an unusually high degree of uncertainty regarding cashflow/profitability. Therefore, we submit that it would be very helpful if SARS would consider accepting a make up in later years for that year, specifically once all the information (for example revenue of all group companies where services charges are allocated based on annual revenue) is known and, if required, audited. This would assist with avoiding unnecessary financial audit adjustments to prevent the need for a transfer pricing adjustment.

SARS response:

SARS understands the above questions to be raised specifically in light of the impact of COVID-19 on transfer pricing. Currently Practice Note 7 to the SA Income Tax Act, 58 of 1962, as amended ("ITA"), refers to the OECD Transfer Pricing Guidelines for Multinational Entities and Tax Administrations ("OECD Guidelines")for guidance where the Practice Note 7 does not provide for sufficient clarity on a particular matter. Given the circumstances, the guidance issued by the OECD Secretariat on the transfer pricing implications of the COVID-19 pandemic in December 2020, will be considered in addition to the OECD Guidelines in analysing the above considerations. The following extracts from the guidance are worth noting:

Paragraph 5: *"It is important not to lose sight of the objective to find a reasonable estimate of an arm's length outcome, which requires an exercise of judgment on the part of taxpayers and tax administrations. Accordingly, this guidance focuses on how the arm's length principle and the OECD Guidelines apply to issues that may arise or be exacerbated in the context of the COVID-19 pandemic. Thus, it should be regarded as an application of existing guidance under the OECD Guidelines to fact patterns that may arise commonly in connection with the pandemic, and it should not be regarded as an expansion or revision of the OECD Guidelines,*

either with respect to such pandemic-related fact patterns or more generally." (Underlining for emphasis)

Paragraph 6: "*This guidance acknowledges that the economic impact of the COVID-19 pandemic varies widely across economies, industries and businesses, which is a key factor when considering and interpreting its content. Therefore, in any transfer pricing analysis of the implications of the COVID-19 pandemic, businesses should seek to contemporaneously document how, and to what extent, they have been impacted by the pandemic*." (Underlining for emphasis)

Taking the above extracts from the guidance into account in determining the application of the guidance to the considerations outlined above, it is evident that each of the considerations will have to be evaluated on a facts and circumstances basis. This will be considered with reference to the taxpayer's contemporaneous documentation supporting to what extent the taxpayer's operations have been impacted by the pandemic and how that affected its transactions with connected persons or associated enterprises. SARS is, therefore, not in a position to provide a definitive response to each of the above considerations, other than to state that each of the considerations will be *considered on a facts and circumstances basis, with reference to the taxpayers' contemporaneous documentation provided in support thereof*. The considerations may be impacted in different ways depending on the nature of the taxpayer's operations. As examples, taxpayers in the medical sphere may have experienced enhanced demand for their products in South Africa, while other taxpayers may have required fewer services from the group due to curtailed operations.

4. UN VS OECD APPROACH TO PILLAR 1

A recently released UN paper[1] proposes an alternate methodology to tax the digital economy using a very simple approach based on a new Article 12B to be introduced into agreements for the avoidance of double taxation. SAICA requested SARS' views on this different proposal in light of the fact that many African countries might decide to adopt this approach rather than the OECD approach. SARS stated that as these negotiations are still ongoing, it is too early to provide any comment and as this is a policy issue, this matter will be dealt with by NT.

5. TRANSFER PRICING DOCUMENTATION: R100 MILLION THRESHOLD

SAICA requested guidance on what the requirements are and what is the level of transfer pricing documentation expected regarding such taxpayers not meeting the R100 million potentially affected transactions threshold, and what is the status on the imposition of penalties for non-compliance with the submission requirements. It was noted that in practice the strict application of the R100 million potentially affected transactions threshold may cause a significant administrative burden for taxpayers, which do not create any transfer pricing related risk to the *fiscus*.

An example would be a foreign inbound loan where the loan capital exceeds R100 million with no interest payable – the South African resident debtor would now have to prepare and file with SARS a local file and potentially a master file, and in addition maintain the required documentation for submission to SARS, on request. Preparing this documentation constitutes a huge compliance burden for this one loan with no interest payable, and no income tax deduction claimed.

[1] https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2020-08/TAX%20TREATY%20PROVISION%20ON%20PAYMENTS%20FOR%20DIGITAL%20SERVICES.pdf.

SARS response:
SARS stated that the R100 million potentially affected transactions threshold would remain applicable and, if exceeded, the taxpayer would need to prepare and file/retain the relevant documentation. SARS added that if the threshold is not met, then the relevant taxpayer must refer to paragraph 5 of the transfer pricing documentation retention notice and the taxpayer would still need to provide documentation proving that each respective transaction is at arm's length.

A related question was posed to SARS on potentially affected transactions and their value to enquire if, in the case of a cross-border connected persons loan, the loan capital and the interest amount should be considered for determining the R100 million potentially affected transactions threshold. SARS stated that one needs to consider the capital amount as well (at the beginning and end of the year), and not just the interest in isolation.

It was suggested to SARS by SAICA that it could be argued that if a taxpayer did not claim a deduction for income tax purposes in respect of intra group financial assistance then there would not be a 'tax benefit' and consequently there could not be an affected (non-arm's length) transaction. SARS's initial reaction is that the argument is unlikely to succeed, however, in the context of this meeting it is not possible to properly consider the taxpayer's detailed technical reasons for the argument but one could potentially approach SARS for a non-binding opinion.

Regarding the implementation of penalties relating to late/no filing of master file and/or local file transfer pricing documentation SARS confirmed that, currently there are only penalties for CbCR late filing with no specific penalties for late local/master file submission. SARS cannot currently comment on whether late filing or non-filing will be subject to penalties in the future.

6. TIMING OF RETROSPECTIVE TRANSFER PRICING ADJUSTMENTS

Some taxpayers apply transfer pricing policies in terms of which retrospective adjustments are made. SARS was asked for their view as to the appropriate timing of these retrospective adjustments and would it be appropriate for a taxpayer to make such an adjustment in the subsequent year of assessment, for example via an additional invoice or a credit note in the subsequent year of assessment.

SARS response:
With regard to the primary and secondary adjustment, SARS stated that the onus is on the taxpayer to transact in line with the arm's length principle and to demonstrate compliance for EACH YEAR of assessment (YOA) and in that year. For instance, if a taxpayer discovered in 2019 that the amount paid for goods purchased from a foreign connected person in 2018 was not arms' length, i.e. it had overpaid, it will trigger both section 31(2) requiring the taxpayer to prepare their tax computation for 2018 using arms' length (not actual) amounts and section 31(3) giving rise to a deemed dividend/ donation equal to the difference between the actual amount and the arms' length amount. If the transactional position is not corrected in the year of the transaction and the taxpayer includes a transfer pricing adjustment in their taxable income computation in order to prepare it on an arms' length basis as required under section 31(2), it still triggers the deemed dividend / donation under section 31(3). If the facts were that there was an arms' length agreement in 2018 that the amount charged would be the arms' length amount with a credit note issued for any variances then even if only quantified in 2019, that position existed at the end of 2018 and needs to be included in the 2018 financial accounts (accrual for the credit note to be issued) and considered for tax purposes. In that case, the actual amount would be the arms' length amount so it would not trigger section 31(2) or section 31(3).

7. SECONDARY ADJUSTMENT TRIGGER

SARS was also asked whether, in instances where a taxpayer makes the necessary adjustment to ensure that the taxpayer complies with the arms' length principle so that the taxpayer can pay the correct amount of tax, this triggers a secondary adjustment. There is a view that in essence this adjustment would not constitute a primary adjustment. This is based on the understanding that a primary adjustment takes place once the tax has been paid and found to be underpaid as a result of non-compliance. Paragraphs 5.4.7 or 5.4.8 of the South Africa Country Summary chapter in the United Nations Model state that if an adjustment is made after the tax return is submitted then there would have to be a secondary adjustment. The wording therefore seems to suggest that a TP adjustment prior to submission of the return (or in the return) would not trigger the secondary adjustment.

SARS response:
In SARS' view when a taxpayer assesses whether an affected transaction's non-arm's length term or condition results or will result in a tax benefit under section 31(2)(ii) of the ITA, that assessment is based on an assumption that the non-arm's length term or condition, as appropriate, is taken into account in calculating taxable income / tax payable. If the answer is that it would give rise to a tax benefit, then the "actual" taxable income or "actual" tax payable by the person contemplated in section 31(2)(b)(ii) of the ITA must be calculated as if the transaction had been conducted on an arm's length basis. The taxpayer is required to prepare their taxable income or tax payable on this basis and therefore the arm's length principle would need to be taken into account before any relevant return is submitted. Section 31(2) of the ITA does not give rise to a primary adjustment that only "takes place once the tax has been paid and found to be underpaid as a result of non-compliance", it requires the taxpayer to prepare their taxable income/ tax payable calculations on an arm's length basis which is before the return is submitted.

Under section 31(2) of the ITA if there is a difference between the arm's length amount that is taken into account in calculating taxable income or the amount that, but for section 31(2) of the ITA, would have been taken into account (that is, the actual amount) the difference is subject to a secondary adjustment and constitutes a deemed dividend for dividends tax purposes or a donation for donations tax purposes. Therefore, the secondary adjustment would apply irrespective of whether the taxpayer initially prepared their taxable income / tax payable calculation on an arm's length basis and submitted their return on that basis or whether they only subsequently adjusted it after the return was submitted. With an understatement of income or overstatement of expenses irrespective of what is included or claimed for taxable income/ tax payable purposes the underlying funds still flow out of the country and therefore the secondary adjustment is considered appropriate.

In relation to the South African comments[2] in paragraphs 5.4.7 and 5.4.8, we note that the UN Practical Manual on Transfer Pricing is not an "official publication" that is issued by a senior SARS official or the Commissioner for SARS, as described in the Tax Administration Act, 2011 and therefore does not create a practice generally prevailing. However, that said, we disagree that the comments in that manual suggest that a transfer pricing adjustment prior to submission of the income tax return or in the return would not trigger a secondary adjustment. Paragraph 5.4.8 says "*voluntary adjustments made after a tax return has been filed will also incur the secondary adjustment*". The "also" is important and indicates that it is not in those circumstance only that a secondary adjustment will arise. For example, voluntary adjustments made when

[2] Note: Reference is made to the South Africa Country Perspective as reflected in Chapter D.5 of the 2021 UN Practical Manual on Transfer Pricing.

calculating taxable income before the return is submitted will also trigger the secondary adjustment.

8. MEANING AND APPLICATION OF “TAX BENEFIT”

Synopsis: In circumstances where a taxpayer is thinly capitalized, a primary adjustment is required in respect of the excessive interest. That primary adjustment triggers the secondary adjustment. However, the question arises as to what happens if the taxpayer elects not to claim an income tax deduction in respect of the excessive interest? Can it be said that there has been no reduction of income tax by virtue of the excessive interest as it has not resulted in a “tax benefit”? Does it then follow that section 31(2) is not triggered (and there is no secondary adjustment)?

SARS response:
Determining whether or not there is a tax benefit is based on assessing the tax consequences if the actual terms and conditions are applied in calculating taxable income/ tax payable, and if so, then the taxpayer is required to calculate its taxable income/ tax payable applying arm’s length terms and conditions. In the example provided regarding interest, above, one does not therefore look at the amount the taxpayer actually claimed for tax purposes when assessing whether there is a tax benefit, rather one looks at the actual amount of interest. If a taxpayer calculates its taxable income using an arm’s length amount of interest (as that taxpayer is required to do under section 31(2)), a difference still arises under section 31(3) of the ITA between the amount that was applied in calculating taxable income and the amount that would have arisen but for subsection (2), which means there will be a secondary adjustment. Under section 31(2) of the ITA the taxpayer in this example is required under section 31(2) of the ITA to only claim the arm’s length amount of interest. It would not be correct to take the view that because the taxpayer only claimed the arm’s length amount of interest that section 31(3) of the ITA is not triggered.

9. CONCLUSION

SAICA thanked SARS for their time and input. SARS reiterated that it prefers taxpayer engagement throughout the process as it also does not want to have extended audits and would prefer to have an understanding of matters earlier rather than later.