develop.influence.lead.

Ref# Submission File

7 August 2018

South African Revenue Service
Private Bag X923
Pretoria
0001

BY E-MAIL: [redacted]

Dear Sir/Madam

COMMENTS ON THE PROPOSED INTERPRETATION NOTE ON TRANSFER PRICING

1. We herewith take an opportunity to present our comments on behalf of the South African Institute of Chartered Accounts' (SAICA) Transfer Pricing sub-committee (a sub-committee of the SAICA National Tax Committee) on the proposed Interpretation Note on Transfer Pricing (TP IN) to be released by the South African Revenue Service (SARS) at a date in the future, as discussed at the meeting on 13 April 2017 between representatives of SAICA, the Transfer Pricing sub-committee, and SARS.

2. The TP IN submission transpires from an initiative to engage more effectively with SARS, as agreed during the meeting held on 13 April 2017, on transfer pricing matters. Given the future update of the TP IN, SARS requested SAICA to submit proposals in this regard, which SARS will consider during the update procedure of the TP IN.

3. Our submission includes a discussion of some of the most pertinent matters, which we believe require SARS' most urgent attention.

4. We would like to thank SARS for the opportunity to provide constructive comments in relation to the TP IN. SAICA believes that a collaborative approach is best suited in seeking actual solutions to complex problems.

Should you wish to clarify any of the above matters please do not hesitate to contact us.

Yours sincerely

Christian Wiesener

CHAIRMAN: SAICA Transfer Pricing sub-committee

Madelein Grobler

SAICA Project Manager: Taxation

The South African Institute of Chartered Accountants

Contents

A. Introduction and general observations

5. The current SARS' Practice Note 7 (PN 7) objective is to provide taxpayers with guidelines about the procedures to be followed in the determination of arm's length prices, taking into account the South African business environment. It also sets out the Commissioner's views on documentation and other practical issues that are relevant in setting and reviewing transfer pricing principles in international agreements.

6. It is noted in general that the Organisation for Economic Co-operation and Development (OECD), in its Transfer Pricing Guidelines for Multinational Enterprises 2017 (OECD Guidelines), has provided significant further guidance relating to transfer pricing, since the release of PN 7 on 6 August 1999.

7. Submission: SAICA therefore recommends that the TP IN should follow the OECD Guidelines to the extent possible and any deviations from the OECD Guidelines should be specifically noted in this TP IN.

B. Definitions and terminology

8. The OECD Guidelines have gone to great lengths to define the terms relevant within the transfer pricing industry to ensure that they accommodate all role players.

9. Submission: SAICA recommends that all definitions should be as set out in the OECD Guidelines' Glossary, unless a more specific definition exists in the South African transfer pricing legislation or regulations. This should then be specified in the TP IN. It is submitted that the consistent use of definitions is of the utmost importance, as it provides clarity.

C. The arm's length principle

10. The South African transfer pricing legislation is contained in section 31 of the Income Tax Act No 58 of 1962 (the Act).

11. Section 31 of the Act used to empower the Commissioner for SARS to adjust the transfer price between connected persons to a cross-border transaction for the supply of goods or services to reflect an arm's-length price.

12. For tax years commencing on or after 1 April 2012, SARS' powers apply to any transaction, operation, scheme, agreement or understanding entered into directly or indirectly between:

- A South African tax resident and any other connected person which is not a South African tax resident;
- South African branch and a related off-shore group company;
- A South African company and an off-shore branch of a connected group company; and
- A controlled foreign company in relation to a South African resident and a connected person that is not a resident.

13. Section 31 of the Act does not prescribe a particular methodology to determine an arm's-length price. However, South Africa follows the arm's length principle as noted in paragraph 7 of PN 7, given that it is an international norm.

14. Submission: SAICA therefore proposes that the TP IN expressly state that South Africa applies the arm's length principle, as defined and applied from time to time in Article 9(1) of the OECD Model Tax Convention on Income and on Capital. In order to make this principle even more clear, it is proposed that National Treasury is requested to amend section 31 of the Act to include exactly the same requirement.

15. We also propose that it is made clear to what extent Multinational Enterprises (MNEs) may deviate from the arm's length principle. For example, as set out in the OECD/G20 Base Erosion and Profit Shifting Project "Aligning Transfer Pricing Outcomes with Value Creation" Actions 8-10: 2015 Final Reports, a mark-up of 5% is proposed as a safe harbour/cap for low value adding services. SARS should clarify whether it will support this safe harbour provision and also what other safe harbour or similar provisions it will support as a deviation from the arm's length principle.

16. In the alternative, SARS should clearly indicate how the taxpayer is to demonstrate the arm's length nature of the pricing, e.g. depending on the value and/or nature of the potentially affected transaction.

D. Principles of comparability and comparability adjustments

17. Paragraph 8 of PN 7 emphasises that "comparability" is the fundamental to the application of the arm's length principle, which can be affected by various factors.

18. As stated above, SAICA is of the view that the TP IN should align with the OECD Guidelines. This also applies regarding the principles of comparability and comparability adjustments.

19. Submission: SAICA is of the view that only where and to the extent that SARS requires specific additional comparability factors to be considered, or where the comparability factors set out in Chapter III of the OECD Guidelines should not be applied by taxpayers, should SARS provide detailed guidance in the TP IN. The same would apply to instances where comparability adjustments are made, or should be made.

20. SAICA however requests that SARS provides guidance on the following items:

- The treatment of location savings and local market advantages/disadvantages;
- Any comparability adjustments taxpayers should make relating to fluctuations in respect of foreign exchange differences;
- Which foreign country comparables SARS would accept, including from which regions;

- Whether country adjustments are required to be made to these foreign country comparables to reflect material differences between the South African and foreign markets. If this is a requirement, SARS is further requested to provide illustrative examples of how these country adjustments should be effected, as the OECD Guidance does not provide guidance when it comes to country adjustments.

- Comparability adjustments that SARS considers appropriate to be made; e.g.:

  – Working capital adjustments;
  – Group synergy adjustments; and
  – Country adjustments.

- Confirmation that SARS accepts, and taxpayers should rely on, the benchmarking study timeline guidance set out in paragraph 5.38 of the OECD

21. In addition, it is recommended that SARS confirms that it will also perform arm's length outcome testing, using comparable data that was available at the time when the taxpayer would have prepared its transfer pricing documentation for the purposes of the tax return/local file submission.

E. Acceptable methods for determining an arm's length price

22. The current PN 7, more specifically paragraph 9, endorses the standard transfer pricing methods referred to in the OECD Guidelines in order to determine and appraise a taxpayer's transfer prices.

23. Submission: SAICA recommends that such support should continue in the TP IN and furthermore specifically note that the guidance as set out in Chapter II of the OECD Guidelines will be followed.

24. However, it is also suggests that SARS should clarify its position regarding commodity pricing and whether any specific rules should be followed in South Africa. Thus, only if there is an intention to deviate from the OECD view should SARS provide further guidance under this section.

F. Benchmarking and databases

25. SAICA proposes that SARS should include and clarify the following relating to the use of databases and benchmarking studies in the TP IN:

Benchmarking studies

26. The purpose of benchmarking studies is to determine the general conditions surrounding the transactions conducted by third parties in a given market to justify the arm's length nature of an inter-company transaction.

27. Submission: SAICA submits that clear guidance should be provided regarding SARS' expectation in respect of benchmarking studies. We propose the following:

- It should be indicated for general, intellectual property and loan financing benchmarking studies, whether there should be specific search and exclusion steps or, in any case, certain compulsory search and exclusion steps;

- It should be indicated whether there are certain jurisdictions that should be included or excluded for purposes of the search process;

- It should be confirmed that taxpayers are to comply with the guidance set out in paragraph 5.38 (i.e. benchmark studies would be valid for a three year period with annual financial updates) of the OECD Guidelines, unless the value of the transaction does not warrant this (SAICA recommends to apply the R5 million threshold in this regard for consistency);

- It should be indicated whether the financial data of a benchmarking study should be updated on an annual basis or a different period;

- It should be confirmed whether certain adjustments are compulsory; and

- It should be indicated whether in certain instances or under a certain annual monetary threshold, database benchmarking studies would not be required. If this would be the case, SARS should indicate on which alternative basis such transaction/s should be supported.

Databases

28. In order to ensure reliability and accuracy of the benchmarking studies, taxpayers use specialised databases provided by external suppliers. South Africa currently has various databases available in the market to assist taxpayers in performing the benchmarking.

29. Submission: SAICA proposes that SARS should indicate the minimum criteria which such databases would need to meet in order to enable taxpayers to utilize the most suitable database(s) taking into account these criteria. The criteria for these databases should be listed per transaction type, i.e. intellectual property benchmarking, financial assistance benchmarking and “others”.

G. Documentation

30. Transfer pricing documentation guidance is important for taxpayers to clarify the level of documentation that must be prepared, maintained and/or filed with SARS.

31. The documentation guidelines set out in paragraph 10 of PN 7 broadly follows Chapter V of the OECD Guidelines. As South Africa has adopted the Base Erosion and Profit Shifting (BEPS) Action 13 recommendations, it is suggested that it be made clear in the TP IN that the rules as set out in Chapter V of the OECD Guidelines should be followed.

32. Submission: SARS should state in the TP IN to be prepared that taxpayers should follow in the preparation of transfer pricing documentation the guidance set out in Chapter V of the OECD Guidelines.

33. In addition, transfer pricing documentation rules for South Africa are set out in the transfer pricing documentation related Public Notices. Thus, any documentation related rules set out in the TP IN should be consistent with these regulations.

34. Clarity should be provided regarding the use of foreign transfer pricing documentation by a South African taxpayer to support its pricing. Also, the level of transfer pricing documentation rules applicable to taxpayers which do not meet the thresholds set out in the transfer pricing documentation public notices should be clarified.

35. <u>Submission:</u> SAICA submits that it would be useful if specific guidance could be provided in the TP IN regarding:

- Whether it is mandatory for a taxpayer which/who does not meet the threshold set in the transfer pricing documentation public notices to prepare and maintain/file transfer pricing documentation;

- The extent of documentation expected from a taxpayer which does not meet the threshold set in the transfer pricing documentation public notices. In addition, where the documentation threshold is exceeded, however, the company has potentially affected transactions not exceeding R5 million, clarity on whether any analysis needs to be performed for transfer pricing purposes; and

- SARS' approach to foreign transfer pricing documentation, i.e. documentation prepared for a non-South African taxpayer, which is used to support transactions from a South African perspective.

37. Furthermore, it is suggested that it would be helpful to taxpayers if SARS could provide clarification in the TP IN on what constitutes the R100 million threshold for transfer pricing documentation purposes, that is:

- The value of the cross-border connected party transactions which affects the income statement of the taxpayers, or the value in the balance sheet items; and

- The total value of the cross-border connected party transactions of a South African taxpayer alone or the group of SA taxpayers within an MNE Group.

38. The same level of clarification would be required regarding the R5 million threshold.

<u>Example 1(a):</u>

39. The South African taxpayer grants an interest-free loan of R200 million to its foreign connected party, and there are not any other cross-border connected party transactions entered into during the year.

40. The question therefore arise whether this South African taxpayer should be subject to the transfer pricing documentation requirements, ignoring the foreign control rules in South Africa, or not.

Example 2(a):

41. The South African taxpayer has only 1 cross-border connected party transaction during the year. It is the purchase of raw materials amounting to R110 million for production of finished goods.

42. However, during the year, the South African taxpayer only uses R90 million raw materials for production of finished goods, which are then sold to third parties in this year. The South African taxpayer therefore has R20 million raw materials in closing stock.

43. For accounting purpose, only R90 million is expensed as the cost of goods manufactured, and the remaining R20 million raw materials is still accounted in the balance sheet, i.e. not having an impact on the income statement in the financial year in question.

44. The question therefore arises in such instance, should this South African taxpayer be subject to the transfer pricing documentation requirements or not.

H. The Commissioner's approach to transfer pricing reviews, audits and investigations

45. Paragraph 12 of the existing PN 7 deals with the Commissioner's approach to transfer pricing reviews, audits and investigations. PN 7 pre-dates the promulgation of the Tax Administration Act No 28 of 2011 (TAA), which overrides aspects dealt with under this section. We therefore deal with the sections which are not governed by the TAA.

46. Furthermore, the developments at the OECD in terms of the Country by Country (CbC) reporting, Master File and Local File and the Automatic Exchange of Information pertaining to certain of these documents also addresses some of the aspects previously dealt with in paragraph 12.

47. In April 2013, the OECD released a discussion draft on approaching risk assessments in transfer pricing. Numerous comments were received on this draft. The OECD generally provides best practice in matters associated with transfer pricing.

48. Submission: SAICA submits that SARS should incorporate and take cognisance of the TAA, CbC reporting, Master File and Local File and the Automatic Exchange of Information, as well as the OECD discussion draft and the resulting comments thereof when compiling the proposed TP IN.

Use of publicly undisclosed information

49. The use of information which is not publicly available such as "secret comparable" information is frequently used by tax administrations to assess levels of risk. SARS has acknowledged this approach.

50. We agree with the current SARS' approach, which also follows international precedent, that publicly undisclosed information should only be used for risk assessment and not for the basis of any adjustment.

51. Paragraph 12.3.2 of PN 7 however states: *"Nevertheless, the Commissioner does not rule out the possibility that publicly undisclosed information will be used in administering the transfer pricing rules."*

52. Submission: It is suggested that SARS provides clarity should similar wording be used in the proposed TP IN on whether or not that applies to risk assessments or adjustments.

Acceptability of analyses prepared for a foreign tax administration, global pricing policies and Advanced Pricing Arrangements entered into with foreign tax administrations

53. Paragraph 12.5.3 of PN 7 previously required an analysis to be undertaken to determine if the pricing was rewarding the South African taxpayer commensurate with its functions and risks.

54. The OECD adopts the approach that the simple party to the transaction should be the tested party where a one-sided method is adopted. We agree with this view, adopting an alternative approach creates additional burden for South African taxpayers which are affiliates of and transact with less complex foreign entities. Furthermore, this approach is at odds with the revised approach to undertaking and documenting such analyses under the Master File and Local File approaches following the OECD approach.

55. Submission: SAICA recommends that SARS adopts a mechanism for analysis which accords with its stated approach to preparing supporting documentation and that the Local File analysis should suffice.

56. In addition, there is very limited comparable information available to support South African operations, therefore it is common for foreign comparable analyses to be submitted where the South African entity is the tested party in the application of a one-sided method.

57. Submission: SAICA therefore proposes that where an appropriate economic analysis has been prepared as part of a Master File and this is relevant to the local operations, SARS should be prepared to accept this to the extent SARS accepts the delineation of the transaction.

58. SARS has indicated it is not currently considering the adoption of an Advance Pricing Agreement (APA) program. However, in terms of section 29 of the TAA, SARS has requested that taxpayers provide details of APA's concluded with foreign tax administrations.

59. Whilst we disagree with the right of SARS to request this information, in the event that this information is provided, SARS should consider the merits thereof, where it supports a position which may differ from SARS'. Thus, it should be considered as persuasive in demonstrating an arm's length position, where similar to the transaction under review.

60. Paragraph 53 to 59 should be read in conjunction with paragraph 20, 27 and 35 of the TP IN submission.

Transactions with entities in low tax jurisdictions

61. As indicated above, the sharing of information under the automatic exchange of information may go some way to alleviating SARS' concerns in respect of these transactions. However, not all transactions with low tax jurisdictions are motivated by tax savings. Furthermore, it is unclear as to how SARS defines a low tax jurisdiction. Page 161 of the SARS Comprehensive Guide in completing an ITR14 seems to propose that a corporate tax rate of 18% is considered to be a low tax jurisdiction.

62. Submission: SAICA proposes that SARS provides guidance as to the definition of a low tax jurisdiction and keep it consistent with other guidance provided by SARS.

General anti-avoidance provisions

63. SARS has indicated that any adjustment under section 31 of the Act will not prohibit the application of the broader anti-avoidance provisions.

64. Submission: SARS is requested to confirm whether it views section 31 as an anti-avoidance provision and confirm that it should be applied before the application of section 80 of the Act.

65. SARS is also requested to consider the application of section 31 of the Act in relation to transactions with Controlled Foreign Companies (CFC's), where section 9D of the Act has resulted in the income of these CFC's being imputed into South Africa.

I. Interest and penalties

66. SAICA suggests that the applicable rules to penalties and interest be set out in the TP IN. This could largely be based on the information set out in paragraph 13 of the existing PN 7.

67. Paragraph 13.1 of PN 7 (dealing with penalties) refers to provisions applicable in the event of "default" or "omission" in the completion of the tax return or "evasion" of taxation and refers to sections 75, 76, and 104 of the Act that will be applied in such circumstances. It also states that *"The Act does not impose specific penalties in respect of non-arm's length pricing practices".*

68. Detailed provisions relating to tax administrative non-compliance have however been introduced in the TAA and it is not clear whether or not such provisions also apply to transfer pricing non-compliance.

69. Submission: The proposed TP IN should clarify to what extent the TAA is applicable when interest and penalties are levied as a result of transfer pricing non-compliance and adjustments.

70. Paragraph 13.2 of PN 7 (dealing with interest) indicates that an underpayment of tax as a result of a transfer pricing adjustment will trigger the application of section 89*bis* and section 89*quat* of the Act. It is not clear whether a voluntary adjustment/self-adjustment by the taxpayer would automatically trigger the application of this section or not.

71. Submission: The current wording in paragraph 13 of PN 7 dealing with penalties and interest should be updated to ensure it is aligned with Chapter 15 of the TAA. The TP IN should provide clear guidance to taxpayers as to what specific actions/activities would trigger the application of an administrative penalty relating to Part B, a fixed amount penalty (section 210 and 211) or Part C, a percentage based penalty (section 213) under the TAA relevant to non-compliance.

72. The guidance relating to what penalty provisions apply to each type of non-compliance should also be consistent with the regulations set out in Public Notice No 480 GG 41621 (Public Notice 480) dated 11 May 2018 and any notices to be released. For example it is our view that the Public Notice 480 only addresses non-submission of CbCR, Master File and Local File where a taxpayer is required to file all three returns, but it does not, however, address the scenario where a taxpayer only is required to file a Master File and Local File.

73. In the case of the application of the TAA relevant to an understatement of tax, given such TP assessment is typically made by SARS and typically subjective by nature, examples should be provided by SARS as to circumstances in which the "behaviours" contained in section 223 of the TAA would trigger the application of the penalty percentages contained in the understatement penalty percentage table.

74. It should also be confirmed that a "voluntary" transfer pricing adjustment by a taxpayer would trigger a "voluntary disclosure before notification of audit or criminal investigation" as noted in the table.

75. SARS should thus provide specific examples of what the behaviours (i.e. reasonable care not taken in completing return, no reasonable grounds for tax position taken, impermissible avoidance arrangement, gross negligence and intentional tax evasion) for levying of understatement penalties entail with a focus on transfer pricing matters.

J. Tax treaties and Secondary adjustments

76. The secondary adjustment provisions in section 31 of the Act were amended with effect from 1 January 2015. It was, however, not clear whether the deemed dividend *in specie* would be subject to relief in terms of a double tax treaty/agreement (DTA).

77. The Davis Tax Committee made some comments in this regard and came to the conclusion that, in their view, no DTA relief is available as the secondary adjustment results in a tax levied on the South African company rather than on the foreign related party.[1] Guidance was therefore required from SARS regarding the treatment of secondary adjustments.

78. The recent proposed amendment to section 1, 31 and 64D of the Act in terms of the 2018 Draft Taxation Laws Amendment Bill (2018 Draft TLAB) has tried to address this. The 2018 Draft Explanatory Memorandum notes that the proposed amendment clarifies that an amount which constitutes a deemed distribution of an asset *in specie* as a result of a transfer pricing secondary adjustment in terms of section 31 of the Act is excluded

---

[1] Davis Tax Committee BEPS Interim Report on Action 13, page 19 – January 2016.

from the definition of dividend in section 1 of the Act, thereby clarifying that no double taxation relief is available in this respect.

79. It may, however, also be beneficial for the TP IN to refer to the withholding tax (WHT) article to provide guidance on when the secondary adjustment is due and payable.

80. Submission: The TP IN should incorporate the proposed amendments regarding deemed dividend *in specie* which can be reduced by a DTA. The guidance should in addition touch on current DTAs that specifically mention a deemed dividend *in specie,* as well as those which don't. In our view, the comments made by the Davis Tax Committee should be followed.

K. **Burden of proof**

Initial burden of proof

81. Section 31(2) of the Act requires that the taxable income of a person must be calculated as if the transaction, operation, scheme, agreement or understanding has been entered into on arm's length terms and conditions, where a tax benefit is derived by any person as a result of terms and conditions, which differ from arm's length terms and conditions.

82. SARS also issued Public Notice No 1334 GG 40375 (Public Notice 1334) in terms of section 29 of the TAA setting out additional record-keeping requirements. By providing the list of documents under Public Notice 1334, a taxpayer is required to carry out its duty of proving that all potentially affected transactions have been entered into at arm's length.

83. Section 31(2) of the Act, read with sections 2 and 3 of the Public Notice 1334, brings to light the fact that the initial onus to prove the arm's length characteristics of an potentially affected transaction lies with the taxpayer.

84. Determination of an arm's length price of potentially affected transactions requires an understanding of the industry in which the taxpayer and its connected persons are operating. It further requires an understanding of the value chain, functional analysis of the taxpayer *vis-à-vis* connected persons and economic analysis of the transactions in question, including a comparability analysis and benchmarking studies.

85. The reason for placing the initial burden of proof on the taxpayer is that the taxpayer is generally in a better position to understand and analyse the industry in which it is operating and perform an economic and comparability analysis. Being a party to the transactions with its connected persons, the taxpayer is in full knowledge of its business and also has the knowledge about the business of the connected persons.

Shifting burden of proof

86. Once SARS forms an opinion that the taxpayer's determination of arm's length price is not in accordance with specific transfer pricing provisions, it may then proceed to determine the arm's length price in accordance with the specific transfer pricing provisions by issuing a notice to the taxpayer.

87. Since the initial burden to prove the arm's length price lies with the taxpayer, the taxpayer is required to prove that the transactions entered into by it with its connected persons are at arm's length.

88. If the taxpayer presents reasonable arguments and provides sufficient evidence that the transactions with its connected persons were at arm's length, then the burden of proving that the transactions were not arm's length shifts to SARS.

89. In order to prove that the taxpayer's pricing of transactions with its connected persons was not at arm's length, SARS should follow the statutory provisions to determine the arm's length price. SARS cannot merely reject the transfer pricing document maintained by the taxpayer without assigning reasons.

90. In other words, once the taxpayer proves its *bona fides* and that the taxpayer exercised due diligence and good faith, while determining transfer price for a potentially affected transaction with connected persons, the burden of proof shifts to SARS to prove otherwise before making any adjustments to the taxable income of the taxpayer.

91. Submission: SAICA therefore proposes that SARS clarifies in the TP IN its views towards what is required by a taxpayer to discharge the burden of proof.

L. Automatic exchange of information

92. The OECD notes that the world has become increasingly globalised and cross-border activities have become the norm. Greater transparency between tax administrations are therefore required through the Automatic Exchange of Information (AEOI) to counter cross border tax evasion, aggressive tax avoidance and BEPS through, for example, transfer pricing arrangements.

93. SARS notes on its AEOI webpage[2] that South Africa was an early adopter of the new international standards for AEOI, which include both the US Foreign Account Tax Compliance Act (FATCA) and the OECD Common Reporting Standard (CRS). SARS specifies on the AEOI webpage who, what, how and by when taxpayers should report, but no detail is provided where SARS would obtain taxpayer's information utilising the adopted new international standards for AEOI or other available sources.

94. Submission: It is recommended that SARS lists the various sources from which it will obtain taxpayer information in the TP IN. For example, it should be listed that information will be obtained through, CRS, CbC reporting, the transfer pricing documentation requirements as set out in the related Public Notices, etc.

95. It should also be made clear whether, and on what basis, SARS may consult sources external to the taxpayer, for example, by looking at the CbC reporting, transfer pricing documentation or tax returns of another taxpayer within the same or similar industry.

[2] http://www.sars.gov.za/ClientSegments/Businesses/Mod3rdParty/AEOI/Pages/default.aspx

96. It should further be made clear what databases will be used by SARS (see discussions above in this regard).

97. If SARS intends to adjust/convert any information provided to it by a taxpayer before submitting it through the AEOI mechanisms, SARS should confirm the accuracy/facts with the taxpayer. For example, if SARS extracts information from the Business Requirement Specification (BRS) and populates the CbC reporting forms in order to submit it to another authority/administration, the taxpayer should be able to confirm that it agrees with the information. Alternatively, SARS should submit information in the exact format in which the taxpayer submitted it.

M. Advance pricing agreements

98. SARS currently does not offer an APA programme as stated in paragraph 16 of PN 7, and it has indicated that there is no intention to introduce any such programme in the near future.

99. However, internationally, APA programmes have become more and more accepted, for example in India, where since the launch of the programme more than 800 applications have been filed and 152 agreements signed, as of 31 March 2017.[3]

100. The purpose of APAs is to remove uncertainty for both taxpayers and tax administrations, thereby mitigating transfer pricing disputes. In addition, where a transfer pricing dispute has already arisen, an APA may be a useful mechanism to settle the dispute and, if required, to provide certainty going forward.

101. In the South African environment, APAs would be a useful instrument.

102. APAs are often bilateral, i.e. negotiations on the transfer pricing issues at stake are not only between the tax administration and the taxpayer, but also with the cross-border connected party in relation to the taxpayer and the relevant tax administration.

103. Submission: It is submitted that SARS should consider introducing an APA regime, ideally a bilateral APA regime, to provide clear guidance in this regard.

104. The proposed APA regime should follow the guidance set out in the OECD Guidelines and also include a roll-back mechanism. Specific skills in respect of the implementation and administration of such APA regime should be acquired.

N. Safe harbours

Introduction

105. The reliance on safe harbour provisions in respect of specific transfer pricing transactions has been viewed by many tax administrations as a transfer pricing tool open to abuse by taxpayers. The view has been (and currently still is in many instances) that by introducing some kind of safe harbour provision, taxpayers would be in a position to *inter alia* manipulate transactions in such a way to fall within the ambit of these provisions

[3] APA Annual Report 2016-17 issued by the Central Board of Direct Taxes released on April 2017.

in order to benefit from this simplified method of transfer pricing compliance, when in reality it does not meet the arm's length principle.

106. The OECD has moved away from its initial view of complete rejection regarding the use of safe harbours,[4] to a view where the proper determination and implementation thereof is supported[5].

The need for safe harbour provisions

107. It is crucial to acknowledge that the transfer pricing landscape has undergone significant changes recently and is more in the international spotlight than ever before, no small thanks to the OECD's BEPS project.

108. While the "new" transfer pricing environment places a significant additional burden on taxpayers to ensure it remains tax compliant within the various countries it operate, it is submitted that it also places an increased responsibility on tax administrations to assist taxpayers with the compliance burden and to provide certainty, one of the corner stones of an equitable tax system.

109. Taxpayers recognise this[6], but more importantly, the OECD recognises this: [7]

"Transfer pricing compliance and administration is often complex, time consuming and costly. Properly designed safe harbour provisions, applied in appropriate circumstances, can help to relieve some of these burdens and provide taxpayers with greater certainty."

110. Some of the reasons for the generally negative perception tax administrations have on the subject of safe harbour provisions include[8]:

- The safe harbour may displace a more appropriate method in specific cases, such as a Comparable Uncontrolled Price (CUP) or other transactional method, or sacrifice accuracy — and thus be inconsistent with the arm's-length method;

- Safe harbours are likely to be arbitrary, and sufficient refinement to satisfy the arm's-length standard would impose burdens on the tax administration;

---

[4] 2017 OECD Guidelines, paragraph 4.96, page 204

[5] *Supra,* paragraph 4.97

[6] *"There is, arguably, a need for a low value-adding intra-group service safe harbour. With the increase of compliance for transactions at high risk of base erosion and profit shifting, it would be helpful to have a compensating reduction of compliance for transaction at low risk of base erosion and profit shifting"* - https://www.tpcompass.com/?id=10:a-transfer-pricing-cocktail-safe-harbours-for-services

[7] OECD Discussion Draft on the revision of the Safe Harbours section of the Transfer Pricing Guidelines, paragraph 33

[8] http://www.thesait.org.za/news/198312/Why-SARS-should-consider-transfer-pricing-safe-harbours.htm and OECD Guidelines, paragraph 4.110

- Shifting income to the safe harbour jurisdiction to satisfy the safe harbour could undermine compliance in the foreign jurisdiction, and also lead to the prospect of double taxation;

- Foreign tax administrations may find it necessary to audit more extensively situations where a safe harbour was elected abroad to avoid revenue loss, thus shifting the administrative burden to such countries;

- Tax planning opportunities might be created — for example, for relatively profitable companies — including shifts to low-tax countries or tax havens; and

- Equity and uniformity concerns.

111. The existing PN 7 specifically notes in this regard at paragraph 11.16 that the introduction of safe harbours can produce results that may be inconsistent with the arm's length principle. The Commissioner therefore supports the view of the OECD that warns against the use of safe harbours.

112. However, in response to the above the following is noted:

"As transfer pricing is not an exact science, any unilateral safe harbour, if based on arm's length principles and ranges, should not lead to major exposure of double taxation or non-taxation by, thus, achieving an effective balance between certainty, compliance simplicity, risk management, and tax revenues collection… by consensus on the overarching goal of simplification for all stakeholders. Safe harbours would be an instrument of simplification at times in which legitimate requests of many Countries to get a thorough understanding of the transfer pricing policy applied by MNEs have caused an increasingly burdensome level of transfer pricing documentation compliance in most Countries on top of all further reporting compliance about intragroup transactions…"[9]

"To that end, although the Discussion Draft surely offers a more balanced view about the "benefits" and "concerns" of safe harbours than do the [Transfer Pricing Guidelines], the stated concerns remain unnecessarily sceptical. While the principal benefits derive directly from the safe harbour concept (i.e., simplifying taxpayer compliance, ensuring greater taxpayer certainty, and freeing up tax authorities to focus on higher-risk transactions), the principal concerns apply as much to the arm's-length standard generally as to safe harbours specifically (i.e., the challenges of precisely determining an arm's-length result, the risk of double taxation, and potential inconsistencies in taxpayer treatment). Rather than exacerbating these concerns, safe harbours should help to resolve them, especially with some of the refinements proposed in the Discussion Draft, such as (i) making safe harbours elective, (ii) requiring disclosure of taxpayer elections and either fixed-term elections or tax authority review of changed elections, (iii) subjecting unilateral safe harbours to competent authority resolution, and (iv) encouraging the negotiation of bilateral safe harbours in the form of MOUs. Arguably,

[9] Comments to the OECD Discussion Draft on the revision of the Safe Harbours section of the Transfer Pricing Guidelines, page 48

the Discussion Draft changes the tone in the [Transfer Pricing Guidelines] only from decidedly (not "somewhat") negative to "neutral," when, in fact, the advantages of safe harbours clearly outweigh the disadvantages for taxpayers and tax authorities alike."[10]

113. The TP IN could provide for "risk" harbours compared to "safe" harbours. It is unlikely SARS will incorporate/provide safe harbours, but for certain transactions there may be some guidance on what is deemed less risky. For example, the draft Interpretation Note on financial assistance provides a risk harbour.

114. Submission: SAICA submits that, if possible, the safe harbour section in the proposed TP IN could refer to the low value adding services mark-up of 5%. We agree that the process of determining the cost base of low value adding services may not be thorough enough, but should one apply a robust transfer pricing analysis on a cost base, a taxpayer could apply the 5% for routine/administrative (non-core) services. Alternatively, the question arises if benchmarking is always required.

115. Further areas for safe harbours that could be useful and should be discussed are:

- Interest rates for loans below a certain threshold, arguably these could be at prime;
- Debt capacity safe harbour for companies that have a certain debt to equity ratio or less; and
- Non-core services cost base below a certain threshold may not require a detailed allocation analysis or benefit test, in line with BEPS Action Point 8 to 10.

Benchmarking studies versus safe harbours

116. In terms of South African transfer pricing legislation taxpayers are required to ensure that transactions with connected parties comply with the arm's length principle. In support of an arm's length price, with specific reference to intra-group services, taxpayers would typically rely on a benchmark study performed, which set outs the inter-quartile range for services of a similar nature.

117. In our view, however, the stance taken that reliance on the results generated from these types of benchmark studies would automatically ensure compliance with the arm's length principle is incorrect. There are too many variables to such a search which in itself could lead to manipulation by taxpayers. Often these benchmark studies are accepted by tax administrations without testing its validity.[11]

118. In addition, the availability of comparable data is a problem in general, but specifically in developing countries like South Africa.

[10] Comments to the OECD Discussion Draft on the revision of the Safe Harbours section of the Transfer Pricing Guidelines, page 224

[11] "reliance on searches for comparables cannot realistically be expected to generate data of sufficient quality to be useful in day-to-day tax administration" - *supra* page 69

119. The United Nations Practical Transfer Pricing Manual for Developing Countries (2012) describes specific challenges for developing countries as follows:[12]

"It is often in practice extremely difficult, especially in some developing countries, to obtain adequate information to apply the arm's length principle for the following reasons:

a) *In developing countries there tend to be fewer organised players in any given sector than in developed countries; finding proper comparable data can be very difficult;*
b) *In developing countries the comparable information may be incomplete and in a form which is difficult to analyse because the resources and processes are not available. In the worst case, information about an independent enterprise may simply not exist. Databases relied on in transfer pricing analysis tend to focus on developed country data that may not be relevant to developing country markets (at least without resource and information-intensive adjustments), and in any event are usually very costly to access; and*
c) *In many developing countries whose economies have just opened up or are in the process of opening up there are many "first movers" who have come into existence in many of the sectors and areas hitherto unexploited or unexplored; in such cases there would be an inevitable lack of comparables."*

120. The Group of Eight (G8), under the United Kingdom's presidency requested the OECD:[13]

"to find ways to address the concerns expressed by developing countries on the quality and availability of the information on comparable transactions that is needed to administer transfer pricing effectively."

121. In response, the OECD in their paper entitled *"Transfer Pricing Comparability data and developing countries"* (the Paper) confirms the problem as follows: [14]

"Applying the arm's length principle to review transfer prices set in transactions between associated enterprises often requires a comparison to be made between these prices and the prices set in similar transactions between independent enterprises in similar circumstances. OECD and non-OECD countries frequently express concerns about the availability and quality of financial data on transactions between unrelated parties that can be used for comparisons, as well as the availability and quality of information regarding the financial results of operations of comparable independent enterprises. These concerns about the lack of available comparables are particularly pressing for developing countries." (our emphasis)

122. The Paper proposes four possible solutions namely:

---

[12] The United Nations Practical Transfer Pricing Manual for Developing Countries (2012), paragraph 1.10.6

[13] Transfer Pricing Comparability data and developing countries, page 1 - http://www.oecd.org/ctp/transfer-pricing/transfer-pricing-comparability-data-developing-countries.pdf

[14] Transfer Pricing Comparability data and developing countries, page 1 - http://www.oecd.org/ctp/transfer-pricing/transfer-pricing-comparability-data-developing-countries.pdf

- Expanding access to data sources for comparables;

- More effective use of data sources for comparables;

- Advance Pricing Agreements (APA) or Mutual Agreement Procedures (MAP); and

- Importantly, *"approaches to identifying arm's length prices or results without reliance on direct comparables, including guidance or assistance in making use of proxies for arm's length outcomes, the profit split method, value chain analysis, and <u>safe harbours</u>, an evaluation of the impact, effectiveness and compatibility with the arm's length principle of approaches such as the so called "sixth method", which is increasingly prevalent particularly in developing countries in Latin America and Africa…"*

<u>International practice</u>

123. Despite the OECD's initial reluctance to support the use of safe harbours, it would appear that there is widespread acceptance of safe harbours. Globally, some of the safe harbour provisions implemented include:[15]

- Australia allows a mark-up of 7.5% on inter-company services;

- New Zealand accepts recharge of cost plus 7.5% for intra-group core services;

- In the final US services regulations, there is a cost-only safe harbour allowing for the charge of routine services without a mark-up; and

- India has introduced safe harbour provisions with reference to low value adding intra-group services (largely in line with the OECD BEPS guidance hereon), but additional requirements included that certain aspects require sign-off by an accountant, e.g. method of cost pooling.[16]

124. In support of a favourable view towards safe harbour provisions, the OECD has introduced a safe harbour provision of 5% in respect of low value adding intra-group services[17]. The reasons in support hereof include:[18]

- Reducing the compliance effort of meeting the benefits test and in demonstrating arm's length charges;

---

[15] http://www.thesait.org.za/news/198312/Why-SARS-should-consider-transfer-pricing-safe-harbours.htm

[16] http://www.in.kpmg.com/taxflashnews/KPMG-Flash-News-CBDT-notifies-revised-Safe-Harbour-Rules-2.pdf

[17] The UN Model provides for a low value adding services safe harbour as well as one for a minor expenses – UN Pricing Manual on Transfer Pricing for Developing countries, page 262

[18] OECD Guidelines, paragraph 7.52, page 338

- Providing greater certainty for MNE groups that the price charged for the qualifying activities will be accepted by the tax administrations that have adopted the simplified approach when the conditions of the simplified approach have been met; and

- Providing tax administrations with targeted documentation enabling efficient review of compliance risks.

Benefits to SARS and taxpayers of introducing safe harbour provisions

125. Some of the benefits of introducing safe harbour provisions would include:[19]

- Simplifying compliance and reducing compliance costs for eligible taxpayers in determining and documenting appropriate conditions for qualifying controlled transactions;

- Providing certainty to eligible taxpayers that the price charged or paid on qualifying controlled transactions will be accepted by the tax administrations that have adopted the safe harbour with a limited audit, or without an audit beyond ensuring the taxpayer has met the eligibility conditions of, and complied with the safe harbour provisions;

- Permitting tax administrations to redirect their administrative resources from the examination of lower risk transactions to examinations of more complex or higher risk transactions and taxpayers;

- Reducing or eliminating the possibility of litigation; and

- Helping boost foreign direct investment.

Conclusion

126. The introduction of a safe harbour provision would be to the benefit of both SARS (ensuring resources can be allocated to high risk areas) and the taxpayer (providing certainty and reducing tax compliance cost).

127. Submission: SARS is hereby requested to seriously consider the adoption of a safe harbour provision in relation to less complex transactions. This can be done by adopting for example existing guidance such as the OECD Guidance on low value adding intra-group services and/or developing specific requirements or thresholds similar to what India has adopted.

[19] http://www.thesait.org.za/news/198312/Why-SARS-should-consider-transfer-pricing-safe-harbours.htm

128. Transactions for which safe harbours can be introduced include:

- Low value adding intra-group services;
- Intra-group current accounts; and
- Standard intra-group loans meeting certain criteria.

O. Intangible property

129. Chapter VI of the OECD Guidelines, in 2017, was updated to reflect the BEPS Actions 8 to 10 reports, and sets out an exhaustive discussion addressing intangibles and their treatment from a transfer pricing perspective.

130. Paragraph 17 of the existing PN 7 states that the Commissioner considers the guidance provided in Chapter VI of the OECD Guidelines relevant and recommends that taxpayers follow the guidance.

131. Submission: It is SAICA's view that reference should be made to the OECD Guidelines' Chapter on Intangible Property in the TP IN, and recommending that such guidance should be followed by taxpayers. However, should SARS intend to deviate from the provision in the OECD Guidelines, this should be clearly stated in the new TP IN.

P. Intra-group services

132. The current guidance contained in PN 7 in respect of intra-group services is set out in paragraph 18, wherein it is stated that the Commissioner considers the guidance provided in Chapter VII of the OECD Guidelines relevant and recommends that taxpayers follow the guidance.

133. The general guidance provided by the OECD in relation to intra-group services has remained substantially the same, with the exception of the addition of guidance relating to "Low value-adding intra-group services", introduced by the OECD as part the work done in its BEPS project.

134. While SARS has always followed the guidance provided by the OECD in relation to intra-group services, it has stated that it will not generally be applying the simplified approach to low value-adding services as outlined in the OECD Guidelines.

135. As stated in the UN Practical Manual on Transfer Pricing for Developing Countries (2017):[20]

"*SARS is currently taking a pragmatic but firm approach to evaluating payments for intra-group services and where clear commercial justification or reasonableness for those payments is lacking, the payments are disallowed.*"

[20] UN Practical Manual on Transfer Pricing for Developing Countries (2017), page 627

136. Globally some of the Countries have incorporated the OECD Guidelines when it comes to the implementation of low-value-adding intra-group services. The following Countries have provided guidance on low-value-adding intra-group services as follows:

Country	**Guidelines**
Australia	7.5% markup (or a markdown of 5% [up to 10% in certain circumstances]) on “non-core services” and in *de minimis* cases, provided that certain conditions are met.
Austria	5 to 15% margin (5% mark-up if only direct costs) or cost (no mark-up). The margin applies to routine services, i.e. services relating to routine functions where assets are involved only on a small scale and where risk taking is small. The cost of only safe harbour applies to ancillary services, i.e. intra-group services that are not part of the core business of the enterprise.
India	Provision of software development services other than contract Research and Development (R&D) services with insignificant risks: Up to INR1 billion: 17% or more on total operating costs.
	Provision of software development services other than contract R&D services with insignificant risks, above INR1 billion up to INR2 billion: 18% or more on total operating costs.
	Provision of information technology enabled (ITES) with insignificant risks, Up to INR1 billion: 17% or more on total operating costs.
	Provision of ITES with insignificant risks, above INR1 billion up to INR2 billion: 18% or more on total operating costs.
	Provision of Knowledge Process Outsourcing (KPO) services with insignificant risks, up to INR2 billion: 24% or more Margin on total op costs; 60% or more employee cost to op costs.
	Provision of KPO services with insignificant risks, up to INR2 billion: 21% or more Margin on total op costs; 40% or more but less than 60%employee cost to op costs.
	Provision of KPO services with insignificant risks, up to INR2 billion: 18% or more Margin on total op costs; 40% or less employee cost to op costs.
	Provision of specified contract R&D services wholly or partly relating to software development with insignificant risks, up to INR2 billion.
	Provision of specified contract R&D services wholly or partly relating to generic pharmaceutical drugs with insignificant risks, up to INR2 billion: 24% or more on total operating costs

	Receipt of low value adding intra-group services, up to 100 million: Mark-up on costs not exceeding 5%. The cost allocation methodology should be certified by an accountant.
New Zealand	7.5% markup (or a markdown of 5% [up to 10% in certain circumstances]) on "non-core services," provided that certain conditions are met.
Singapore	5% markup on "routine services" provided by the parent or a group service company for "business convenience and efficiency".
United States	Under "services cost method," certain "low-margin" services may be compensated on the basis of cost without a profit (mark-up), provided a range of conditions is met.

137. Submission: We are of the view that the simplified approach to low value-adding intra-group services would alleviate much of the disproportional administrative burden on South African taxpayers with respect to such services, and should be followed by SARS, particularly where the value of the services is below a certain threshold.

138. We are further of the view that transfer miss-pricing is routinely not in relation to the mark-up applied to the costs charged, but in relation to the determination of the cost base to which the mark-up is applied. In many situations, this is not because of any deliberate intention of the taxpayer to avoid tax, but more due to a lack of understanding and clarity on how to calculate the cost base.

Q. Financial transactions

Draft Interpretation Note issued in relation to thin capitalisation

139. On 22 March 2013 SARS issued the draft interpretation note on thin capitalisation (Draft IN on TC) which provides guidance on the thin capitalisation provisions in section 31 of the Act, which was amended with effect for years of assessment commencing on or after 1 April 2012. Significantly, the thin capitalisation provisions previously contained in section 31(3) of the Act were removed and are now dealt with as a purely transfer pricing analysis, that is, financial assistance is subject to the arm's length principle.

140. Submission: Given that the Draft IN on TC has not yet been finalised and for years of assessment commencing on or after 1 April 2012, thin capitalisation is dealt with as a transfer pricing analysis, it is recommended that when the proposed TP IN is prepared that the contents of the Draft IN on TC should also be included therein and the Draft IN on TC should be withdrawn.

Audit Risk assessment

141. In terms of the Draft IN on TC, it states that from an audit risk perspective, SARS will consider interest on the following inbound loans to be of higher risk:

- Rand denominated debt: A rate exceeding the weighted average of the South African Johannesburg Interbank Agreed Rate (JIBAR) +2%.

- Foreign currency denominated debt: A rate exceeding the weighted average of the base rate of the country of denomination +2%.

142. Submission: Like with the Draft IN on TC, it is recommended that SARS provides guidance as to what it would consider as high risk in relation to interest charged on both inbound and outbound loans. This approach, would reduce the administrative burden that taxpayers face in preparing documentation where "reasonable" interest is charged.

South African focused databases

143. In terms of the Draft IN on TC, it is stated that SARS is currently investigating the availability of a third-party South African focused database to assist with the assessment of the appropriateness of a taxpayer's comparable data and the arm's length amount of debt, both from a quantitative perspective and qualitative perspective.

144. Submission: Where such databases are being used by SARS, SARS should specify in the proposed TP IN which databases are used to allow taxpayers to use similar databases to avoid unnecessary queries from SARS.

Uncertainty about the application of the Draft IN on TC

145. The Draft IN on TC does not provide a clear definition of what constitutes debt for the purposes of calculating the Debt: EBITDA ratio. Thus, taxpayers are uncertain whether to include long-term debt and short-term, non-interest bearing debt, trade debt, provisions, accruals, taxes payable and deferred tax liabilities.

146. It would also be helpful if SARS could clarify whether entities need to be evaluated on a "stand-alone" basis as suggested in the Draft IN or whether the principles of the much publicised Chevron case should be applied in which the halo effect is relevant.

147. Submission: SARS has provided some guidance in the Draft IN on TC on what constitutes debt. Apart from the reference to IFRS for determining debt, SARS should also provide taxpayers with an extensive list of examples and guidelines of what it considers to be equity and debt to avoid uncertainties, unnecessary queries and inadvertent non-compliance. In addition, SARS should clarify whether entities need to be evaluate on a 'stand-alone' basis or whether the principles confirmed in the Chevron case should be adhered to.

148. Paragraph 4.1.1 of the Draft IN on TC refers to direct and indirect funding stating that section 31 is far wider than a loan between two of the parties specified in part (a) of the definition of "affected transaction". It briefly explains what indirect funding is and illustrates using one example.

149. Submission: Considering that the impact of the far wider application may lead to uncertainties, it is recommended that SARS provides more clarification on what it considers "indirect" funding as the current guidance is not sufficient.

Sections 31(6) and 31(7) of the Act were introduced after PN 7 was published

150. Section 31(6) of the Act was introduced by the Taxation Laws Amendment Act, No 22 of 2012 and came into effect on 1 January 2013 in respect of any year of assessment commencing on or after that date. Whereas section 31(7) of the Act was introduced by the Taxation Laws Amendment Act, No 31 of 2013 and came into effect on 1 April 2014 in respect of any year of assessment commencing on or after that date. Accordingly, sections 31(6) and 31(7) were introduced after PN 7 was published and therefore the proposed TP IN should specifically address these sections in detail.

151. Submission: The proposed TP IN should specifically consider sections 31(6) and 31(7) of the Act in detail.

Practical application of section 31(6) of the Act

152. Section 31(6) of the Act provides that the provisions of section 31 will not apply to high-taxed CFCs. While these provisions are progressive and welcomed by SAICA, no guidance is provided for CFCs resident in high-tax jurisdictions that may not have qualified for the high-tax calculation for a specific year or years of assessment due to reasonable grounds such as losses suffered due to start-up phase or any other extraordinary activities or even tax holiday periods or any other scenarios.

153. Submission: It is recommended that these specific scenarios are also catered for in the TP IN by the inclusion of sufficient commentary and examples.

R. Cost contribution arrangements

154. PN 7 currently refers in paragraph 19 to the OECD Guidelines regarding Cost Contribution Agreements (CCA).

155. Submission: SAICA recommends that the TP IN continues to refer to the provisions in the OECD Guidelines.

156. However, the OECD Guidelines on CCA place additional administration burden on taxpayers.

157. Submission: SARS should clarify its approach to the treatment of existing CCAs, i.e. under the old rules and if and to what extend “grandfathering rules” will be applied.

158. SARS should particularly clarify whether it will align its grandfathering rules with existing CCA’s, specifically around cost based contributions and control requirements.

159. SAICA is concerned that if these rules are not consistent, MNE’s with existing CCA’s will need to determine and implement specific structural changes, which may result in significant cost and administrative burdens for South African taxpayers.

S. Effective date

160.	Submission: The effective date of the new TP IN should be the date when PN 7 ceases to exist. Ideally, the effective date should be a prospective one, and there should not be any retrospective application to provide certainty and clarity to the taxpayer.