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Submission File

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South African Revenue Service
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BY E-MAIL: policycomments@sars.gov.za

Dear SARS

COMMENTS ON THE DRAFT INTERPRETATION NOTE ON THE DEFINITION OF "ASSOCIATED ENTERPRISE"

We herewith present the comments of the South African Institute of Chartered Accountants' (SAICA) Transfer Pricing Committee on the Draft Interpretation Note (IN) that provides guidance on the interpretation and application of the definition of "associated enterprise" in section 31(1) of the Income Tax Act No. 58 of 1962 (the Act). Section 66(1) of the Taxation Laws Amendment Act No. 20 of 2021 amended the effective date such that the inclusion of an "associated enterprise" in section 31 comes into operation on 1 January 2023 and applies in respect of years of assessment commencing on or after that date.

We set out below our overarching and specific comments in this regard.

OVERARCHING COMMENTS

Interpretation as per the OECD Model

1. The Draft IN proposes that the concept of "associated enterprise" as used in the OECD Model Tax Convention on Income and on Capital, 2017, (OECD Model) is what should be used to interpret the term from a South African perspective.

2. Submission: The OECD Model was never meant to be prescriptive in the way that SARS attempts to interpret it. There seems to be a lack of appreciation of the function of model-based income tax treaties. The models were not designed to serve as models for enabling domestic legislation; rather their sole aim is to be models for bilateral relief mechanisms to avoid and resolve double income taxation.

3. Article 9 of the OECD Model was not intended to be imported into domestic law; rather its purpose is to regulate the interaction of two sets of domestic transfer pricing regimes. The function and aim of Article 9 of the OECD Model explain why concepts found in it are deliberately wide, vague and open-ended, namely because it is accommodative in nature of domestic law, and not prescriptive in its aims. Different domestic regimes will differ in the scope of a transfer pricing rule, and the OECD Model does not aim to set out how domestic income tax law is to be designed in its scope and content.

4. More specific guidance from a local South African perspective is required.

Associated Enterprises and Affected Transactions

5. The Draft IN conflates two separate issues in multiple instances.

6. In applying section 31, the determination of whether entities are 'associated enterprises' should be performed separate from the examination of the transaction, operation, scheme etc. in question.

7. The Draft IN bases the question whether entities are associated enterprises on a consideration of whether, for example, the one enterprise participates directly or indirectly in the management or control of the other enterprise over the 'affected transaction' under examination.

8. Whether or not enterprises are 'associated enterprises' would not vary depending on the specifics of the 'affected transaction'. Two enterprises would, for example, not be 'associated enterprises' for purposes of one transaction but not for purposes of another transaction.

Examples provided

9. We submit that the Draft IN contains an insufficient number of examples. The examples provided are also rather 'crystal clear' and therefore do not provide much assistance to taxpayers.

10. Submission: Given the far-reaching impact of the proposed Draft IN, we would appreciate more examples (which are also more nuanced) to illustrate SARS' interpretation of the definition of the term more broadly.

SPECIFIC COMMENTS

Page 2 - Background

11. The background section on page 2 states that the Act contains rules in section 31 which are aimed at preventing a reduction in the South African tax base as a result of the mispricing or incorrect characterisation of specified transactions, operations, schemes, agreements or understandings. Broadly, this is achieved by applying the arm's length principle to affected transactions, as defined in section 31(1), and requiring the persons specified in section 31(2) to calculate their taxable income or tax payable as if transactions, operations, schemes, agreements or understandings had been entered into on terms and conditions that would have existed had the persons been independent persons dealing at arm's length.

12. Submission: The reference to 'mispricing' is inappropriate in as far as it refers to fraudulent, deliberate and inaccurate pricing. The purpose of section 31 does not include

measures against so-called illegal/illicit financial flows and cannot be used to impinge the commercial price of transactions.

13. Section 31 should be purposively interpreted and therefore inaccurate statements as to its intended aim should be avoided. The Draft IN should clarify that the effect of section 31 is to adjust certain affected intercompany prices for income tax purposes alone.

Page 5 - Examples

14. The Draft IN states that in assessing whether participation in management results in the parties to the transaction, operation, scheme, agreement or understanding being considered "associated enterprises", for the purposes of section 31, the outcome of such participation in management must result in or have the consequence of controlling, effecting or influencing the terms or conditions, which includes pricing, of any transaction, operation, scheme, agreement or understanding, directly or indirectly entered into or effected between or for the benefit of either or both resident or non-resident party.

15. An entity might be economically dependent on a single customer or supplier, leading to the customer or supplier having significant influence over the entity's operation or a specific transaction, operation, scheme, agreement or understanding. There is a difference between an independent supplier or customer using their economic dominance to negotiate the best position for their own interest and a supplier or customer that crosses the line into participating in management and controlling, effecting or influencing the terms or conditions, including pricing, of transactions, operations, schemes, agreements or understandings. Whether or not the line is crossed must be determined on a case-by-case basis.

16. Submission: The relevance of economic dependencies of **legally unrelated** parties to establish a meaning for the concept of 'management' is unclear and needs explanation. It should also be explained on what legal basis such a consideration can be considered and how would taxpayers establish when they are economically dependent.

Pages 6 to 7: Example 1 – textual errors

17. Submission: Notwithstanding what is stated in the 'facts', CyprusCo2 is actually **not** the majority shareholder of SACo, since it holds less than 50% of SACo.

18. The last word before the last sentence on page 6 is "SACo2". However, this should be "SACo" as there is no SACo2 in the example.

19. The first bullet point on page 7 refers to 'SwitzerlandCo2'. The "2" should be deleted as there is only "SwitzerlandCo".

20. The fourth bullet point on page 7 refers to "CyprusCo". This should be "CyprusCo2".

Page 7 – Example 1 result

21. The result of Example 1, as noted in the first sentence on page 7, is that CyprusCo2 participates directly in the management of SACo and SwitzerlandCo with an influence on pricing, and accordingly SACo and SwitzerlandCo are associated enterprises in relation to each other.

22. It seems that SACo and SwitzerlandCo would already be considered connected persons in relation to one another in terms of paragraph (d)(vA) of the connected persons definition in section 1 of the Act.

23. The same point can be made for Example 2 on Page 10, viz ChinaCo1 and ChinaCo2 would already be considered connected persons in relation to SACo3 in terms of paragraph (d)(vA) of the connected persons definition; notwithstanding that both Chinese companies would also qualify as associated enterprises in relation to SACo3.

24. Submission: We suggest that SARS considers using other examples for Example 1 and 2 where the relevant companies are associated enterprises without also being connected persons in relation to one another.

Pages 7 to 8 – Direct or indirect participation in control

25. The Draft IN states that the concept of control is related to the structure of decision-making within an entity with the relevant persons having the ability to and being involved in directing the strategic financing and operating policies of the entity. In the context of the definition of an "associated enterprise", the type of control which is relevant is *de facto* control and relates to the ability of a person, and the exercise of that ability, to directly or indirectly materially influence the terms or conditions of the transaction, operation, scheme, agreement or understanding, especially the pricing.

26. It continues by stating that the facts and circumstances of each case are critical in determining who is participating in the control of a company by influencing the terms or conditions of a transaction, operation, scheme, agreement or understanding, because the presence and influence of a controlling person or persons can have a significant impact on the terms or conditions of a transaction, operation, scheme, agreement or understanding.

27. Submission: The interpretation of the concept of "control" does not appear to be based on South African legal authority in respect of how statutory language must be interpreted, nor any of the many authorities about what "control" means in relation to legal persons such as companies, trusts, partnerships, etc. The only source cited is a generic internet website of no clear relevance.

28. The proposition that 'control' is purely a factual question does not appear to be based on any authority nor is it entirely logical in the context of how "associated enterprise" is intended to function to establish the scope of section 31's application.

29. It seems that the approach adopted by SARS will introduce arbitrariness in the scope of the legislation – for example, if in a specific transaction there happens to be factual

control of an isolated transaction, but not of any others between the same persons, then is SARS saying that this isolated instance of factual control in one transaction alone is sufficient to draw the parties into the ambit of section 31 and if so, to what extent?

30. This requires further clarification in the Draft IN.

Page 8 – Direct or indirect participation in control – First Paragraph

31. The impression is created in this paragraph that merely having one director in common results in participation in control of both companies.

32. Although this is caveated by saying that the 'facts and circumstances of each case are critical', the issue of common control is critical to the definition of 'associated enterprise'.

33. Taxpayers are looking to this Interpretation Note, once finalised, for guidance and there should be multiple examples to clarify SARS' interpretation. There is hardly a purpose in having an Interpretation Note that merely states that the 'facts and circumstances are critical'.

34. Submission: Numerous nuanced examples should be provided to illustrate SARS' interpretation of various facts and circumstances.

Pages 11 to 12: Example 3 of a dual listed entity

35. The example explains how two entities, that are subsidiaries of two different ultimate holding companies that are dual listed companies, are regarded as "associated enterprises" in relation to each other as the same persons in the form of the senior executive management team participate indirectly in the management of the companies in a manner which has a direct impact on the determination of the terms and conditions which includes pricing of the export sales between the two companies takes place.

36. Submission: We would appreciate it if SARS could explain why the "connected persons" definition, on a legal substance understanding, does not in theory apply to the dual listed structure.

37. In Interpretation Note 67 (Issue 4) concerning the view of SARS on the "connected persons" definition, SARS puts forward the argument that *"[i]t is considered that a person holds equity shares in a company if that person is the beneficial owner of the shares*" (at page 17). If this is accurate, the effect of the equalization agreement between the dually listed companies will be that they beneficially own the shares in the split holdings down the investment chain, and therefore are connected. There are foreign cases on the meaning of "beneficial ownership" in which shareholder agreements between holding companies were seen to be relevant in assessing whether income of a subsidiary could be said to be beneficially owned by the holding entities themselves.

38. It is our view that SARS has not sufficiently proven that the existing legislation is inadequate to deal with dual listed entities.

Page 13 – Direct or indirect participation in capital

39. On page 13, the "participation in capital" is said to refer to "*beneficial ownership of shares or voting rights in an entity*". This is the same view expressed in Interpretation Note 67 (Issue 4) at page 17.

40. Submission: The above understanding is not written in the text of the OECD Model so it cannot be said to be derived from it. SARS appears to be suggesting there is a general implied term of "beneficial ownership" and this should be clarified further.

41. The importation of deliberately vague notions from the OECD Model into section 31 will not improve certainty in the area of transfer pricing. There will be many disputes about what undefined, and open-ended notions such as "control", "management" and "capital participation" mean in relation to specific facts. The speculative nature of statements in the Draft IN provides eloquent testimony. SARS' own conclusions seem to admit that the imported notions are so vague that they have no particular defined or certain general meaning (page 5 in relation to "management": "*An assessment of whether participation in management resulted in or has the consequence of controlling, effecting or influencing the terms or conditions, including pricing, as mentioned above is very fact specific and can only be determined on a case-by-case basis*."; page 8 in relation to "control": "*The facts and circumstances of each case are critical in determining who has de facto control*"; page 13 in relation to participation in capital: "*a facts and circumstances test applies*").

42. An amendment of section 31 that replaces notions with clear cut-off lines such as "connected person" with vague open-ended notions is open to challenge on constitutional grounds; they displace rules of law (e.g. 20% shareholding) with rules of discretion because complete open-ended concepts are prone to subjectivity. Surely this cannot be a way to design tax law in a context of a society plagued by a lack of resources.

43. We also question how a pure "facts and circumstances" approach relates to the apparent commitment by South Africa to improve tax certainty (e.g. via APAs) and to reduce transfer pricing disputes via the MAP changes under the MLI? Furthermore, it has to be asked whether SARS has the resources to investigate all these open-ended notions.

Page 14 - Conclusion

44. The justification for the change and introduction of the "associated enterprise" concept is stated to be motived by a "*potential anomaly and unfair reduction in the tax base*".

45. Submission: This reason provided is speculative and reliant on highly subjective notions and we suggest that the Draft IN should provide the necessary facts and figures supporting such a statement.

Conclusion

46. We once again thank SARS for the ongoing opportunity to provide constructive comments in this regard. SAICA continues to believe that a collaborative approach is best suited in seeking solutions to complex challenges and should you wish to clarify any of the above matters please do not hesitate to contact us.

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

Yours sincerely

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The South African Institute of Chartered Accountants