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Submission File

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Dear Tebogo Mathosa

SAICA COMMENTS ON A SUGGESTED DRAFT INTERPRETATION NOTE ON TRANSFER PRICING TO REPLACE PRACTICE NOTE 7

We herewith take an opportunity to present the comments of the South African Institute of Chartered Accountants' (SAICA) Transfer Pricing Committee on a suggested Draft Interpretation Note (IN) on transfer pricing to replace the current Practice Note 7.

We set out below our general observations and specific comments on suggestions for the content of such an interpretation note. These comments include, *inter alia*, various domestic legislative issues for consideration, areas where there is divergence by SARS from the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations and matters relating to dispute resolution processes.

GENERAL OBSERVATIONS

1. South Africa introduced transfer pricing rules in 1995 and these rules were significantly overhauled in 2012. In support of the rules and to assist taxpayers understand how they should be applied, SARS introduced Practice Note 7 in 1999. ("PN7")
2. This practice note has largely been superseded by both the revised wording of section 31 and updates to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD TPG") on which it was based. Although still in force, the practice note is arguably no longer useful in assisting taxpayers to understand how SARS will apply section 31.
3. SARS has already considered the changes to South Africa's thin capitalisation rules by withdrawing the out-of-date Practice Note 2 and issuing two draft interpretation notes in its place.
4. In the Transfer Pricing Committee's consultation with SARS, SARS has acknowledged that PN7 is no longer relevant in its current form and has indicated it is open to suggestions for a new draft interpretation note ("IN") to replace it. To this extent we provide some thoughts on content for such an IN.



SPECIFIC ITEMS FOR CONSIDERATION

Adoption of the OECD Transfer Pricing Guidelines

5. We acknowledge that SARS largely adopts the guidance included in the OECD TPG. We also acknowledge that the OECD TPG are ambulatory. The OECD TPG were first presented in 1979 and updated in 1995, 2010, 2017 and 2022. This trend suggests that the OECD TPG are being updated on a more frequent basis. This may result in changes to the OECD TPG which South Africa is not happy to accept.
6. We further note that South Africa has entered into a number of Double Tax Conventions ("**DTC's**") which are based on the OECD Model Tax Convention ("**MTC**"). Most of these DTC's adopt the MTC's Article 9. The OECD TPG are designed to complement Article 9 of the MTC by providing guidance to avoid the incidence of double taxation. Adopting both Article 9 of the MTC together with the OECD TPG should significantly reduce the risk to South African taxpayers of suffering double taxation as a result of a transfer pricing audit and possible adjustment.
7. Submission: We propose that the revised IN broadly accept the guidance in the OECD TPG and include by exception only additional guidance as to the implementation of section 31 in the IN.

Domestic legislative issues: Connected person / Associated Enterprises definition

8. The application of section 31 is dependent on the parties being "Connected Persons" as defined or "Associated Enterprises" as defined.
9. The current PN7 includes an old version of the definition of connected persons. Furthermore, SARS has to date not provided a domestic definition or guidance on the proposed "Associated Enterprises" inclusion.
10. Submission: The new IN should refer to the existing definition of a "connected person" in section 1 of the Act.
11. The new IN should include a definition (to the extent a definition is not brought into section 1 of the Act) of "Associated Enterprises" together with clear guidance.

Domestic legislative issues: Controlled Foreign Company ("CFC") inclusion in s31(1)

12. Section 31(1) currently extends the application of the transfer pricing rules to transactions between CFC's and non-resident connected persons.
13. Section 9D also provides the rules for the imputation of net income of a CFC to the parent company to the extent none of the exemptions apply.
14. Where a CFC transacts with a connected party non-resident entity and that transaction is deemed to be non-arm's length in SARS' view, section 31(2) allows SARS to adjust the consideration in respect of that non-arm's length transaction of the CFC for the purposes



of section 9D(9)(b). This results in the Foreign Business Establishment Exemption being denied in respect of the net income attributable to the non-arm's length transaction.

15. Submission: We recommend guidance relating to how the provisions of section 31(1), section 31(2), and section 9D interplay in respect of transactions entered into by CFCs with non-resident connected persons to make the provisions easier to understand.

Domestic legislative issues: Exclusions in section 31(6) and section 31(7)

16. Section 31 contains two specific exemptions which are included in section 31(6) and section 31(7).

17. Section 31(6) applies where the transaction is the granting of financial assistance or the use on intellectual property to a CFC which has a foreign business establishment ("**FBE**") and the tax payable by that CFC amounts to 67.5% of the tax that would be paid in South Africa if that CFC were subject to tax in South Africa.

18. Section 31(7) provides an exemption for loan funding made to a foreign group company where the loan is interest free and for a minimum period of 30 years and certain other conditions are met. The purpose of this exemption is to allow resident companies to extend loan funding which is in economic substance equity to group companies without risk of an adjustment.

19. Both the above only relate to transactions between separate legal entities where one is a South African resident entity and the other is a non-resident entity. The sections do not seem to cater for similar transactions between a South African resident and a foreign permanent establishment of another South African resident.

20. Submission: The new IN should make it clear that the two exemptions apply to all potentially affected transactions listed in section 31(1)(a).

Section 31 application to Permanent Establishments

21. Section 31 only applies to transactions between separate legal entities. Article 7 of South Africa DTCs applies to the attribution of profits to permanent establishments ("**PEs**"). Article 7, however, only addresses the attribution of profits to two separate parts of the same legal entity.

22. Section 31(1)(a) includes transactions between two residents where the transaction is in favour of a foreign PE of one of the residents; and to transactions between two non-residents where the transaction is in terms of a transaction with a South African PE of one of the non-residents.

23. In effect this allows SARS to adjust the consideration paid or received in respect of a South African resident and a foreign PE of another South African resident, or between a South African PE and a non-resident entity.

24. In the event SARS makes an adjustment to a South African PE of a foreign resident under section 31(2), it is adjusting the attribution of profit to that PE where such transaction is with a different foreign resident entity. This could result in double taxation for the foreign resident entities.

25. Submission: Guidance should be included which makes it clear any adjustment to the profits of the South African PE are made within the context of Article 7 on the basis that SARS is of the view the profit attributed to the PE is in contravention of this Article. This will ensure the non-resident entity is able to resolve any double taxation incidence through a Mutual Agreement Procedure ("**MAP**") on the application of Article 7.

Adoption of Article 7 of the MTC

26. The MTC introduced an updated Article 7 and accompanying commentary in July 2010. South Africa has reserved the right to use the version of Article 7 and the commentary to this Article applicable prior to the introduction of the revised Article and commentary.

27. It is understood the reservation results in the non-adoption of notional charges between two separate parts of the same legal entity which may impact the overall profit position of the legal entity. This could apply if the PE operates as a limited risk entity or service provider and applying the transfer pricing principles by hypothesis results in the arm's length amount to be attributed to the PE as a profit where the entity as a whole suffered losses.

28. The OECD issued an updated version of the guidance for applying Article 7 and its commentary in 2010. This represents the OECD's Authorised Approach to the attribution of profits to PE's ("**AOA**"). As with the OECD TPG, the AOA is intended to be ambulatory guidance.

29. Submission: Due to the uncertainty taxpayers face as to the appropriate guidance to use when considering the application of Article 7 in South Africa's DTC's, it would be beneficial for the IN to include guidance on this matter.

SPECIFIC DIVERGENCES FROM THE OECD TPG

Tax Benefit test

30. Section 31 requires the taxpayer to have received a tax benefit as a result of the pricing policy SARS may seek to adjust under section 31(2). The concept of a tax benefit is not addressed specifically in the OECD TPG.

31. Instances occur whereby a taxpayer may have entered into a transaction which is arguably not arm's length but has not resulted in a tax benefit. For instance, the taxpayer may be in receipt of a loan on which interest is charged but has not claimed the interest as a tax deduction. SARS will still have received the withholding tax on the interest paid so there is no loss to the fiscus.

32. Submission: The draft IN should consider instances where a transaction results in an expense to the taxpayer which is not claimed for tax purposes and define why this either does or does not confer a tax benefit on the taxpayer for the purposes of section 31.

Comparability

33. The OECD TPG provides substantial guidance on undertaking a comparability analysis in Chapter III. The only key variance is the lack of comparable data applicable to South Africa unlike most OECD countries.

34. It is also recognised that internal comparable data remains the most reliable source of data to perform a comparability analysis.

35. SARS has indicated verbally that it is prepared to accept foreign comparable data.

36. Submission: SARS is requested to provide examples and guidance on using internal comparable data to apply the traditional transactional methods in favour of foreign comparable data to apply the transactional profit methods notwithstanding the analysis may not be perfect.

37. We remain of the view an imperfect analysis applying a traditional transactional method on internal comparable data is far more reliable than an imperfect analysis using transactional profit methods on foreign comparable data.

The arm's length range: Statistical tools

38. The OECD TPG recognises that the use of statistical tools to refine a data set into a meaningful range is appropriate. However, it cautions against using such tools indiscriminately.

39. SARS tends to apply statistical tools, notably the use of the inter-quartile range and the Tukey test to eliminate comparables even when the set of comparable data is very small. The OECD TPG recognises that to apply statistical tools to a small set of equally reliable comparable data points is meaningless. In fact, this could result in one of the more comparable data points being eliminated.

40. Submission: The IN should provide guidance on SARS' view of the use of statistical tools if this is to vary from the guidance in the OECD TPG.

The arm's length range: Multiple year data

41. The OECD TPG advocates the use of multiple year data to smooth out the impact on comparable data resulting from variances in the financial years and product/business life cycles.

42. SARS invariably denies the use of multiple year data in most cases but does often apply three year rolling average data to account for differences in timing of the availability of comparable data.

43. Submission: The IN should provide guidance on SARS view of the use of multiple year data if this is to vary from the guidance in the OECD TPG.

The arm's length range: Adjustments

44. Where the results arising from a transaction fall outside of the range, the OECD TPG states that in the absence of compelling data to evidence a point in the range, any adjustment should be made to a point of central tendency.

45. Where SARS undertakes an audit and concludes that in the main the audited entity is a low-risk entity, it invariably makes an adjustment to the lower quartile. However, this is not usually accompanied by a compelling argument to this effect.

46. Submission: The IN should provide guidance on what level of evidence is needed to support a point in the range other than the median/mid-point in the event of any adjustment.

Services

47. The OECD TPG introduced the concept of Low Value-Added services in Chapter VII of the 2017 edition of the TPG. This guidance allows for a simplified approach to support the arm's length nature of non-core routine services typically found within a multinational group.

48. SARS has verbally stated it does not intend adopting this guidance. As the current PN7 endorses the OECD TPG approach in the absence of specific guidance from SARS, this needs to be clarified to provide certainty.

49. Submission: The draft IN needs to provide clarity on SARS' view on the simplified approach to low value-added services and in the event this is not to be adopted, provide alternative guidance relating to services.

50. Should alternative guidance be considered, this should give comprehensive guidance on satisfying the requirements of the arm's length test from both the perspective of the service provider as well as the service recipient. Furthermore, this guidance should encourage the analysis to be considered from both perspectives.

Financial transactions

51. The 2022 OECD TPG has incorporated the guidance from the BEPS final report on Financial Transactions. In response to this SARS has now issued a draft IN on intercompany loan arrangements.

52. SAICA has provided comments on this draft IN under a [separate submission](#).

53. SAICA has raised concerns relating to the interaction of Article 11 of the MTC and Section 31 in relation to interest bearing loans. Article 11(6) which is present in most of South Africa's DTC's removes the reduced withholding tax provision on the non-arm's length

interest paid to the non-resident lender. The result is that there is economic double withholding tax on the non-arm's length interest as a result of the impact of Article 11(6) and section 31(3). SARS is in effect charging the non-arm's length interest to withholding tax at 15% on the non-resident lender and 20% withholding tax on the South African borrower as well as denying the deduction under section 31(2).

54. Submission: To the extent the IN on intercompany loan arrangements does not cover all transactions included in the OECD TPG and SARS adopts a different view, guidance should be provided on these transactions.

55. A cross reference from the new IN to the IN on intercompany loans should be included.

56. SARS should consider the interplay between Article 11(6) and section 31(3) on the non-arm's length interest.

Documentation

57. SARS has adopted the BEPS Action 13 proposals on the three tier documentation rules which are now included in Chapter V of the OECD TPG.

58. SARS has also issued various gazettes and Business Requirement Specifications ("BRS") on compiling the documentation and the nature of support required.

59. Submission: The draft IN should summarise the guidance in the various documents issued and provide guidance on any specific practical issues. It should also cross reference to the BRS in this regard.

DISPUTE RESOLUTION

Burden of proof

60. PN7 followed the previous version of section 31 which was applied at the Commissioners discretion and therefore resulted in the initial burden of proof resting with the Commissioner. The current version of section 31 requires a taxpayer to file its tax return on the basis that all potentially affected transactions are conducted at arm's length. This results in the initial burden of proof resting with the taxpayer.

61. International precedent suggests that when SARS conducts an audit and issues a finalisation of audit letter and an assessment resulting in a primary adjustment to the transfer price, the burden of proof shifts to SARS to support its position.

62. Submission: The IN should state clearly where the burden of proof rests and at what stage it changes to SARS. The IN should also provide supporting evidence for this.



Mutual Agreement Procedure ("MAP")

63. SARS has issued a number of guidance documents relating to MAP. It is our view that these guidance documents are largely theoretical in nature as SARS has been reluctant to pursue MAP in the majority of cases.
64. The MAP guidance also provides for SARS to seek a unilateral solution, if possible, prior to entering into MAP negotiations. This further compounds SARS' preference to resolve transfer pricing disputes as opposed to pursuing the MAP.
65. As transfer pricing audits increase which result in more frequent adjustments, the incidence of double taxation also increases. Whilst currently most transfer pricing matters are resolved through the alternative dispute resolution process, this cannot continue as Multinational Enterprises will not continue to bear the cost of double taxation.

66. Submission: The IN should provide greater certainty to taxpayers that SARS' is adopting its own guidance relating to the MAP process. It should provide updates of cases and those resolved which would also provide comfort to taxpayers that the MAP works in transfer pricing disputes.

Advanced Pricing Agreements ("APA")

67. SARS has issued two guidance documents relating to its considerations around implementing an APA program. SAICA has provided [comments](#) on both [these documents](#).
68. SAICA is of the view an APA program would be extremely beneficial to Multinational Enterprises operating in South Africa to ensure tax certainty and mitigation of the risks of double taxation. SAICA, however, believes that the APA program should encompass unilateral, bilateral and multilateral APAs from the onset.
69. SAICA acknowledges SARS' concerns around resource constraints but maintains that an APA is a far less onerous negotiation and agreement process than an audit.

70. Submission: The IN should bring in the proposed APA program even if the legislation remains to be brought in at a later date. This would enable taxpayers to consider whether they would have the appetite to pilot an APA with SARS in advance of a formal program.

71. SARS should give serious consideration to adopting unilateral APAs as a roll back for dispute resolution. This could shorten the dispute resolution process, reduce the need for MAP and minimise potential litigation.

Transfer pricing auditors and Competent Authority ("CA") roles

72. The concern raised by SARS regarding limited transfer pricing resources has raised concerns that there is a lack of independence between the audit teams and the CA. This has been compounded in the Proposed Model for Establishing an Advanced Pricing



Agreement Programme in South Africa document issued in 2021. In this document SARS states:

"Although the APA unit will require independence from the transfer pricing unit, it is envisaged that in the APA unit's early stages of development the relationship between the units will be relatively fluid, necessitating the exchange of expertise and personnel between the units."

73. Our concerns relating to this have already been raised on our [previous submission](#) in response to this document (paragraph 8 – 11). It is important to bear in mind that an APA process and a MAP process is a negotiation which will inevitably result in some compromise on the taxing rights of South Africa from the position they may have had, if or when the matter was under audit. Thus, it is impossible for the auditors to be impartial in such negotiations.

74. International support is available to SARS through Tax Inspectors Without Borders, amongst others, which should be able to ensure complete independence. Our concern is that without that independence, the entire MAP and APA program is at risk of failing.

75. <u>Submission</u> : The IN should address this issue and ensure that at best, international resources are used to ensure independence and at worst, SARS guarantees strong "Chinese walls" to ensure there is no influence from audit teams with a vested outcome on a MAP or APA.
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Conclusion

76. We once again thank SARS for the ongoing opportunity to provide constructive comments and suggestions in this regard. SAICA continues to believe that a collaborative approach is best suited in seeking solutions to complex challenges.

77. 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