

15 October 2019

SAICA'S TRANSFER PRICING COMMITTEE UPDATE ON LATEST DEVELOPMENTS

FEEDBACK SUMMARY – TRANSFER PRICING MATTERS

GENERAL

SAICA attends various discussions and meetings on behalf of members with National Treasury (“NT”), South African Revenue Service (“SARS”) and other stakeholders (internal and external). These meetings represent an opportunity for them to obtain further information on any tax matter from the public and discussions and views expressed do not represent policy or decisions. Furthermore, these discussions do not represent an undertaking by SARS, NT or other stakeholders, but merely statements of their understanding or how they perceive or anticipate a particular matter to be addressed. The below Feedback Summary should be seen in the above context as merely attempts to inform SAICA members of the discussions and of any proposals that were made during such discussions.

Taking the above into account, the SAICA Transfer Pricing Committee would like to provide feedback to SAICA members on the latest developments in the area of Transfer Pricing based on its discussion with SARS earlier in the year (SAICA would like to thank SARS for the co-operative spirit with which the meeting was conducted) as well as work recently released by the OECD.

1. OECD's efforts to address challenges from digitalisation of the economy

On 9 October 2019, the OECD Secretariat published a proposal to advance international negotiations to ensure large and highly profitable Multinational Enterprises, including digital companies, pay tax wherever they have significant consumer-facing activities and generate their profits.

The new OECD proposal brings together common elements of three competing proposals from member countries, and is based on the work of the OECD/G20 Inclusive Framework on BEPS, which groups 134 countries and jurisdictions on an equal footing, for multilateral negotiation of international tax rules, making them fit for purpose for the global economy of the 21st Century.

The proposal, which is now open to a public consultation process, would re-allocate some profits and corresponding taxing rights to countries and jurisdictions where MNEs have their markets. It would ensure that MNEs conducting significant business in places where they do not have a physical presence, be taxed in such jurisdictions, through the creation of new rules stating (1) where tax should be

paid (“nexus” rules) and (2) on what portion of profits they should be taxed (“profit allocation” rules).

Please visit: <https://www.oecd.org/tax/oecd-leading-multilateral-efforts-to-address-tax-challenges-from-digitalisation-of-the-economy.htm> for more details on these proposed changes and send your comments to sharons@saica.co.za by 4 November 2019.

2. Withdrawal of Practice Note 2

Practice Note 2 was withdrawn on 5 August 2019 with effect from years of assessment commencing on or after 1 April 2012. See the link below for more details:

<https://www.sars.gov.za/Legal/Interpretation-Rulings/Pages/Find-a-Practice-Note.aspx>

3. Proposed Interpretation Note on transfer pricing

To be prudent, SARS and National Treasury have stated that they are waiting for the OECD to conclude their work on the Transfer Pricing Guidelines for Financial Transactions which deals with follow-up work in relation to BEPS Actions 8-10, before finalizing this Interpretation Note.

4. Status of the LBC

Transfer pricing is one of the main concerns for the LBC due to its effect on revenue leakages. The LBC will be focusing on completing audits in a timely manner and requests taxpayers to assist by providing the necessary documentation.

5. OECD Guidelines

It appears that South Africa’s position is that it generally follows the Organisation for Economic Cooperation and Development (**OECD**) Transfer Pricing Guidelines for Multinational Entities and Tax Administrations (**OECD Guidelines**), but SARS reserves the right to deviate from them. The OECD Guidelines constitute a consensus document and SARS was part of this consensus. There appears to be some reservations both locally and internationally relating to the adoption of the safe harbour rule for low value adding services as set out in Chapter VII of the OECD Guidelines. SARS may thus consider the use of this safe harbour, but not generally accept it as the norm. Concerns are raised more around the benefit and allocation keys that are applied in respect of intra group services, than in respect of the level of the profit mark-up applied. Bundled services, which include low-value adding services, may pose a problem with regard to benchmarking and SAICA has requested that perhaps a 5% mark-up on low value adding services should be allowed if it can be proven.

6. Transfer pricing comparables

There are 3 main issues with comparability analyses:

- a) Applicable databases;
- b) Multi-year data and weighted averages; and
- c) Use of the full versus inter-quartile ranges.

- a) It is our understanding that in order to derive an appropriate set of comparables, SARS would not only consult European data, but in addition, it would explore the possibility and existence of comparable data from other developing countries, for example Brazil, Russia, India or China (BRICS). SARS would also consider sovereign credit ratings when selecting countries from which to source comparable data and furthermore the geographic region selected depends on the industry in which the tested party is operating.

When considering the source of comparable data, SARS would also look at economically similar regions in an industry context. With regard to the appropriateness of applying working capital adjustments to the comparable data, these should be effected on a case by case basis.

- b) The use of multiple year data must be justified by the taxpayer, for example, the effect of business cycles or other relevant economic circumstances on the operating results of the taxpayer. However, SARS would typically, in the absence of this justification, effect adjustments on a year-on-year on annual basis. It is our understanding that SARS would endorse the guidance in Chapter V of the OECD guidelines that the comparable data which should be used is that which is available at the time the tax return is lodged. SARS would also take cognisance of this and the version the taxpayer used when considering external databases and would always aim to use the same version.
- c) With regard to whether the full range or the inter-quartile range of comparable margins determined should be used for comparison with the result achieved by the tested party the following should be considered: Where an equal degree of comparability can be justified for all the data points in a particular dataset, the full range from the minimum to the maximum of such a range, can be viewed as the arm's length range, as supported by the existing Practice Note and OECD guidelines. This is, however rare, in practice, and typically statistical tools will be applied (for example calculating an interquartile range) to the dataset to determine a more accurate degree of comparability through central tendency. Hence supporting the view that, the interquartile range is typically viewed as the arm's length range. The reliability of the underlying set is important to ensure there is a meaningful set. It is our understanding that SARS applies a statistical outlier test where it is needed to make the range more robust.
- d) With regard to frequency of conducting benchmarking studies, it would appear that typically there is no need for a company to conduct new benchmarking studies annually where the underlying business activities or transactions have not changed, however, SARS would expect taxpayers to update the financial data of the comparable companies to derive an updated arm's length range. As such, a taxpayer would only be required to perform a benchmarking study every three years while updating the financial results annually. This, however, is also dependent on the particular industry.

7. 'Affected transactions' clarification

The concern is it that taxpayers are unsure what constitutes an 'affected transaction'. SAICA has requested clarity on this from SARS as well as whether disclosure is required in respect of transactions which fall within section 31(6) and 31(7). SARS queried whether this issue should be included in the guidelines for South Africa as stated in the BRS regarding the documentation requirements. SARS feels this is more of a Country by Country (CBC) reporting requirement. SARS is still to confirm its position on this matter. It is important to note the discrepancy between the South African rules when compared to the OECD rules when it relates to filing of the master file data, mainly regarding the record keeping requirements. SARS will take this issue on advisement and revert back to SAICA.

8. Advanced Pricing Agreements

SARS confirms that Advanced Pricing Agreements are currently *not* made available to South African taxpayers.

9. Safe Harbours

SAICA requested clarification from SARS on whether the application of materiality thresholds can be considered, however, SARS pointed out that the wording of section 31 does not currently allow for this.

10. Financial & Capital Transactions

SARS emphasized that these will be treated according to the OCED Financial Transactions Report & urged taxpayers to wait until an Interpretation Note has been released.

11. Transfer pricing – return/Master File (MF)/Local File (LF) submission & penalties

It was confirmed that there is a specific system used for CbC/MF/LF and the taxpayer must file all the required information under the CbC site on E-filing, not on the ITR14 system. There is no system link between the ITR14 and CbC system.

Once the information is submitted by taxpayers, the SARS system should generate letters - to inform taxpayers of the rejection or acceptance of the transfer pricing return(s), ie MF and/or LF but currently no reasons are provided. SARS will consider issuing automated letters with reasons for rejections as the system doesn't currently provide such details. SAICA, however, noted that taxpayers are not receiving these letters automatically, and such letters have only been generated upon request by the relevant taxpayers. SARS confirmed that it will follow up and revert back on the matter.

12. Potentially affected transactions threshold

The requirement to prepare and file MF and or LF in South Africa for a taxpayer that is a member of a foreign headquartered MNE Group is dependent on whether or not the entity's total potentially affected transactions exceed or are likely to exceed R100 million during the year of assessment without offsetting any amounts. The term "potentially affected transaction" is broad and, in terms of SARS' Guide on

CbC/MF/LF filing includes, for example, dividends. It appears that in SARS' view loan capital should also be included in the determination of the value of total potentially affected transactions entered into during the year of assessment. Taxpayers should consider this to ensure compliance with transfer pricing documentation requirements.

13. Penalties for late submission of transfer pricing returns

Penalties for late submissions of the Master and Local Files are not yet active for domestic inbound MNE companies (as at September 2019), however, it is expected that this will change soon. Taxpayers need to rectify their position if they have not filed the master and local file through the CbC system. However, it is noted that penalties are already in place in respect of certain members of South African headquartered groups, and in respect of CbC filing obligations in South Africa.

14. ITR14 disclosure – Financial Assistance

SAICA requested that guidance be provided regarding the question raised in the ITR14 disclosure when it comes to interpreting the, debt, tangible assets, corporate tax ratios, etc. For example, if a debt to equity ratio is considered, what would be included in debt, i.e. would it be all debt or just connected party debt and is short term debt included (the conservative view being that it is). Furthermore, guidance was requested regarding what is included in “tangible assets”.

SARS advised SAICA members to refer to the ITR14 definitions which say if the effective tax rate – in a particular country - is less than 75% of the corporate tax; then SARS will regard that jurisdiction as a tax haven.

SAICA questioned whether there is a need for financial ratios where no inbound financial assistance transactions occur. SARS will consider this as they continue to refine the transfer pricing project parameters.

15. Secondary adjustments

SAICA noted that the application of treaty reduced rates had arguably been resolved in the 2019 amendments. SAICA raised a question as to when a taxpayer should make a declaration for the dividends tax and remit payment. SARS stated that the obligation to make the dividends tax declaration rested with the taxpayer, irrespective of whether the taxpayer made a primary self-adjustment, or if there was a primary adjustment raised through an audit.

When a transfer pricing adjustment is done, SARS confirmed that a dividends tax return is required. Furthermore, SARS noted that the system doesn't currently pick up if a primary transfer pricing adjustment has been made, but no dividend tax return has been filed in relation to the secondary adjustment, however, a solution is being devised. SARS confirmed CbC data is used for economic research and risk assessment only.

16. Digital economy

Both the African Tax Administration Forum (ATAF) and the OECD (see point 1 above) have undertaken significant work in this space but there was little indication of SARS' view. SARS commented that this was a National Treasury competence and will be driven by the steering committee. SARS acknowledged ATAF's work and advised they are collaborating with ATAF on this. National Treasury is fully involved and presented at OECD forum for transfer pricing. The current OECD interim recommendations are taken into consideration by SARS. South Africa is a developing country and additional factors be taken into account in this regard to seek compatible solutions to address transfer pricing.

ATAF has created a working group for the digitalised economy that is currently analysing the impact of the digitalised economy on revenue. ATAF is focusing on item 1 and 3 above. SARS explained to SAICA that it is difficult to assess revenue losses caused by the digitalised economy due to the fact that revenue losses are currently attributed not only to the digitalisation of the economy but to various other factors.