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Transfer Pricing

Arm's Length Standard

Is settlement worth the price of double taxation?

Transfer pricing is becoming one of the most costly audit experiences for Multinationals. With Tax Authorities across the globe grappling with reduced revenues, the pressure for aggressively protecting the domestic tax base has grown. The focus on Base Erosion and Profit Shifting has seen a global move to scrutinise and close down many legitimate tax planning scenarios, and an increased focus on transfer pricing.

South Africa is no different, perhaps facing greater pressure in terms of resources; it nonetheless has the legislative teeth and the specialist staff to mount transfer pricing audits which can result in significant adjustments. The majority of these adjustments never make it through the formal litigation process and are in the main resolved through the settlement process.

This is not entirely aligned with other countries, where there has been a notable increased in transfer pricing litigation of late, although most transfer pricing matters are resolved through Mutual Agreement Procedure (MAP). This has received its fair share of criticism, in that it can be a long drawn out affair (requiring the involvement of two sets of revenue authorities), but it does ensure the one outcome Multinationals want to see, and that is resolution of double taxation.

The problem with resolving a transfer pricing matter using the settlement process is that the outcome is inevitably a degree of double taxation, but the question is, does it have to be?

The Tax Administration Act (TAA)[1] provides for either the taxpayer or the South African Revenue Service (SARS) to enter into a settlement where there is a dispute relating to taxation due. A dispute is a disagreement on the legal interpretation of the relevant

[1] Tax Administration Act No 28 of 2011

facts involved or the law applicable thereto and arises as a result of the issue of an assessment or the making of a decision. Herein lies the first challenge. How often is a transfer pricing dispute arising as a result of the interpretation of the law or the facts? In the majority of transfer pricing disputes, the area of dispute is in relation to what constitutes an arm's length price, term, condition or outcome. This is a subjective test as there is no clear definitive definition of what is arm's length. The underlying support being at best comparable information existing between independent parties. Most often a profit based approach is followed, which evaluates the tested party's profitability against a set of comparables which, in the case of South African tested parties, are situated in another geographic region altogether (most often Europe).

The exact fact pattern of the taxpayer may be well known but, unless the exact fact pattern of the comparable transaction can be determined, it cannot be stated that there is a dispute around the comparable facts and circumstances. Transfer pricing is not simply a case of interpreting the intention or literal wording of a section of the Act, it is considered an art, requiring subjective analysis and a best fit approach. Therefore, it is arguable that the existing rules for settlement actually permit it to be used as a remedy in a transfer pricing case.

Certainly settlement is favoured by SARS. This approach meets the requirements in that it is cost effective for SARS and provides an option for agreeing a positon where the facts are complex. From the taxpayer's perspective a settlement may be favoured taking into consideration the costs of litigation, specifically where expert witnesses may need to be called, as well as the fact that it may be several years before the matter ultimately reaches court.

But is it always in the best interest of the taxpayer to settle and when should this be considered in the dispute process?

Two key areas of concern come to mind. Firstly we are seeing a trend from SARS to push for settlement very early on in the dispute process. The lack of resources and drive for increased revenue are key factors but Multinationals need to think carefully before agreeing to accept the settlement terms and conditions for the following reasons:

- What are the implications for years following the dispute?
- How will this affect my compliance history with SARS?
- Will I have to change my transfer pricing policy and what is the impact of this?
- Will the country Tax Authority in the transacting party's jurisdiction agree to any changes to the policy?
- What are my double tax risks?

As with any transfer pricing dispute, it is imperative to engage with the other jurisdiction as early as possible within the process to determine what the strategy will be. In the event settlement is determined to be appropriate, then the content of the governing agreement is critical.

The settlement agreement needs to contain the following:

- How each issue is settled. Importantly this should indicate the section of the Act applicable, the terms agreed and the resulting agreement. For instance, if the issue in dispute is the quantum of a mark-up being applied to a cost base, this should be clearly stated together with any supporting basis for this.
- All material facts must be set out in the agreement Failure to do so will entitle SARS to treat the settlement agreement as void and enforce the original disputed amount;
- The relevant undertakings of each party, for instance what remedial actions may be taken by the taxpayer as part of the terms of settlement. It is also useful to tie SARS to its treatment of other possible open years as well.
- An undertaking that SARS will not consider the matter as non-compliance or the existence of any wrongful behaviour category for the purposes of any future potential understatement penalty impositions (so as not be considered a 'repeat case');
- Agreement to the withdrawal of objections and appeals in order to ensure the process can be completed; and
- Arrangement for any payments outstanding including payments of interest and penalties.

It should be noted that the TAA is not specific regarding any further rights of the taxpayer to seek relief from any double taxation incurred. However, the trend we are seeing is that SARS considers that settlement will preclude the right of the taxpayer to seek relief from double taxation in terms of any relevant Double Tax Agreement (DTA), in many cases including such a clause within the settlement agreement. The question is, does SARS have the right to do so?

The settlement process is a mechanism to resolve a dispute as to the South African tax payable, not any liability for foreign tax. If a settlement is reached, the Multinational will almost always have suffered some degree of double taxation. S108(2) of the Income Tax Act (The Act)[2] incorporates into the Act any DTA entered into by South Africa which seeks to reduce the incidence of double taxation. Most of South Africa's DTA's are

[2] Income Tax Act no 58 of 1962

based on the OECD Model Tax Convention (MTC). Article 25 of the MTC provides that, where the actions of one of the contracting states to the DTA results in double taxation, irrespective of the remedies provided in terms of the domestic laws of that state, the taxpayer can approach the competent authority (CA) of the state in which it is a resident for relief from that double taxation.

The implication of the above is that, even where a settlement has been reached, (irrespective of the basis) and double taxation has occurred, the Multinational is still free to approach the CA to seek relief from that double taxation.

In the event the Multinational is a non-South African resident taxpayer, this would occur in the country of residence and it would be for that tax authority to determine whether the agreement reached under settlement is acceptable as arm's length in deciding whether to reduce the tax position. In the event that the CA does not agree with the terms of the settlement, the CA will then negotiate with the South Africa CA to arrive at an agreed position. This process is a completely separate process from the audit matter and resulting outcome and should be handled by an independent body from the audit team in South Africa.

In the event the Multinational is a South African resident, it can approach the CA to negotiate with the CA in the foreign country to reduce the tax position there. Again it is for the CA's to agree.

Because the process followed by the CA's is a Mutual Agreement Process (MAP) both CA's have to ultimately agree on the final position. In an ideal world this would result in one or both of the CA's tasking the audit teams to make any necessary adjustments. This is why most developed countries (and an increasing number of developing countries) have separated the roles and responsibilities of the CA from the revenue audit teams. In reality these two work against each other. In any MAP case, the CA will always be under pressure to give up some of the tax collected by the audit teams, thus making the two at odds with each other. The problem in smaller tax teams (as with South Africa) is that this degree of independence is challenged, the outcome being that often the same audit team are the key decision makers under MAP.

This creates a serious flaw in the process and has had the effect of allowing the audit teams within SARS to create a prohibition during the dispute resolution process from following a MAP process which is arguably outside their jurisdiction. A taxpayer can never be prevented from using the remedies available to it under the law and associated DTA's and SARS, in settling an audit dispute, cannot create a prohibition to this.

If a taxpayer wishes to forego its right to MAP that is a different issue completely and is often used as a bargaining tool for a more favourable settlement outcome, in effect

resolving a portion of the double tax through the SARS settlement. The automatic inclusion of prohibitions to MAP in standard settlement agreements drafted by SARS is however not in accordance with the Act or the DTA's entered into. In such cases the audit team is arguably over reaching their powers and acting as the auditor and CA at the same time.

Wherever there is a DTA in force and a transfer pricing matter in dispute, relief from double taxation remains the right of the Multinational and this should be explored in full. When settling a dispute, care should be exercised to ensure the settlement agreement remains within the ambit of the TAA and does not stretch the powers of the audit team. The importance of engaging with the counter party cannot be over emphasised and often an informal discussion with the tax authority in the foreign jurisdiction can be enlightening!

Settlement can be an effective resolution tool but needs to be considered carefully especially on how it impacts any possible rights to claiming relief from double taxation. The key take away is approach settlement with care, ensure the process is followed correctly and the agreement is drafted appropriately. Engage with the affiliate concerned in the foreign country early on and ensure you agree and understand the strategy and the possible outcomes.

Most importantly, do not jump quickly to settlement to appease SARS.

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