Transfer Pricing

Arm's Length Standard

Secondary Transfer Pricing Adjustments

Introduction

Section 31 of the Income Tax Act and the application of the arm's length principle requires a taxpayer to consider, whether the price charged in a cross border transaction with a "*connected person*" was *"calculated as if that transaction, operation, scheme, agreement or understanding has been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm's length."*

If such transactions are not arm's length – and if they disadvantage the South African resident company (i.e. if it has been over-charged or has been under-charged) – the company is required to make a transfer pricing ("TP") adjustment. More specifically, the South African company is required to calculate the arm's length consideration for the transaction and calculate its taxable income accordingly.

However, taxpayers sometimes overlook the fact that there is both a primary TP adjustment and a secondary adjustment. A significant change to section 31 took effect from 1 January 2015. This change introduced a new form of secondary adjustment mechanism.

Before considering the impact of the change in legislation it is important to understand the meaning of the terms "primary adjustment" and "secondary adjustment".

- Primary Adjustment

  The primary adjustment is the adjustment to the taxable income of the taxpayer. It would invariably result in additional taxable income.

  Assume, for example, that a South African company had provided services to a foreign related party and had not charged for those services. It is determined that the value of those services, during a specific tax year, was R1m. The South African taxpayer is required to make a primary adjustment of R1m – resulting in additional taxable income of that amount.

- Secondary Adjustment

  Apart from the primary adjustment, there is also a secondary adjustment which is required to be made. This is in recognition of the fact that, by virtue of the non-arm's length transaction, something of value has, in effect, been distributed by the South African company to the foreign connected person.

  Prior to the amendment to Section 31, the primary adjustment gave rise to a secondary adjustment in the form of a deemed loan on which interest was required to be calculated. The taxpayer was then required to pay tax on such deemed interest annually until and unless the original non-arm's length transaction was physically reversed (i.e. until the taxpayer received actual reimbursement from the foreign connected person of the non-arm's length consideration).

  However, keeping track of secondary adjustments in the form of a deemed loan proved to be a significant administrative burden both for the taxpayer and SARS. In practice, there was no legal basis for the foreign company to repay the deemed loan and the deemed interest because there were no contractual legal obligations supporting the settlement of the loan. It also created difficulties in relation to the accounting treatment of the deemed loan and the relevant currency of the deemed loan and deemed interest.

Secondary adjustments as of 1 January 2015

Due to the problems with the deemed loan secondary adjustment mechanism, National Treasury revised the legislation surrounding the secondary adjustment.

Therefore, as of 1 January 2015, the amount of the secondary adjustment will be deemed to be a dividend *in specie* for companies. The deemed dividend *in specie* will be deemed to have been declared and paid on the last day of a period of six months following the end of the year of assessment in which the adjustment is made.

Deemed loans still in existence as of 1 January 2015 will be deemed to be a dividend *in specie* declared and paid on 1 January 2015.

Dividends tax at the rate of 15% is payable by the company on such deemed dividends in specie.

With reference to the example mentioned above of the South African company which failed to charge for services worth R1m – and accordingly makes a primary TP adjustment of this amount – there will also be a secondary adjustment.

Therefore the total additional tax payable by the company is likely to be as follows:

- Income tax: 28% x R1m = R280 000
- Dividends tax: 15% X R1m = R150 000

It may be possible for the company to set off the income tax against an assessed loss. But it must be borne in mind that dividends tax is a cash tax and must be paid even if the company has an assessed loss.

An exposure calculation for the secondary adjustments on a TP adjustment which should have been made before 1 January 2015 can be complicated since the company would be liable for:

- Tax on the deemed interest up to 31 December 2014; and
- Dividends tax at 15% triggered on 1 January 2015.

Difference between a pricing adjustment and a TP adjustment

In order to avoid confusion, it is important to highlight the difference between a pricing adjustment and a TP adjustment.

Pricing adjustments occur when the actual price of goods is adjusted and has an accounting impact on the selling party's sales figure and the purchasing party's cost of goods sold figure. When pricing adjustments occur within the limited risk distributer ("LRD") model it is usually for purposes of achieving a targeted operating margin as determined by the intercompany agreements.

A pricing adjustment is an actual two-sided transaction and is recorded in the accounts of both related parties. This adjustment would usually involve the issue of a debit or credit note and would result in an actual payment. In this case, an arm's length price would be achieved through a payment and there would be no resulting TP issue.

Where an actual pricing adjustment occurs, there is no reason for primary or secondary TP adjustments to be made. However, confusion arises because companies often refer to pricing adjustments which are made in terms of a TP policy (e.g. an LRD model) as TP adjustments.

TP adjustments, on the other hand, are one sided and occur only through the adjustment to the taxable income of a taxpayer which that taxpayer is required to make in order to achieve an arm's length price.

Examples

- Example of a pricing adjustment

  South African entity, Company A is a distributer operating under the LRD model in terms of the agreement with its offshore related party company B from which it purchases goods for resale in South Africa. Company A is guaranteed an arm's length profit equivalent to the median of the inter-quartile range of results as determined by the latest benchmark study.

  According to the results of the latest benchmark study, the median profit of the range of identified comparable companies is 6%. Company A has achieved a profit of 5%, lower than the targeted amount. In order to achieve the targeted profit, Company B will adjust the prices of its good sold to

Company A downward and effectively refund Company A the difference in the amounts in order for Company A to achieve its targeted profit of 6%. An actual payment will be made and Company A's cost of goods sold will decrease in order for the company to achieve its targeted arm's length profit of 6%.

In this situation the arm's length price is achieved through an actual transaction between the parties. Therefore, no primary or secondary TP adjustment is required.

- Example of a TP adjustment

  South African entity, Company A received a loan of ZAR 100,000 from its offshore related party, Company B on which it is required to pay 7% interest per annum (ZAR 7,000). Upon examination, the company determined that the arm's length interest rate should have been 5% per annum (ZAR 5,000). Therefore, Company A determines that it has paid excessive interest of ZAR 2,000 to its related party.

  Company A is therefore required to make a TP adjustment so as to increase its taxable income by ZAR 2,000 in order to account for the excessive interest expense. This will be the primary adjustment and income tax will be levied on the extra ZAR 2,000. Furthermore, the secondary adjustment will result in the creation of a deemed dividend in specie in the amount of ZAR 2,000 which will be subject to dividends tax.

DTA Relief

It has been suggested that, where the foreign connected person is in a country with which South Africa has a double tax agreement (DTA), there should be DTA relief available in respect of the dividends tax on the deemed dividend in specie.

The following excerpt from the Davis Tax Committee Interim Report describes the current view regarding whether the deemed dividend in specie would be subject to relief. The excerpt gives guidance as to how SARS may interpret and apply the amendment to Section 31.

> "*It is suggested that the secondary adjustment should take into account the fact that, regardless of the relationship between the South Africa taxpayer and the counter-party, a transfer pricing adjustment is triggered as a result of economic value being transferred from South Africa for no, or inadequate, consideration. This transfer of economic value results in depletion in the asset base of the South African taxpayer; and a resultant potential loss of future taxable income for the Fiscus. For this reason it is suggested that transfer pricing adjustments are economically similar to outbound payments of dividends to foreign related parties since they represent a distribution of value from South Africa to the foreign company. Therefore the secondary adjustment mechanism should result in a tax equivalent to the proposed 15% withholding tax. For example, a tax similar to the old secondary tax on companies (STC) would be appropriate. Because it would be a tax levied on the South African company rather than on the foreign related party, no DTA relief would be available.*"[1]

[1] *Addressing Base Erosion and Profit Shifting in South Africa* Davis Tax Committee Interim Report.

However, a point which has not yet been fully resolved is whether section 64FA of the Income Tax Act does not provide relief from the dividends tax in such circumstances.

Withholding tax

There is a further issue which arises in relation to the secondary adjustment which relates to charges that attract withholding tax (i.e. interest or royalties). For example, if it is found that excessive interest has been paid, the excess portion would be deemed a dividend in specie through the secondary adjustment mechanism. However, withholding taxes would have already been paid on the excessive portion and will then have to be paid again in the form on dividends tax on the deemed dividend *in specie*.

There seems to be no mechanism for the withholding taxes to be offset against one another (for example by means of a credit for the withholding tax already paid).

Conclusion

In conclusion, while the shift from a deemed loan to a deemed dividend *in specie* is definitely a welcome change, there are some transitional issues which are challenging and which will require further consideration.

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