Arms Length Standard

Transfer Pricing: An overwhelming compliance burden for taxpayers

By Billy Joubert

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Taxpayers were burdened with two significant new transfer pricing compliance measures during 2016. Firstly, country-by-country reporting was introduced with effect from 1 January. Secondly, detailed record retention rules for transfer pricing were introduced with effect from 1 October.

Transfer pricing rules are anti-avoidance rules which are primarily aimed at preventing multinational groups from shifting profits to low tax jurisdications. The cornerstone of transfer pricing rules is the arm's length principle, in terms of which taxpayers are required to show that they have transacted with foreign related parties on the same terms as would have applied if the parties had been unrelated.

Transfer pricing rules form part of the wider issue of base erosion and profit shifting (BEPS). BEPS remains firmly on the agenda of governments and tax authorities worldwide and South Africa is no exception. BEPS has been a specific focus area of the Davis Tax Committee and its second and final BEPS report was submitted to the Minister of Finance in September last year. That report incorporates input from South Africa's leading transfer pricing and international tax experts. We will be interested to see whether the Budget speech gives an indication of the report's release date and any legislative changes that might be introduced as a result of its recommendations.

The existing transfer pricing practice note (SARS Practice Note 7) was issued in 1999 and is therefore quite significantly out of date. Parts of it have been superceded by the recent regulations discussed below. SARS has been promising a new interpretation note and taxpayers will be watching closely for indications that it might happen this year.

At the same time, clarity is needed on the tax treatment of thin capitalisation. These rules potentially apply when a South African company receives inbound loans from a foreign related party. The rules limit the extent of the interest liability which the local company can incur. A company which is considered to have borrowed too heavily is described as thinly capitalised.

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There used to a separate practice note dealing with thin cap (SARS Practice Note 2) but that has now been replaced by a draft interpretation note. There have been ongoing discussions between SARS, taxpayers and advisors on the issue of thin cap and the final version of the interpretation note is being eagerly awaited. It seems quite possible that, instead of having a separate interpretation note dealing with thin cap, the long awaited transfer pricing interpretation note will deal both with transfer pricing in general and with thin cap.

Transfer pricing record retention rules make transfer pricing documentation compulsory for all taxpayers who have cross-border transactions with foreign related parties. Full compliance is required where the total value of such transactions exceeds R100m and applies to each type of transaction to the total value of R5m per year. However, even taxpayers which fall below these thresholds are required to keep some records, in order to demonstrate to SARS that the transactions are arm's length.

Group documentation retained centrally outside South Africa will not be sufficient to satisfy the new record keeping requirements. Although these records provide a valuable starting point, they would need to be adapted into documentation which is specific to the South African entity or entities and additional records must be kept. This can include detailed information about foreign group companies. Taxpayers must therefore ensure that they either have this information or are able to access it if required.

A further change is that the country-by-country (CbC) report as well as the transfer pricing documentation (masterfile and local file) must be physically submitted to SARS. Transfer pricing documentation was not previously compulsory, with submission at the taxpayer's discretion, unless requested by SARS.

The remaining records specified in the Notice do not need to be submitted but must be retained by the taxpayer in the event of audit enquiries.

CbC reports will primarily affect South African based multi-nationals. Generally, the South African subsidiaries of foreign based multinationals will not be required to submit this report, as long as the foreign head office has a CbC reporting obligation. This obligation should be in a country which has signed the multinational agreement providing for automatic exchange of such reports. Currently, it is not altogether clear how SA subsidiaries of head offices in the United States would be affected, as the US is not willing to sign the multilateral agreement, but only bilateral agreements with selected countries (including South Africa). NO such agreement has yet been signed with South Africa.

Additionally, the US only introduced these reports from July 2016, causing some timing issues. However, this issue has been addressed by recent rules being issued by the IRS in the US permitting early filing of CbC reports (from periods starting from1 January 2016) for US MNE groups.

South African subsidiaries of foreign groups should therefore double check whether they need to submit a CbC report.

Taxpayers need to carefully plan so that they can meet the new compliance requirements, and this may well involve obtaining detailed information from group companies situated all over the world. If they have to submit a CbC report, they may well want to give themselves time to identify areas of concern for the report – for example, group entities situated in low tax jurisdictions which employ very few people, and/or with insignificant assets, but which make disproportionately high profits. There might be good reasons for these apparent anomalies which can be explained in the transfer pricing documentation.

South African taxpayers affected by transfer pricing probably therefore have more than enough on their plates for 2017.