Arms Length Standard

Transfer Pricing Disputes on the Rise

By Michiel Els

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The growing importance of transfer pricing in South Africa is clearly outlined by the South African Revenue Service's ("SARS") notice published at the end of last year. This notice makes it compulsory for companies with cross border transactions to submit local transfer pricing documentation together with a Masterfile and Country-by-Country reports. Not only are illicit financial flows (for which transfer mispricing forms the biggest part) constantly in the news, political parties are demanding that companies be scrutinised in order to ensure that they pay their fair share of tax.

Article written by
Michiel Els
Head: Transfer Pricing Dispute Resolution & Controversy Management
Taxation
Deloitte
Tel: +27112096458
Email : mels@deloitte.co.za

Transfer pricing is not, in itself, illegal or necessarily abusive. What is illegal or abusive is transfer mispricing, also known as transfer pricing manipulation or abusive transfer pricing.

It comes as no surprise that African governments are extending and tightening controls over cross-border transactions between companies within the same group. Not only are they aiming to stem the illicit outflows of funds but also to obtain tax revenue that is so desperately needed.

Multinationals operating in Ghana, Zimbabwe, Mozambique and Tanzania now have to contend with new or greatly expanded transfer pricing regimes, while virtually all the larger economies (South Africa, Nigeria and Kenya) which already have transfer pricing regulations in place, are intensifying their audit programs and tightening their rules.

Determining an appropriate transfer price in Africa is not a precise science, with the result of multinationals and governments having different opinions on the same transaction. Finding comparable information in Africa is difficult at best, with governments challenging the comparability thereof, as well as the most appropriate method used and the range determined.

This includes the new found focus on transfer pricing from the South African Revenue Service.

However, the international approach to dealing with transfer mispricing is through the "arm's length" principle, i.e. that a transaction should have the substantive financial characteristics of a transaction between independent parties, where each party will strive to get the utmost possible benefit from the transaction.

Let's use the example of a mobile phone manufacturer in the US (Hold Co) with a distribution company in South Africa (Sub Co). The manufactured cost for a single mobile phone is in the region of R7 000. Sub Co's distribution cost is in the region of R500. The transfer price for a single mobile phone is then set at R7 500. Once in South Africa, Sub Co retails it for R8 000. Accordingly, the group overall made of profit of R500 for which it is liable for tax.

On further investigation, Sub Co is audited and SARS notices that the South African company is not showing an arm's-length profit, with the transfer price set at R7 500 and the distribution cost at R500. SARS would want the transfer price to be shown as R7 000, in order for Sub Co to show a taxable profit of R500. However, this might pose a problem as Hold Co might have already paid tax on the R500 shown as profit in its accounts. Accordingly, should an adjustment be made this might lead to double taxation.

But, before we get to double taxation and the remedies available for multinationals we need to understand the process available for multinationals with regards to transfer pricing disputes in South Africa.

Once an assessment has been received from SARS and the taxpayer feels aggrieved therewith, the taxpayer may choose to have the dispute resolved in the following manners:

- SARS and the taxpayer could attempt to resolve the dispute by way of a mutual agreement through the Alternative Dispute Resolution ("ADR") process. The ADR process is less formal and expensive as it remains outside the litigation arena. It is also more time efficient, as the whole process should be completed within 90 days from the day of commencement. An ADR is available in addition to a taxpayer's right to appeal to the Tax Court or Board;
- By way of approaching the Tax Board, for disputes not exceeding R500 000. In all likelihood due to the amounts involved in transfer pricing cases this option would be seldom used if at all; or
- The Tax Court, which has jurisdiction over matters where the tax in dispute is in excess of R500 000.

As a further resort the matter may also be taken to the High Court and Supreme Court of Appeal.

As per the example earlier, should a transfer pricing adjustment be made, it might lead to double taxation. In principle a taxpayer can engage in competent authority discussions with SARS using Mutual Agreement Procedure ("MAP") once it receives a formal notification of a transfer pricing adjustment which might result in double tax with another country with which South Africa has a tax treaty.

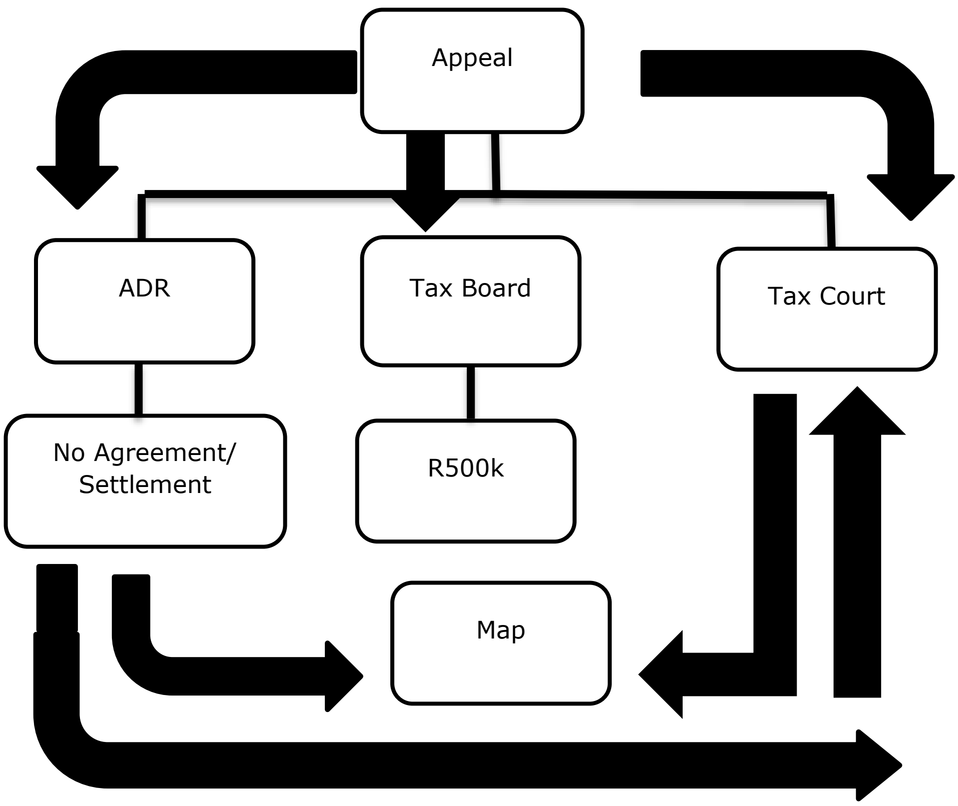
SARS has recently issued guidance on applying for the MAP. Generally, this procedure is available once there is an incidence of double taxation that cannot be easily resolved through the domestic dispute process. South Africa adopts a two-tier process: initially, a taxpayer can object to an assessment if there is a disagreement as to the assessment issued. SARS will then either accept, partially accept, or reject the taxpayer's objection (as stated above). If the objection is disallowed the taxpayer can appeal this decision to the tax court, and at the same time appeal the decision to the competent authority when there is an incidence of double taxation and there is a DTA in place.

The MAP request should only be submitted to SARS after the South African resident taxpayer has, where applicable, first approached the foreign revenue authority to make that revenue authority aware that, in that taxpayer's view, tax which is not in accordance with the provisions of the relevant DTA, has been levied by the foreign revenue authority.

If the matter cannot be resolved through that approach, then the South African resident taxpayer can approach the competent authority at SARS for assistance.

From the above it is evident that being involved with a transfer pricing dispute is long and costly and will eventually cause a financial and administrative nightmare for CFO's and their shareholders. To date we have not had a single transfer pricing court case to set a precedent. Normally both SARS and multinationals are keen to settle the matter after a long and frustrating battle. However, from the number of assessments and amounts involved, we expect a taxpayer to call SARS' bluff and go to court. Transfer pricing in South Africa will then move to the next level as legal precedence will be set and a degree of certainty will be given.

Example of process that could be followed


Appeal
ADR
Tax Board
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Map