

Transfer Pricing Country Summary Republic of South Africa

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1 Legislation

1.1 *Existence of Transfer Pricing Laws/Guidelines*

Section 31 of the Income Tax Act No.58 of 1962 ("ITA") contains the main legislative provisions relating to the South African transfer pricing rules. The current, revised, version of section 31 of the Act was introduced by the Taxation Laws Amendment Act, 2011 with effect from 1 April 2012, and is applicable in respect of years of assessment commencing on or after that date ("South African transfer pricing rules").

The South African transfer pricing rules will apply, broadly speaking, to any transaction, operation, scheme, agreement or understanding where:

- a) that transaction constitutes an "affected transaction" as defined; and
- b) results or will result in any tax benefit being derived by a person that is a party to the affected transaction.

The term "affected transaction" is defined in section 31(1) and includes, *inter alia*, any transaction, operation, scheme, agreement or understanding which has been directly or indirectly entered into or effected between or for the benefit of either or both, *inter alia*, a resident and a non-resident which are connected persons in respect to each other and where any of the terms or conditions agreed upon are not of an arm's length nature.

In these circumstances section 31(2) places an obligation on each party to the affected transaction which derives a tax benefit, to calculate its taxable income or tax payable as if that transaction, operation, scheme, agreement or understanding had been entered into on the terms and conditions that would have existed, had those persons been independent persons dealing at arm's length.

Essentially, the burden of proof is thus on the taxpayer to show that he has entered into the transaction, operation, scheme, agreement or understanding with connected persons on the terms and conditions that would have existed had the persons been independent persons dealing at arm's length.

Section 31(3) of the Act further provides for a secondary adjustment on the basis that any "adjustment amount" (i.e. the difference between the tax payable calculated in accordance with the provisions of section 31(2) and otherwise) will, in the case of an affected transaction between a resident company and *inter alia*, any other person that is not a resident, be deemed to be a dividend *in specie* paid by the resident company to that other person.

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.

In terms of section 64EA of the Act, a company that is a resident that declares and pays a dividend that

consists of a distribution of an asset *in specie* is liable for dividends tax in respect of that dividend. Dividends tax is calculated at 20% of the amount of any dividend paid (increased from 15% for any dividend paid on or after 22 February 2017), but might be reduced by the applicable double taxation agreement entered into between South Africa and the jurisdiction where the non-resident is resident for tax purposes if the non-resident would have been entitled to a reduction in the rate had it been liable for the dividends tax and provided certain documentation requirements are met.

Status of the OECD Guidelines

Although South Africa is not a member country of the Organisation for Economic Co-operation and Development (“OECD”), it was awarded OECD observer status in 2004 and is also a member of the OECD BEPS Committee. South Africa closely follows the guidance contained in the OECD’s Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (“OECD Guidelines”) in respect of transfer pricing matters in the absence of specific South African guidance.

In this regard, it has been acknowledged by SARS that the OECD Guidelines are an important document that reflect unanimous agreement amongst the member countries, reached after an extensive process of consultation with industry and tax practitioners in many countries and, as the OECD Guidelines are also followed by many countries that are not OECD members, they have effectively become a globally accepted standard. SARS also endorses the standard OECD transfer pricing methods, including the traditional transaction methods, such as the CUP method, the resale price method and the cost plus method, as well as the transactional profit methods, such as the TNMM and profit split method.

Thin capitalisation

With the introduction of the current transfer pricing rules, the issue of thin capitalisation has also become part of the general transfer pricing mandate, which is in alignment with the view of the OECD. On this basis, the South African transfer pricing rules require that the arm’s length principle be applied to financial assistance in the same way as it is applied to any other transaction, operation, scheme, agreement or understanding. In practice, in the context of financial assistance, this will result in a taxpayer having to determine, *inter alia*, what amounts it would and could have been able to borrow in the open market (that is, its lending capacity), on what overall terms and conditions, and at what price.

Additionally, section 23M of the ITA contains a “fixed-ratio” rule as contemplated in the Final report on BEPS Action 4 “Limiting Base Erosion Involving Interest Deductions and Other Financial Payments”. In terms of section 23M, net interest expenses in respect of certain inward loans may be disallowed as a deduction to the extent that they exceed a specified percentage of a resident taxpayer’s EBITDA. The percentage of EBITDA to be applied depends on the prevailing base lending rate, but is currently 44 percent.

SARS issued a Draft Interpretation Note, *Determination of the Taxable Income of certain persons from international transactions: Thin Capitalisation*, which is yet to be finalised. SARS has indicated in their Draft Interpretation Note that, in order to consider what is an appropriate amount of debt for thin capitalisation

purposes and in applying the arm's length principle to funding arrangements, a taxpayer should consider the transaction from both the lender's perspective and the borrower's perspective.

That is, in determining the arm's length amount of debt from the lender's perspective, whether the amount borrowed *could* have been borrowed at arm's length (that is, what a lender would have been prepared to lend and therefore what a borrower could have borrowed) and from the borrower's perspective, whether the amount *would* have been borrowed at arm's length (that is, what a borrower acting in the best interests of its business would have borrowed). In addition, the taxpayer needs to consider whether the interest rate is an arm's length interest rate.

In this regard, it should be noted that SARS' interpretation notes are not law, but provide insight into the prevailing practice of SARS and guidelines on SARS' view on the interpretation and application of the provisions of the tax acts. In addition, this interpretation note is still only in draft format. We are expecting SARS to update the Draft Interpretation Note in line with the latest guidance of the OECD (as discussed in more detail below), but considering that further work is still envisaged by the OECD in this regard, we are not sure when to expect such an update.

Exchange controls

It should be noted that South Africa is subject to a system of exchange control which may also impact on the terms of cross-border related party transactions.

1.2 *Transfer Pricing Scrutiny*

In line with most other jurisdictions, SARS has substantially increased its focus on transfer pricing as one of the main sources of income in fighting its increasing budget deficit. In recent years, the main focus has been scrutinizing so-called high-risk transactions, in particular in the mining and resources sectors.

In addition, benchmarking studies are not necessarily accepted at face value by SARS, and the validity of the assumptions underlying a benchmark may be called into question.

1.3 *Definition of Related Party*

Related parties are defined as "connected persons" for South African tax and transfer pricing purposes. The definition of a "connected person" is contained in section 1 of the ITA.

In terms of the general definitions in the ITA, a connected person with regard to a company is any other company which would be part of the same group of companies as that company, if the below threshold of "at least 70 per cent of the equity shares in" is replaced by "more than 50 per cent of the equity shares or voting rights in".

In addition, any company that individually or jointly with any connected person in relation to itself, directly or indirectly holds at least 20 per cent of a company's share capital or voting rights is also considered to

a connected person to such company, as long as no shareholder holds the majority voting rights in the company. In respect of transactions involving intellectual property or financial assistance, the above qualification “as long as no shareholder holds the majority of the voting rights in the company” falls away, therefore a 20 per cent shareholding is sufficient to constitute connected persons for transactions involving intellectual property or financial assistance, independent of whether any other shareholder holds the majority of voting rights in the company or not.

A connected person relationship between two companies may also exist where a connected person in relation to one company (or a connected person in relation to such person) manages or controls the other company.

The connected person definition is extensive and requires careful consideration. Structures involving trusts are especially likely to include connected persons.

1.4 *Transfer Pricing Penalties*

In addition to the primary and secondary adjustment, where the application of non-arm’s length terms has resulted in any prejudice to SARS or the fiscus, the taxpayer may be liable for understatement penalties in terms of section 222 of the Tax Administration Act, 28 of 2011 (“TAA”).

Understatement penalties are determined as a percentage of the difference between the understated amount of tax and the amount that should properly have been chargeable to tax. The percentage depends on the “behavior” involved in the understatement and ranges between 10 percent, for a first case of “substantial understatement” to 200 percent for a repeat case of “intentional tax evasion”.

In terms of sections 89*bis* and 89*quat* of the ITA, interest is payable on underpaid amounts of tax at a rate which is prescribed from time to time.

1.5 *Advance Pricing Agreement (APA)*

At this stage, South Africa does not provide for Advance Pricing Agreements. Although taxpayers may make an application for an Advance Tax Ruling (“ATR”) from SARS to confirm the tax treatment of a proposed transaction where uncertainty as to the tax treatment thereof exists, transfer pricing related transactions are specifically excluded in terms of the “No Rulings List” published by SARS in terms of a Public Notice.

2 Documentation And Disclosure Requirements

2.1 *Tax Return Disclosures*

The ITR14 corporate tax return requires disclosure of whether the taxpayer has entered into any “potentially affected transactions” (i.e. cross-border, related party transactions, regardless of whether the terms thereof are arm’s length) during the year of assessment.

Where potentially affected transactions have been entered into, the taxpayer is required to disclose the value of such transactions in respect of various payment categories (royalties, commissions, service fees etc), on a jurisdiction by jurisdiction basis, for the 5 most valuable jurisdictions in each category.

The ITR14 also requires further specific disclosures aimed at assessing transfer pricing risk, including the disclosure of various financial assistance ratios.

2.2 *Level of Documentation*

South Africa has committed itself to introducing transfer pricing documentation requirements in line with the three-tiered approach as suggested by the OECD. The requirements for country-by-country (“CbC”) reporting were finalised on 23 December 2016 while the master file and local country file requirements were finalised on 20 October 2017 in a Public Notice.

CbC returns

On 23 December 2016, the Minister of Finance issued regulations governing CbC reporting which closely follow the implementation package in Annex IV to Chapter V of the OECD Guidelines. The main requirements in respect of CbC reporting may be summarised as follows:

- MNE Groups with consolidated group revenue of less than R10 billion are not required to file CbC returns.
- Returns are to be filed electronically, using the CbC01 form, which captures CbC information according to the OECD’s CbC XML Schema.
- CbC returns are to be submitted within 12 months of the last day of the Reporting Fiscal Year. The notice applies in respect of Reporting Fiscal Years commencing on or after 1 January 2016, and the first returns will therefore be due by 31 December 2017.

Master file and local file returns

On 20 October 2017, the Minister of Finance issued regulations governing transfer pricing documentation. In the Public Notice, requirements for the master file and local file were set out which closely follow Annexes I and II to Chapter V of the OECD Guidelines.

The key requirements in terms of the Public Notice are as follows:

- Persons who have the filing obligation to submit CbCR returns or have “potentially affected transactions” for the year of assessment that exceeds or is reasonably expected to exceed R100 million in aggregate value are required to submit a return in the form and containing the information specified in the Business Requirement Standard: CbC and Financial Data Reporting (“BRS”) in relation to the master file and local file.

- The BRS incorporates the master file and local templates from Annexes I and II of Chapter V of the OECD Guidelines. In respect of the master file, the BRS notes that the information required in terms of Annex I represents a minimum requirement for the master file. No set format exists for the presentation of the master file information. The BRS notes however that, given this flexibility, MNEs are encouraged to prepare the master file as a “real-life summary”, depicting the overall TP policy and supply chain for each of their businesses in such a manner that any person reading the document may understand the intercompany pricing policies adopted. The BRS does not provide any guidance in respect of the local file contents beyond that contained in Annex II to Chapter V.
- The master file and local file are to be submitted electronically via the South African Revenue Service (“SARS”) e-filing system. MNEs are therefore able to prepare the master file and local file returns in a form which they choose, and upload those documents to the system.
- The master file and local file returns are to be submitted within 12 months of the last day of the year of assessment. The submission deadline therefore coincides with that for the corporate tax return.

In the case of persons who have the filing obligation to submit CbCR returns, the requirement for submission applies for Reporting Fiscal Years commencing on or after 1 January 2016 and for subsequent Reporting Fiscal Years.

In the case of persons do not have the filing obligation to submit CbCR returns but have “potentially affected transactions” (essentially cross-border transactions with connected persons) for the year of assessment that exceeds or is reasonably expected to exceed R100 million in aggregate value, the requirement for submission applies for financial years commencing on or after 1 October 2016 and for subsequent financial years.

No documentation is required to be submitted by a person whose potentially affected transaction are below the R100 million threshold. However, on submission of the ITR 14 tax return, the taxpayer is required to disclose whether it has prepared transfer pricing documentation. In terms of the guide to the ITR 14 this should only be confirmed if such documentation is readily available.

Penalties for failure to submit CbCR, Masterfile and Local Files

The definition of “International Tax Standard” has been amended in section 1 of the TAA to include the CbCR standard of Multinational Enterprises.

All the South African reporting MNE groups that must file the CbC report must also submit a master and/or local file to SARS when required in terms of section 25 of the TAA.

Administrative non-compliance penalties comprise fixed amount penalties as well as percentage-based penalties as per sections 210(1) and 211 of the TAA . The penalty amount that will be charged depends on a taxpayer’s taxable income and can range from R250 up to R16 000 a month for each month that the non-compliance continues.

2.3 *Record Keeping*

In addition to the documentation requirements described above, SARS has issued a public notice specifying records, books of account or documents which must be kept for transfer pricing purposes ("Record-Keeping Requirements"). Persons whose potentially affected transactions for the year of assessment exceed or are reasonably expected to exceed R100 million in aggregate value, are required to keep certain records regarding their structure and operations. Such persons are additionally required to keep transaction-specific records in respect of any potentially affected transaction which exceeds or is reasonably expected to exceed R5 million in value. Particularly detailed record-keeping is required in respect of "financial assistance transactions".

Persons whose potentially affected transactions fall below the R100 million threshold are nevertheless required to keep such records as allow them to ensure and for SARS to be satisfied that such transaction are conducted at arm's length.

The information specified in the Record-Keeping Requirements is not required to be submitted as a matter of course but must be available in case of audit.

The Record Keeping Requirements apply for years of assessment commencing on or after 1 October 2016 and for subsequent years of assessment

2.4 **Language for Documentation**

Transfer pricing documentation should be drafted in the Commissioner's functional language, which is English, even though, in theory, all 11 official languages of South Africa are accepted.

2.5 **Small and Medium Sized Enterprises (SMEs)**

As described above, no documentation is required to be submitted by a person whose potentially affected transaction are below the R100 million threshold. The Record-Keeping Requirements in respect of such persons are also reduced.

2.6 **Deadline to Prepare Documentation**

In the scenario where no requirement to submit any transfer pricing documentation, on submission of the ITR 14 tax return, the taxpayer is required to disclose whether it has prepared transfer pricing documentation. In terms of the guide to the ITR 14 this should only be confirmed if such documentation is readily available. The failure to confirm the preparation of transfer pricing documentation is generally an audit trigger.

2.7 **Deadline to Submit Documentation**

The deadline for submission of master file and local file returns is 12 months from the last day of the

financial year. The deadline for submission of country-by-country returns is 12 months from the last day of the Reporting Fiscal Year.

3 Statute Of Limitations

The standard statute of limitations is three years from the date of the original notice of assessment. However, considering that section 31 of the Income Tax Act essentially requires a self-assessment by the taxpayer, the statute of limitations is extended in terms of section 99(1)(b) of the Tax Administration Act to 5 years after the date of the original assessment by way of self-assessment by the taxpayer. No statute of limitations applies in case of fraud, misinterpretation or inaccurate or incomplete disclosure of material facts.

4 Transfer Pricing Methods

As mentioned before, SARS generally follows the guidance of the OECD Transfer Pricing Guidelines. Accordingly, all transfer pricing methods accepted by the OECD in the OECD Transfer Pricing Guidelines are accepted by SARS, including the CUP method, the resale price method, the cost plus method, the profit split method and the transactional net margin methods.

As a general rule, the most reliable method will be the one that requires fewer and more reliable adjustments to be made. Taxpayers will not be required to undertake an intricate analysis of all the methodologies, but should have a sound basis for using the selected methodology.

5 Comparables

Information on South African companies is only readily available in the form of published financial accounts of public companies. More detailed information on public companies and information on private companies is generally not publicly available. South African comparables are consequently not easily available.

Accordingly, SARS has stated in Practice Note 7 that it accepts the use of foreign financial databases but may require that adjustments to the data are carried through for use in the South African market. SARS currently uses Bureau Van Dijk's AMADEUS and Orbis Databases to conduct comparable studies. While in the past SARS was relying heavily on European companies for comparability, its approach has recently been widened to include other geographic areas, depending on the specific circumstances of the transaction and the industry in which the tested party operates.

This document was updated in cooperation with Jens Brodbeck, [ENSafrica](#)

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