Are you prepared for a Transfer Pricing Audit?

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A significant volume of global trade consists of transactions where goods, services, capital and intangibles (such as Intellectual Property and Royalties) are transferred between the various entities of a Multinational Corporation. Where one of these entities is a resident of South Africa, SARS may test these transactions against the provisions of Section 31 of the Income Tax Act, taking into account the interpretation as set out in Income Tax Act, Practice Note No. 7 of 1999 ("PN 7"), to evaluate if a **tax benefit** was derived by any party to the transaction.

Should it be concluded that such a **tax benefit** has been derived by the South-African entity, Section 31 enables SARS to adjust the consideration for the supply or acquisition of goods or services in terms of an international agreement between connected persons. SARS may adjust the consideration, for tax purposes, if the actual price is either less or greater than the price that would have been charged if the supply or acquisition had occurred between independent parties on an arm's length basis.

Section 31, therefore, provides a mechanism by which SARS adopts the internationally accepted "arm's length principle" for taxation purposes in order to ensure that the South African fiscus receives its fair share of tax. This is achieved by adjusting the consideration, in the determination of taxable income, based on the conditions which would have existed between unconnected persons under comparable circumstances.

It is important to note that the application of Section 31 could lead to a situation where the total percentage of tax paid on a transaction could be higher than the highest tax percentage levied by either of the two tax authorities.

To illustrate such a situation the following example is used:

> *Company A, a resident of South Africa, manufactures and sells product x to its subsidiary, Company B. Company B is a resident of Country B, where the effective tax rate for companies is 20%.*
>
> *The total cost to manufacture product x is R100. Shipping to Country B is R10 per unit.*
>
> *If company A decided to sell product x in South Africa, it would be able to sell the product for R200. Company A, however, sells the product to its subsidiary company B for an amount of R130, thereby realising a profit of R20 after shipping costs have been paid. Company B sells Product X for the equivalent of R250 in Country B. Realising a profit of R120, that is taxed at a rate of 20%.*

If SARS successfully argues that a tax benefit has been derived, Company A will be taxed on a profit of R90 per Product X. This is called the primary adjustment. The secondary adjustment results due the difference between the R130 received and the adjustment to R200. The R70 difference is now deemed a loan to company B and an arm's length interest rate will now be raised on this loan resulting in a further increase in taxable income. The results are shown below.

	Before application of Section 31 Company A	After aplication of Section 31 Company A
Sales Price	130	130
Cost of sales	-100	-100
Shipping costs	-10	-10
Profit before tax	20	20
Section 31 Primary Adjustment (R200 - 130)	-	70
Section 31 Secondary Adjustment (Interest)	-	6
Adjusted profit before tax	20	96
Taxation @ 28% / 20%	-6	-27
Total taxation	6	27
Additional tax paid due to application of Section 31		21

In such circumstances it is clear that the application of Section 31 will drastically reduce profit margins. It is therefore imperative to manage this risk in order to protect your company against an application of Section 31.

The deemed loan will also accrue interest *ad infinitum,* resulting in additional future tax paid on the interest received every year. This situation has however been addressed and the draft Taxation Laws Amendment Bill, released for public comment on 17 July 2014, proposes that the secondary adjustment will now be deemed a dividend *in specie* paid by Company A (The Resident). Company A will therefore be responsible to pay the dividend tax of 15% on the secondary adjustment.

By following the guidelines provided in PN 7, supported by the Organisation for Economic Cooperation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, a Transfer Pricing Policy can be drafted based on the results of a Functional Analysis of the Multinational Corporation and the affected transactions. Based on the result, one of the recognised transfer pricing methods can be applied on the affected transactions, which will strengthen an argument against the application of Section 31.

When advising on the tax implications for a Multinational Corporation, various other international tax provisions must also be considered such as the effect of the Controlled Foreign Company Rules. Furthermore, there are also Foreign Exchange Control provisions which need consideration from a South-African perspective.

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