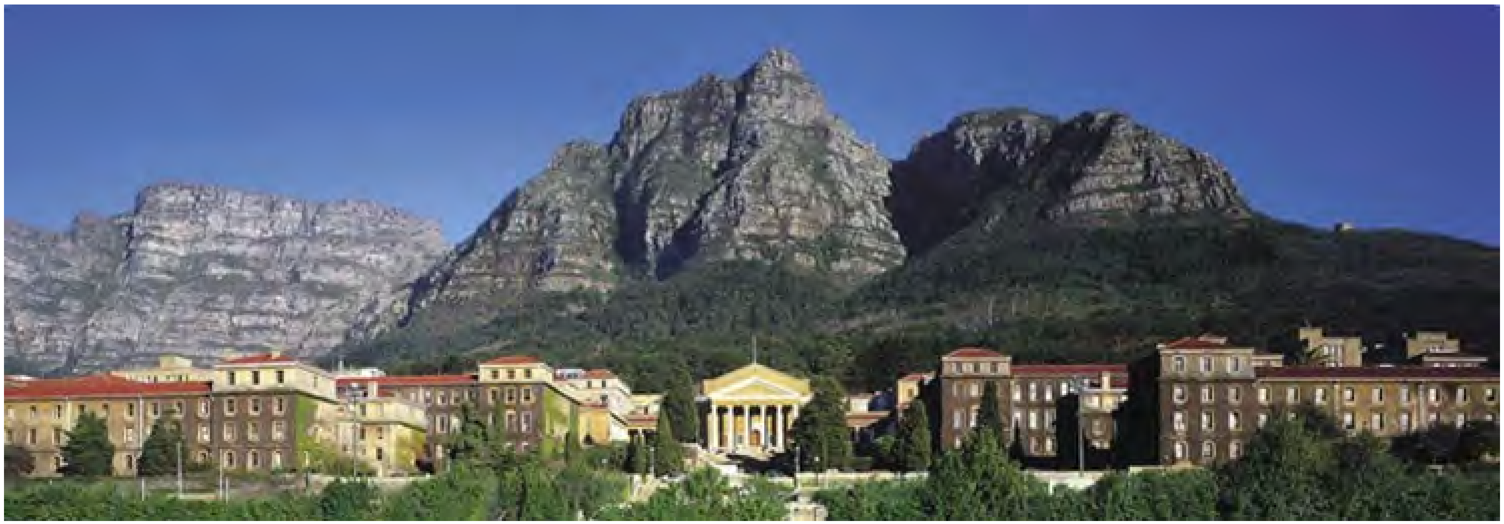
Presentation to Portfolio Committee on Trade and Industry
22 April 2015

Transfer Pricing in South Africa



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Outline

- What is Transfer Pricing?
- Transfer Pricing in practice in South Africa
- Transfer Pricing in the rest of the world
- The South African mining industry
- Concluding remarks

Transfer Pricing defined

- Legal definition (synonym = intercompany pricing):

*"An area of tax law that is concerned with ensuring that prices charged between associated enterprises for the transfer of goods, services and intangible property accord with the arm's length principle." **

*"the setting of prices at which transactions occur involving the transfer of property or services between associated enterprises, forming part of a multinational group. These transactions are also referred to as "controlled" transactions, as distinct from "uncontrolled" transactions between companies that, for example, are not associated and can be assumed to operate independently ("on an arm's length basis") in reaching terms for comparable transactions" **

* International Tax Glossary, International Bureau of Fiscal Documentation, Amsterdam: 2015

Transfer Pricing defined

- A transfer price is therefore colourless:

*"it follows that, with the need to set such prices being a normal incident of how [multinationals] must operate, 'transfer pricing' by itself does not necessarily involve tax avoidance. It is where the pricing does not accord with applicable norms internationally or at domestic law that we are entering into areas more properly called "mispricing", "incorrect pricing", "unjustified pricing" or similar, and where issues of tax avoidance and evasion may arise" **

* Chapter 1, Practical Manual on Transfer Pricing for Developing Countries, United Nations: 2011

Transfer Pricing defined

- Correcting intercompany mispricing by tax authorities are not setting of actual intercompany prices / not price control by the government.
- Purely a legal fiction to work out an amount of tax payable.
  - The fiction is: members of a multinational must, for tax purposes, be considered to transact with each other as if they were acting at arm's length.

Transfer Pricing example

MNE

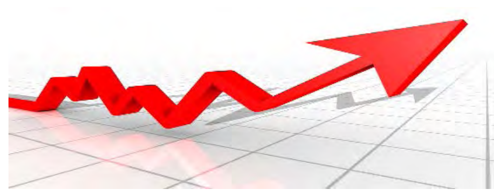
Cost	Profit

Corporate Tax rate is 28% of profits
Tax payable 28% x $50 = $14

Country A

Country B

Market Commodity Price $100



Total tax for MNE = $14

Transfer Pricing example

Related Parties

MNE

Country A

Cost | Profit

Corporate Tax rate 28%

Tax payable \$25 x 28% = \$7

Country X

MNE Global Marketing

Transfer price \$ 75

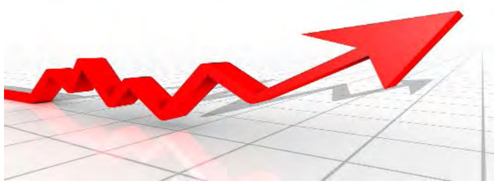
Cost | Profit

Corporate Tax rate 20%

Tax payable \$25 x 20% = \$5

Country B

Market Commodity Price \$100



Total tax for MNE = \$12

Transfer Pricing in practice

- Sec. 31 of the Income Tax Act, 58 of 1962, introduced in 1997 following a recommendation by the Katz Commission.
  - Requires related parties to transact at arm's length for SA tax purposes.
- Supplemented by detailed guidance formulated by SARS:
  - SARS Practice Note 7, 1999, adopts OECD Transfer Pricing Guidelines;
  - United Nations Practical Manual on Transfer Pricing for Developing Countries, 2011 (SA chapter 10.5).
- In addition, SARS can address pure tax avoidance through the General Anti-Avoidance Rule (sec. 80) or abuse through the common law 'sham' doctrine.
- In essence:
  - SARS enabled to apply modern and internationally harmonised transfer pricing Guidelines developed under the aegis of the OECD and the United Nations; and
  - Taxpayers are legally obliged to comply since 1997.

Transfer Pricing in practice

- Implementation of the 1997 legislation and OECD/UN transfer pricing guidelines in SA:
  - SARS has power to require full information to audit and detect intercompany transactions, though not always made compulsory for taxpayers.
  - Full compulsory OECD style taxpayer information disclosure recommended by Davis Tax Committee.
  - Disputes with SARS: Battle of the experts since law, economics & accounting coincide to establish arm's length prices.
  - Complex and ultimately subjective evaluation because of the difficulty in identifying intangibles and services which were transferred or provided and the arm's length price at which they are to be valued.

Transfer Pricing in practice

- Conclusion: More than enough in the legislative armoury to effectively combat intercompany mispricing or tax abusive behaviour.
- BUT SARS is understaffed and outnumbered to effectively implement the transfer pricing legislation on a broad spectrum.
  - Will become severe when international taxpayer information exchange (OECD country-by-country reporting) goes on-line.
  - Compare the UK: Since 2008 HMRC invested heavily in human resources (approx. 200 TP experts) but no change to existing OECD patterned transfer pricing legislation. HMRC TP unit collected GBP 5,8 billion additional tax between 2008 and 2014 (GBP 1,1 billion alone in 2014)*.

* https://www.gov.uk/government/publications/transfer-pricing-statistics-2013-to-2014/transfer-pricing-statistics-2013-to-2014

Transfer Pricing in the rest of the world

- Transfer Pricing is reciprocal:
  - A price adjustment in one country must be reflected by a corresponding adjustment in the other country;
  - Otherwise economic double taxation (edt) occurs;
  - Means that unilateral deviation will upset trade partners (edt is an obstacle to trade);
  - Hence high degree of international uniformity in Guidelines (formulated by the OECD and United Nations);
  - Also: SARS will not only face a multinational taxpayer, but also a foreign counterpart following a transfer pricing adjustment in South Africa.

Transfer Pricing in the rest of the world

- Transfer Pricing in the BRICS:
  - All the BRICS, except Brazil, take the OECD TP Guidelines as a starting point;
  - The BRICS noted individual country practices and challenges in the 2011 UN Practical Manual on Transfer Pricing for Developing Countries;
  - The BRICS are going to require additional taxpayer information when OECD style country-by-country transfer pricing reporting becomes effective;
  - Brazil follows own transfer pricing approach to establish arm's length prices:
    - Uses fixed commodity prices derived from international bourses;
    - Fixed margins / safe harbour ratios for other goods and services;
    - Advantages: Certainty in tax treatment. Creates uneven playing field and thus competitive advantage for Brazilian economy (tax competition);
    - Disadvantages: Results in unresolved economic double taxation of corporate profits.

Transfer Pricing in the rest of the world

- Current international developments:
  - G20/OECD focus on addressing tax planning strategies used by multinationals (Base Erosion and Profit Shifting – BEPS – project);
  - Focus is on industries that rely on intangible assets to create value (e.g. e-commerce and pharmaceuticals);
  - Further sophistication and complexity in TP Guidelines will follow, meaning a continued battle of the experts;
  - Davis Tax Committee recommends adoption of G20/OECD BEPS work to date.

Transfer Pricing in the rest of the world

- New norms for global tax transparency being developed under G20/OECD BEPS project:
  - Transfer Pricing compliance supported by reporting of corporate tax accounts on country-by-country basis (but *only* available to tax authorities);
  - Adoption in SA recommended by Davis Tax Committee.
- Why is South Africa not part of the Extractive Industries Transparency Initiative (EITI)?
  - 48 countries have implemented of which 18 in Africa;
  - Full public disclosure of taxes and other payments made by oil, gas and mining companies to governments.

SA mining industry

- Nothing particularly special about applying transfer pricing legislation and guidelines to mining of minerals or gas.
- Not easy to manipulate intercompany price of heavily traded commodities.
- Pricing of intercompany services are generic to all industries. Mispricing of services is not particular to mining.
- Emphasis should be on transparency and ensuring SARS has capacity to process taxpayer information and audit taxpayer compliance.

Concluding remarks

- SARS should receive significant additional human resource support to audit compliance with the established transfer pricing legislation and guidelines.
- Emphasis should be on transparency in SA extractive industry, both as regards contributions of corporate taxes and all other government earnings from the industry.

Concluding remarks

- Competitiveness of SA tax system is an issue because transfer pricing planning strategies both benefit and present a risk to the SA tax base:
  - Benefit to SA tax base: Tax attributes encourage shifting of business activities and associated profits into SA:
    - Corporate tax rate differences in Africa (e.g. SA 28 % vs. Angola 35%)
    - SA gateway tax incentives (Headquarter regime).
  - Risk to SA tax base: Aggressive tax structures involving shifting profit with no associated substance to low or no tax jurisdictions.