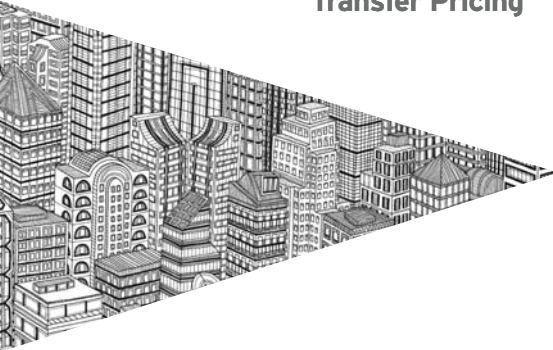


# International Tax Alert

News and views from  
Transfer Pricing



## South Africa proposes changes to the income tax act

### Section 31(2) transfer pricing and Section 31(3) thin capitalization

The draft Revenue Laws Amendment Act (RLAA) issued for comment on 10 May 2010 contain some far reaching changes to the current legislation around transfer pricing and thin capitalization. Purported to bring South Africa more in line with international standards, these changes will pose a real challenge to South African companies involved in cross border activities.

Below we summarize some of the salient changes.

#### Transfer pricing

The existing legislation provides the Commissioner with the power to adjust the consideration paid and received in a transaction between a resident and a non resident, where he is of the view the price paid in relation to that transaction is not in accordance with the arm's length principle.<sup>1</sup>

The South African Revenue Service (SARS) believes the current wording overly focuses on isolated transactions rather than the overall arrangement and does not take into account the economic substance of the commercial objective of the arrangement. In SARS's view, the focus on price instead of the resulting profit does not align with the wording of Article 9 of the Model Tax Convention, which deals with relief from double taxation.<sup>2</sup>

1. Where the conditions made or imposed between associated enterprises in their commercial or financial relations accord to those which would be made between independent enterprises.

2. Model Tax Convention on Income and Capital - OECD 2005 Edition.

As a result, the scope of Section 31(2) is to be significantly widened by the draft RLAA to permit the Commissioner to adjust the terms and conditions of a transaction as opposed to the price, where he is of the view these terms and conditions do not accord to the arm's length principle. Further, in reviewing the arrangement, the Commissioner is no longer restricted to the transaction stated but can look wider to the overall transaction, operation, scheme, arrangement, agreement or understanding of which the transaction(s) form part.

In our view, this reinforces Section 31(2) as a targeted anti avoidance provision strongly aligning it with the powers provided to the Commissioner in terms of Section 80B. How SARS intends to implement this is still to be clarified. The OECD Guidelines<sup>3</sup> maintain that a Tax Administration should always start from the premise of recognising the arrangement as portrayed by the taxpayer and adjusting the price on underlying transactions where this does not accord to the arm's length principle. Only in exceptional circumstances does the OECD support taking an economic substance over form approach and disregarding and re-characterising part or the whole of an arrangement.

SARS still needs to provide clarity as to whether they will still adhere to these fundamental principles of

the OECD and seek to remedy transfer pricing transgressions through pricing of specific transactions as opposed to disregarding and re-characterizing, except in exceptional cases.

The move to the broader wording also suggests a domestic transaction that forms part of an overall arrangement with a cross border nexus may also be caught by the provisions. For instance, if a foreign company sells goods to a South African distributor who also employs another South Africa group company to provide marketing services with respect to the distribution of those goods, the transactions between the two South African companies could potentially also be caught by the wording of the proposed Section. Certainly in the Budget speech and the Explanatory Memorandum supporting the draft RLAA, it seems SARS is intending to bring certain domestic transactions into the transfer pricing net.

#### Thin capitalization

Two key changes are proposed to Section 31(3). The first extends the provisions to South African branches of foreign companies to make financing into South Africa through a branch structure on par with that of a subsidiary structure. At this stage, SARS has not

provided any guidance as to how they will determine a hypothetical debt to capital ratio for a branch, or whether reliance on the OECD Guidelines for profit attribution to branches can be relied on.<sup>4</sup> This could create uncertainty for taxpayers operating in South Africa through branch structures.

The second and perhaps more radical change is the move from a fixed capital test to an arm's length test in determining an appropriate debt to equity ratio. It is common knowledge that SARS intends to withdraw Practice Note 2 at some stage, but currently it represents guidance around establishing a debt to equity ratio using a fixed capital test as well as providing a safe harbor of 3(debt):1(equity). Whether this will still apply once the legislation is enacted is uncertain. If the Practice Note remains in force, whether taxpayers can still rely on its guidance and how it will reconcile to the new provisions, is something that needs to be clarified by SARS.


The introduction of an arm's length test without a safe harbour or adequate guidance would place a huge burden on taxpayers to ascertain whether there is a thin capitalization transgression.

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3. OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations - 2009 Edition.

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4. Report on the Attribution of Profits to Permanent Establishments - OECD July 2008.



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EYG no. CM1974

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