SARS spotlight clearly focused on Transfer Pricing

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With the Minister having recently announced the R3 billion spending allocation towards the enhancement of SARS enforcement with a particular focus on transfer pricing, it is highly probable that we will be seeing more queries and audits in this area.

This is further confirmed in the recent judgement handed down on 7 January 2021 in *ABC (Pty) Ltd v C:SARS (IT14305)*[1] which is now regarded as the second transfer pricing case in South Africa in under 3 years with the first being, *Crookes Brothers Ltd v C:SARS*[2] (judgment delivered on 8 May 2018).

Background

The Applicant (ABC (Pty) Ltd) is in the business of manufacturing, importing and selling chemical products. It has a catalyst division that is focused on manufacturing and selling catalytic converters (catalysts) which are used in the abatement of harmful exhaust emissions from motor vehicles. The catalysts are then sold to South African customers who are primarily motor vehicle manufacturers.

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[1] ABC (Pty) Ltd v Commissioner for the South African Revenue Service (IT14305) [2021] ZATC1
[2] Crookes Brothers Ltd v Commissioner for the South African Revenue Service [2018] ZAGPHC 311

In order to produce such catalysts, the application purchases the metals required from a connected party known as the Precious Group of Metals (PGM) situated in Switzerland.

SARS conducted an audit in 2014 on the taxpayers 2011 year of assessment and raised an additional assessment on 11 January 2016 to effect an adjustment to the Applicant's taxable income due to it holding the view that the purchase of metals from PGM did not meet the arm's length standard.

It is noted that the Applicant did not specifically test its transactions or document for transfer pricing purposes. At this point it is important to note that the tax period to which dispute relates was prior to the mandatory requirement for taxpayers to maintain a transfer pricing policy.

However, Practice Note 7 (PN 7) which existed at the time, recommended that taxpayers maintain such policy so as to support the arm's length nature of transactions between connected persons and further states that where a taxpayer elects not to prepare transfer pricing documentation, it is at risk on two counts. The first being that it is more likely that SARS will examine a taxpayer's transfer pricing in detail and the second being in the event where SARS makes the determination of the arm's length price that it will be difficult for the taxpayer, with a lack of adequate documentation, to rebut that substitution either directly to SARS or in the Courts.

SARS conducted its own transfer pricing analysis based on PN 7 and the Transfer Pricing Guidelines (TPGs) which included a benchmarking study using external companies it considered comparable to the Applicant and concluded that the Transactional Net Margin Method (TNMM) with a Full Cost Mark-up (FCMU) of 1% as applied by the Applicant in its 2011 financial statements fell between the minimum and lower quartile of the range of comparable companies. Accordingly, SARS argued that the that the pricing of the transaction was not at arm's length and adjusted the FCMU to the median arm's length range. This resulted in an increase in the Applicants taxable income of R114,157,077 in the 2011 year of assessment.

Issue

The Applicant sought a separation of issues order to the effect that SARS had incorrectly applied the provisions of section 31(2) by adjusting its profits and effectively the price it charged to the third-party customers as opposed to adjusting the pricing of the metals purchased from PGM hence the additional assessment is invalid.

A separation of issues order effectively allows a separation of a question of law or fact to be decided prior to the dealing with the main issue. For the sole purpose of the court dealing with the application for a separation of issues the Applicant accepted, on a without prejudice basis, that the transaction with PGM was not at arm's length.

Arguments made by the Applicant and SARS

SARS opposed the separation of issues on various grounds, one of which was the fact that the issue is inextricably bound to the main issue of the appeal being the determination of the arm's length price.

Part of the Applicant's argument included a dispute on the methodology adopted by SARS in arriving at the arm's length price as it was of the view that the CUP method should have been applied rather than the TNNM. The CUP method being a direct comparison to the pricing of the transaction as opposed to the TNNM method which focuses on the net profitability of the transaction.

The Applicant also argued that SARS cannot place reliance on PN7 and the TPG as issued by the OECD as section 31 does not make reference to such documents and accordingly these have no legal status. The powers of SARS "must be established only by reference to the statute itself". In this regard the Applicant placed reliance on the decision in *Marshall and Other v C: SARS*[3] where it was held that the statute may not be determined with reference to how the administrative agency responsible for implementing it understands it.

The Applicant further sought to place reliance on the fact that section 31 was amended in April 2012 to shift from the adjustments being made to a specific transaction but to rather focus on the overall arrangements driven by an overarching profit objective. Thus, proving that the legislation as it applied in respect of the Applicant's 2011 year of assessment did not allow for SARS to adjust profits but only the pricing of the specific transaction.

SARS's counter argument to this was that the "amendments were effected to clarify what the legal position always had been" and "merely highlight what has always been in the legislation".

Analysis and Judgement

Consideration was first given to paragraph 1 of Article 9 of the OECD Model Tax Convention which effectively states that where transactions conducted between associated enterprises are not at arm's length the profits of that enterprise must be adjusted and taxed accordingly. Three international transfer pricing cases were then analysed and concluded that regardless of the methodology used to arrive at the arm's length price, the "adjustments are made to the profits of the taxpayer to ensure that tax is levied on the correct amount of taxable income".

The court dismissed the application on the basis that there was no cogent point of law to be tested in what the Applicant was raising. Besides arguing that SARS ought not to have adjusted its profits the Applicant did not make any practical suggestion as to how the adjustment ought to have been done in order to determine its taxable income.

The court further noted that the Applicant also made reference in its representations, primarily via its response to the audit findings, to the authoritative statements, TPG and PN7 and accordingly envinces a practice that is internationally accepted and applied by both SARS and the Applicant. Hence, the Applicant's reliance on the *Marshalls* case is misplaced.

The court also makes mention of the SCA judgement in *Natal Join Municipal Fund v Endumeni Municipality*[4] where it was held that consideration must be given to the language used, the context in which the provision appears, the apparent purpose to which it's directed and the material known to those responsible for its production.

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[3] Marshall and Other v Commissioner, SARS [2018] ZACC 11

[4] Natal Join Municipal Fund v Endumeni Municipality (920/2010) [2012] ZASCA 13

In this regard PN7 and TPGs were known materials responsible for the production of section 31 (2). The court also makes reference to the report from the Davis Tax Commission's Base Erosion and Profit Shifting sub-committee[5] which confirms that "South Africa needs to align itself with the OECD standards or regulations on Transfer Pricing".

Based on the above the court concluded that SARS's reliance on TPGs and PN7 make the point sought for the separation of matters and that ordering such separation "would be a waste of resources." In a transfer pricing matter the establishment of the arm's length nature of the transaction is the first step and an overriding principle which cannot be receded to the back. Therefore, ordering a separation will not achieve any practical benefit. On the contrary it will lead to piecemeal litigation, increase costs and delay finalisation of the matter.

Important lesson to be learnt

Where a taxpayer enters into cross-border transactions with connected persons (i.e., affected transactions), it is imperative that it tests the arm's length nature of these transactions and documents this by way of proper transfer pricing policy. For years of assessment commencing 1 October 2016, where a taxpayer's affected transactions exceed R100 million, it is mandatory for the transfer pricing policy to be submitted to SARS with the tax return.

As suggested in PN7, where a taxpayer does not have a transfer pricing policy in place, they will be on the back foot in defending the arm's length nature of the transaction and have difficulty in rebutting the amount determined by SARS or the Courts. Therefore, whilst this case did not actually deal with whether the transaction was at arm's length, an important lesson to take from this is that even where affected transactions do not exceed the R100 million threshold it is recommended that some level of testing and documentation be retained to confirm the arm's length nature of the transaction to avoid unnecessary assessments being raised which will likely lead to costly disputes/litigation.

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[5] Report released in May 2016: accessed at www.taxcom.org