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Punitive proposed amendment to South Africa's transfer pricing provisions

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Transfer pricing is a self-assessment mechanism that aims to ensure that taxpayers identify all potential cross-border transactions, operations, schemes, agreements or understandings that have been entered into between connected persons (referred to as "**potentially affected transactions**"), to ensure that all such potentially affected transactions have been concluded and implemented on an arm's length basis.

Ideally, where a taxpayer has been a participant to a potentially affected transaction, the taxpayer would ensure upfront that the potentially affected transaction has actually been concluded and implemented on an arm's length basis.

However, where the terms and conditions of that potentially affected transaction differ from those that would have existed at arm's length, the taxpayer is required, in terms of section 31(2) of the Income Tax Act, 1962 ("**Income Tax Act**"), to calculate its taxable income as if the terms and conditions of the potentially affected transaction had been arm's length. To the extent that this results in a difference in taxable income, this amount is typically referred to as the "**primary adjustment**".

Furthermore, in terms of section 31(3) of the Income Tax Act, if the taxpayer is a company, and subject to certain exceptions, the amount of the primary adjustment is deemed to be a distribution of a dividend *in specie* declared and paid by the taxpayer. Where the taxpayer is a person other than a company, the amount of the primary adjustment is deemed to be a donation. This re-characterisation is referred to as the "**secondary adjustment**".

Paragraph 4.8 of the Explanatory Memorandum to the Taxation Laws Amendment Bill, 2011, which introduced the secondary adjustment in its previous form (a deemed loan between the parties bearing interest at a marked-related rate), states the following, with reference to statements published by the Organisation for Economic Co-operation and Development ("**OECD**"):

"The OECD refers to a secondary adjustment within the following context: "To make the actual allocation of profits consistent with the primary transfer pricing adjustment, some countries having proposed a transfer pricing adjustment will assert under their domestic legislation a constructive transaction (a secondary transaction), whereby the excess profits resulting from a primary adjustment are treated as having been transferred in some other form and taxed accordingly." In view of the above, the amount of the primary adjustment will be deemed to be a loan by the South African taxpayer to the non-resident".

In our view, the general principle behind this re-characterisation may be summarised, on a high-level basis, as follows:

Were it not for the extraordinary expenditure charged between the related parties to the affected transaction, the payor would have had increased profits, which it would likely have repatriated to the non-resident related payee in the form of a dividend. The "hidden profits"

that were transferred under the non-arm's length affected transaction should accordingly be re-characterised as a dividend.

In respect of the secondary adjustment in its current form, it has been noted that an adjustment in the form of a deemed dividend is less burdensome to administer than the previous deemed loan, from the perspective of both the taxpayer and the South African Revenue Service ("**SARS**") (a more detailed discussion in this regard can be found at paragraph 5.2 of the Explanatory Memorandum to the Draft Taxation Laws Amendment Bill, 2014).

In principle, the deemed dividend imposed under the secondary adjustment should be treated, for tax purposes, as any other distribution of an asset *in specie* paid by a resident company to a non-resident person. This dividend would, accordingly, be subject to South African dividends tax at a rate of 20%. On the same basis, the taxpayer should, in principle, be able to avail of a reduced rate of dividends tax in terms of any applicable agreement for the avoidance of double taxation ("**DTA**"), provided that the requirements for claiming such relief in terms of 64F(2) of the Income Tax Act are met. This treatment accords with the principle behind the secondary adjustment, as discussed above.

However, in the 2018 Draft Taxation Laws Amendment Act ("**Draft TLAB**"), National Treasury has proposed an amendment to the definition of "dividend" contained in section 1 of the Income Tax Act, to specifically exclude, from the scope of the definition, any amount deemed to be a dividend *in specie* under the secondary adjustment. This proposed amendment would effectively prevent taxpayers from benefiting from any relief that may otherwise have been available under domestic law or any applicable DTA (where the circumstances are such that domestic law or the relevant DTA affords relief) in respect of dividends in specie. Where the recipient of the deemed dividend is a company, it has been the approach of SARS to deny domestic law and/or treaty relief that may have been available to the taxpayer under the provisions of sections 64F/64FA of the Income Tax Act, for, *inter alia*, for reasons that:

1. in order to rely on the relief, the "beneficial owner" would have had to submit to the company declaring the dividend, the required written declaration and undertaking;
2. it is SARS' view that there is no "beneficial owner" in relation to deemed dividend for purposes of section 31. For a more detailed discussion in this regard, please refer paragraph 4.3.3(*c*) of the SARS Comprehensive Guide to Dividends Tax (Issue 2), dated 12 October 2017.

It is accordingly submitted that DTA relief would therefore in any event generally only be available under limited circumstances, including where the applicable DTA's definition of "dividend" includes within its scope, deemed dividends (for example, the United Kingdom/South Africa DTA). In this regard, the Draft Explanatory Memorandum on the Taxation Laws Amendment Bill, 2018 ("**Draft 2018 Explanatory Memorandum**"), suggests that the reason for the proposed amendment is to address the "anomaly" that a secondary adjustment may, in certain circumstances, be afforded treaty relief.

In the Draft Response Document on Taxation Laws Amendment Bill, 2018 and the Tax Administration Laws Amendment Bill, 2018, published by the National Treasury on 12 September 2018, based on hearings by the Standing Committee on Finance in Parliament, National Treasury has noted comments from the public that "the policy concern of the proposed amendment is not understood", and has stated that the "draft explanatory memorandum will be revised to provide clarity on the policy concern the proposed amendment seeks to address and further expound how such concern will be addressed". The effect of denying potential treaty relief to secondary adjustments (which, as considered above, would in any event only be available where the relevant DTA's definition of "dividend" is broad enough to include secondary adjustments), appears punitive.

In our view, this is not in line with the principle behind the secondary adjustment and it has been submitted that it does not appear to take cognisance of the already punitive measures imposed on taxpayers as a result of the operation of various provisions contained in section 31 of the Income Tax Act and the Tax Administration Act, 2011 ("**TAA**"), including, *inter alia*, understatement penalties which may be imposed under the TAA at rates of up to 200%. In our view, it is arguably inappropriate to regard the deemed dividend in terms of a secondary adjustment as punitive on the basis that:

1. this "penalty" penalises taxpayers who, out of their own accord, on a self-assessment basis, correct their tax computations to ensure compliance with the Income Tax Act; and

2. this blanket penalty is not aligned with the penalty regime codified under the TAA, which reflects the necessity of imposing penalties congruent with the "blameworthiness" of the relevant taxpayer (refer to *Mr A & XYZ CC v CSARS*).

We await the release of the TLAB in amended and final form to provide further commentary on the implications should the above proposed amendment be promulgated.

In the interim, it is clearly becoming more important that taxpayers analyse any potentially affected transactions they may be party to and to ensure upfront that such transactions have been concluded and implemented on an arm's length basis before their annual financial statements are finalised.

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