University of the Witwatersrand, Johannesburg

A research report submitted to the Faculty of Commerce, Law and Management in partial fulfilment of the requirements for the degree of Master of Commerce (Taxation)

An analysis of where the transfer pricing rules and the controlled foreign company rules interact: application to intra-group loans

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ABSTRACT

It has become increasingly important for South African tax residents to correctly reflect an arm's length price for which they transfer goods or services, and in the case of intellectual property, grant a use, right of use or permission to use of the intellectual property, to non-residents, as this may attract adverse tax consequences for failure to do so. This is of particular importance when funding cross-border operations. Furthermore, the ownership structure of the non-resident is also of importance, as the ownership structure adopted by the non-resident may have South African income tax consequences, for the South African tax resident, if that non-resident is a connected person to the South African tax resident,[1] the non-resident is a controlled foreign company as defined in section 9D of the Income Tax Act, or both instances are applicable. Therefore, the controlled foreign company rules and the transfer pricing rules must be considered,[2] amongst other factors, when engaging in cross-border tax structuring to correctly structure these transactions.

This research report critically examines the South African transfer pricing rules and South African controlled foreign company rules and discusses the overlap of the two sets of rules. This analysis goes further in identifying the means to manage transfer pricing risk using a controlled foreign company in relation to a South African taxpayer, with a specific focus on intra-group loans.

Key words: Anti-avoidance, Arm's Length Principle, Associated Enterprise, Comparable Uncontrolled Price, Connected Person, Controlled Foreign Company, Cost Plus Method, Anti-Diversionary Transaction Rules, Foreign Business Establishment, OECD Transfer Pricing Guidelines, Profit Split Method, Resale Method, Thin Capitalisation, Transactional Net Margin Method, Transfer Pricing, Uncontrolled Transaction.

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[1] The definition of connected person is discussed at paragraph 3.3 of chapter 3.

[2] The controlled foreign company rules are contained in section 9D of the Income Tax Act and the transfer pricing rules are contained in section 31 of the Income Tax Act.

DECLARATION

I declare that this research report is my own unaided work. It is submitted in partial fulfilment of the requirements for the degree of Master of Commerce (specialising in Taxation) at the University of Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination at any other university.

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Diwan Kamoetie

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GLOSSARY OF TERMS AND ABBREVIATIONS

Advance Pricing Agreement	An arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g., method, comparables, and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time.[3]
BEPS	Base Erosion and Profit Shifting.
Comparable Uncontrolled Transaction	A comparable uncontrolled transaction is a transaction between two independent parties that is comparable to the controlled transaction under examination.[4]
Draft Interpretation Note	'Draft Interpretation Note – Determination of the taxable income of certain persons from international transactions: thin capitalisation' (2013) which has since been updated to the 'Draft Interpretation Note –Determination of the taxable income of certain persons from international transactions: intra-group loans' (2022).
IFRS	International Financial Reporting Standards.
Income Tax Act	Income Tax Act 58 of 1962.
Multinational Enterprise	The OECD Transfer Pricing Guidelines[5] defines a multinational enterprise as 'a company that forms part of an MNE group'. The OECD Transfer Pricing Guidelines defines a multinational enterprise group ('MNE group') as 'a group of associated companies with business establishments in two or more countries'.

[3] *OECD Transfer Pricing Guidelines* (2022) 21.
[4] *OECD Transfer Pricing Guidelines* (2022) 22.
[5] The OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2022).

OECD Model Tax Convention	Organisation for Economic Co-operation and Development's Model Tax Convention on Income and on Capital (2017).
OECD	The Organisation for Economic Co-Operation and Development.
OECD Transfer Pricing Guidance on Financial Transactions	OECD Transfer Pricing Guidance on Financial Transactions (2020).
OECD Transfer Pricing Guidelines	OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2022).
Practice Note 7	Practice Note 7 – Determination of the taxable income of certain persons from international transactions: transfer pricing.
Safe Harbour	A safe harbour is a transfer pricing regime that applies to a defined category of taxpayers or transactions that provides the taxpayer relief from certain obligations otherwise imposed by a country's general transfer pricing rules.[6]
SARS	The South African Revenue Service.
Tax Administration Act	The Tax Administration Act 28 of 2011.

[6] Paragraph 4.102 of the *OECD Transfer Pricing Guidelines*, 2022.

AN ANALYSIS OF WHERE THE TRANSFER PRICING RULES AND THE CONTROLLED FOREIGN COMPANY RULES INTERACT: APPLICATION TO INTRA-GROUP LOANS

1 CHAPTER 1: INTRODUCTION

1.1 Why transfer pricing exists

South African tax residents frequently engage in cross-border transactions. Often, these transactions are between the South African tax resident and a person under common ownership to the South African tax resident.

South Africa follows a residence-based tax system which taxes the resident on its worldwide receipts and accruals.[7] Although this is the case, the source rules contained in section 9 of the Income Tax Act are still of relevance, particularly for a South African company's controlled foreign company. The source rules are relevant for non-residents to determine whether an amount will be subject to tax in South Africa.[8] To determine the tax entitlement of South Africa and the foreign country, the transfer pricing rules contained in section 31 of the Income Tax Act, the source rules for foreign income contained in section 9 of the Income Tax Act and relevant double taxation agreements entered into between South Africa and that foreign country must be considered. Determining the tax entitlement of South Africa and the foreign country will also inform the tax resident of the available tax credits which the South African tax resident may make use of. A discussion of the relevant tax credits which may be available to a South African tax resident falls outside the scope of this research report, however it is advised that section 6*quat* of the Income Tax Act be considered where a South African tax resident is determining the transfer price in a controlled transaction, to determine what the South African tax implications may be, as well as the available tax credits (if any) which the South African tax resident may utilise in cross-border dealings.

The transfer pricing rules are an anti-avoidance mechanism which seeks to re-allocate income and expenses between connected persons or associated enterprises in accordance with an arm's length price.[9] The arm's length principle is the transfer pricing standard used by OECD member countries for tax purposes by multinational enterprise groups and tax administrations.[10]

[7] Definition of 'gross income' in Section 1 of the Income Tax Act.
[8] Stiglingh M, Koekemoer A, van Heerden L, Wilcocks J, van der Zwan P *Silke: South African Income Tax* (2022) 826.
[9] Geach W, Buba Z & Mollagee O *Taxation: A Transaction-Based Approach* 1st Ed (2021) 180.
[10] Paragraph 1.1 of the *OECD Transfer Pricing Guidelines*, 2022.

The rationale behind South Africa applying the arm's length principle is to avoid profit-shifting mechanisms which seek to extract profits from South Africa, which South Africa ought to have a right to tax.[11] Transfer pricing is seen as a risk area by SARS.[12]

Both the OECD and the United Nations have compiled guidelines to assist multinational enterprises and tax authorities in the regulation of transfer pricing issues.[13] With an increased globalised world, transfer pricing continues to be of relevance and will be in the foreseeable future where multinational enterprises set up and conduct their operations across various jurisdictions. Dispute prevention procedures are increasingly becoming relevant in the transfer pricing space, with mechanisms such as documentary requirements relating to specific transfer pricing issues and Advance Pricing Agreements becoming more prevalent in many jurisdictions.[14]

The transfer pricing and thin capitalisation provisions are contained in section 31 of the Income Tax Act. SARS has published Practice Note 7, which provides guidance from SARS on the interpretation of section 31 of the Income Tax Act. Furthermore, SARS has published draft interpretation notes relating to thin capitalisation and intra-group loans.[15] The transfer pricing provisions are discussed in Chapter 3 below.

1.2 **Controlled foreign company rules**

As previously stated, South Africa follows a residence-based taxing system.[16] Therefore, South African tax residents are taxed on their worldwide receipts and accruals[17]. Cognisance must therefore be taken of structures which are set up to artificially shift profits offshore. In

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[11] See Arnold B & McIntyre M *International Tax Primer* 2nd ed (2002) 53.

[12] Horak W & Bouwer A 'South Africa –Transfer Pricing and Dispute Resolution' in *Transfer Pricing and Dispute Resolution* (2021) para 1.2.2.6. Publisher: IBFD, Amsterdam.

[13] The United Nationals released the third edition of the *United Nations Practical Manual on Transfer Pricing* in 2021. See discussion at paragraphs 0 and 0 of Chapter 1 for a discussion on the status of Practice Note 7 and the OECD Transfer Pricing Guidelines in South Africa.

[14] Wiesener C & Gosai N 'Chapter 13 – Controversy' in *Africa Transfer Pricing Practice Guide: A South African Perspective* (2021) 1. See also Wiesener C & Gosai N 'Chapter 11 – Other topics' in *Africa Transfer Pricing Practice Guide: A South African Perspective* (2021) 16.

[15] In 2013, SARS released the '*Draft Interpretation Note – Determination of the taxable income of certain persons from international transactions: thin capitalisation*'. In 2022, SARS substantially amended the 2013 Draft Interpretation Note and replaced it with the '*Draft Interpretation Note –Determination of the taxable income of certain persons from international transactions: intra-group loans*'.

[16] Oguttu A 'International Tax Law' 1st Ed (2015) 139.

[17] Oguttu A 'International Tax Law' 1st Ed (2015) 139.

the absence of legislation curbing the abuse of shifting profits to a low tax jurisdiction, significant benefit may flow from earning foreign income in the name of a separate taxpayer.[18]

To counter the deferral of tax, countries seek to tax income accrued or received by foreign entities over which their tax residents enjoy significant control.[19] One such mechanism aimed at combatting this is the controlled foreign company rules.[20] The controlled foreign company rules seek to prevent the deferral of tax on income earned by offshore companies.[21] The rationale behind this is to prevent tax base erosion, whilst remaining internationally competitive.[22] The two seem to contradict each other, given that countries would seek to retain income within their tax net, whilst to remain globally competitive, countries would need to ensure they adopt rules not too rigid which would result in many tax residents giving up their tax residence in favour of a more favourable taxing jurisdiction. A balance ought to be struck. In terms of section 9D(9A) of the Income Tax Act, certain transactions whether pitched at arm's length, or not, are required to be imputed in the controlled foreign companies' income regardless of whether that controlled foreign company has a foreign business establishment or not.[23] The controlled foreign company rules targets income earned through passive business activities (mobile income) and diversionary income.[24] Diversionary income is income derived from suspect transactions between a controlled foreign company and a resident that may likely lead to transfer pricing transgressions.[25] The anti-diversionary income rules apply to imported goods,[26] and imported services[27] The passive income rules apply to certain highly mobile income such as income derived from financial instruments,[28] or royalties[29]. Tainted (passive or diversionary) income is fully taxable in South Africa because controlled foreign company ownership of this income poses a high risk to the South African tax base.[30]

[18] Olivier L & Honiball M *International Tax: A South African Perspective* 5th Ed (2011) 559.
[19] Olivier L & Honiball M *International Tax* 559.
[20] Section 9D of the Income Tax Act.
[21] Oguttu A 'International Tax Law' 1st Ed (2015) 139.
[22] Para B at pg 1 of National Treasury's *Detailed Explanation to section 9D of the Income Tax Act* (June 2002). Available URL: http://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf; accessed on 21 January 2022.
[23] Benetello M 'Chapter 10 – Transfer Pricing and Thin Capitalisation' in *Silke on International Tax* (2009) 10.8.
[24] De Koker A & Williams R *Silke on South African Income Tax* (2022) 5.43.
[25] National Treasury *Explanatory Memorandum on the Taxation Laws Amendment Bill* (2011) para 4.5.
[26] Section 9D(9A)(a)(i) of the Income Tax Act.
[27] Section 9D(9A)(a)(ii) of the Income Tax Act.
[28] Section 9D(9A)(a)(iii) of the Income Tax Act.
[29] Section 9D(9A)(a)(v) of the Income Tax Act.
[30] National Treasury *Explanatory Memorandum on the Taxation Laws Amendment Bill* (2011) para 4.5.

The controlled foreign company rules seek to balance anti-deferral mechanisms whilst ensuring South Africa remains competitive in the international market.[31]

In response to tax base erosion, the OECD recommended in Action Plan 3, how to design and implement domestic controlled foreign company rules.[32] Action Plan 3 is designed to assist countries which adopt the recommendations contained therein to effectively implement controlled foreign company rules which would prevent taxpayers from shifting income into foreign subsidiaries.[33] Action Plan 3 further acknowledges that the controlled foreign company rules assist with the BEPS project, acting as a backstop to transfer pricing abuse.[34]

South Africa enacted its own controlled foreign company legislation, in section 9D of the Income Tax Act, prior to Action Plan 3. South Africa's controlled foreign company legislation was therefore designed without BEPS Project or Action Plan 3 in mind. Although this is the case, the Davis Tax Committee issued a report on Action 3 which concluded, amongst other conclusions, that South Africa's controlled foreign company rules were some of the most sophisticated and complicated within the G20.[35] The Davis Tax Committee therefore recommended that no further strengthening to South Africa's controlled foreign company rules was required.[36] The controlled foreign company rules under section 9D of the Income Tax Act is discussed in Chapter 4 below.

1.3 **Status of Practice Note 7**

Practice Note 7 is not law. Practice Note 7 provides guidance on the interpretation and application of section 31 of the Income Tax Act by SARS. Whilst SARS no longer publishes practice notes, as these have been replaced by interpretation notes, Practice Note 7 is still in force. Although Practice Note 7 is not law, Practice Note 7 may fall within the ambit of a 'practice generally prevailing' in terms of section 5(1) of the Tax Administration Act. Section 1 of the Tax Administration Act defines a 'practice generally prevailing' as 'a practice set out in an official publication regarding the application or interpretation of a tax Act'. An official

[31] Para B at pg 1 of National Treasury's *Detailed Explanation to section 9D of the Income Tax Act* (June 2002).

[32] OECD/G20 Base Erosion and Profit Shifting Project: *OECD report Designing Effective Controlled Foreign Company Rules, Action Plan 3* (2015), Available at https://read.oecd-ilibrary.org/taxation/designing-effective-controlled-foreign-company-rules-action-3-2015-final-report_9789264241152-en#page1, accessed on 5 January 2022.

[33] OECD/G20's Base Erosion and Profit Shifting Project: *Explanatory Statement* (2015) 15, Available URL: https://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf, accessed on 4 January 2022.

[34] OECD/G20 *Explanatory Statement* 14.

[35] Davis Tax Committee *Summary of DTC Report on OECD Action 3: Strengthening Controlled Foreign Company Rules* (2017) 3.

[36] Davis Tax Committee *Summary of DTC Report on OECD Action 3: Strengthening Controlled Foreign Company Rules* (2017) 35.

publication includes any interpretation note or practice note issued by a senior SARS official.[37] A practice note could therefore significantly impact on the rights of a taxpayer under the Tax Administration Act. Where, SARS assesses a taxpayer in accordance with a 'practice generally prevailing', SARS would be bound by its assessment and would not be able to assess the taxpayer differently.[38]

The status of the interpretation notes when interpreting tax legislation came up in *Marshall NO and Others v Commissioner for SARS*,[39] in which Froneman J, in the unanimous judgement, held:

> '*Why should a unilateral practice of one part of the executive arm of government play a role in the determination of the reasonable meaning to be given to a statutory provision? It might conceivably be justified where the practice is evidence of an impartial application of a custom recognised by all concerned, but not where the practice is unilaterally established by one of the litigating parties. In those circumstances it is difficult to see what advantage evidence of the unilateral practice will have for the objective and independent interpretation by the courts of the meaning of legislation, in accordance with constitutionally compliant precepts. It is best avoided*.'[40]

The author of this research report submits that a court may only have regard to SARS practice notes when interpreting legislation where the practice has been recognised by SARS and the taxpayer. Accordingly, where the taxpayer does not follow the guidance provided in a practice note, a South African court may not have regard for the unilateral practice of SARS. Therefore, each transfer pricing case must be considered on its own merits in light of the prevailing circumstances.

Practice Note 7 generally reflects the OECD Transfer Pricing Guidelines. Therefore, Practice Note 7 may still be of persuasive force where the taxpayer determines an arm's length price in accordance with the OECD Transfer Pricing Guidelines or Practice Note 7.

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[37] Official publication is defined in section 1 of the Tax Administration Act as '*a binding general ruling, interpretation note, practice note or public notice issued by a senior SARS official or the Commissioner*'.

[38] Mazansky E & Fyfe K *Don't be intimidated into relying on a SARS interpretation note* (2019). Available URL: https://www.werksmans.com/legal-updates-and-opinions/dont-be-intimidated-into-relying-on-a-sars-interpretation-note/, accessed 10 June 2022.

[39] (CCT208/17) [2018] ZACC 11 (25 April 2018).

[40] *Marshall* para 10.

1.4 Status of the Draft Interpretation Note

SARS has released a Draft Interpretation Note which pertains to thin capitalisation and intra-group loans. The draft interpretation note intends to provide guidance on how SARS will interpret and apply provisions relating to the determination of the taxable income of certain persons from international transactions in respect of intra-group loans. The Draft Interpretation Note has undergone substantial amendment from its initial publication in 2013 to the version which was published in 2022.

In 2013, SARS released the 2013 Draft Interpretation Note which provided guidance on how to determine an arm's length amount in the context of determining whether a taxpayer is thinly capitalised under section 31 of the Income Tax Act. Whilst the 2013 Draft Interpretation Note had not been finalised, SARS and taxpayers had generally used the note as a guide.[41] Notably, the use of safe harbours in the 2013 Draft Interpretation Note, as was previously allowed under Interpretation Note 2 (which has since been withdrawn), to determine whether a taxpayer is thinly capitalised has been removed in its entirety from the 2022 Draft Interpretation Note. The 2013 Draft Interpretation Note provided certain ratios which were used to indicate whether a taxpayer is a high risk for it being thinly capitalised, however these ratios were merely tools to identify 'high risk' taxpayers. Therefore, this approach aligned with the current legislation under section 31(4), read with section 31(2), of the Income Tax Act which requires that a broader investigation must be undertaken to determine whether a taxpayer is thinly capitalised.

In 2022, SARS released an updated draft interpretation note which provides guidance on how to determine an arm's length amount in relation to intra-group loans between related parties. As mentioned above, the draft interpretation note on intra-group loans was released on prior occasions, in 2013 and again in 2017, but due to changes in the content of the legislation, SARS has updated the draft interpretation note in light of the legislative amendments. The 2022 Draft Interpretation Note has been published for comment. Whilst working with the 2022 Draft Interpretation Note, the author of this research report observed that the 2022 Draft Interpretation Note largely follows the guidance in the OECD Transfer Pricing Guidelines.

[41] Wiesener C & Gosai N 'Chapter 3 – Legislation and supplementary guidance' in *Africa Transfer Pricing Practice Guide: A South African Perspective* (2021) 24.

Given that the interpretation note is still in draft form, SARS is not obliged to follow the contents thereof and therefore the OECD Transfer Pricing Guidelines may provide further guidance on how to determine an arm’s length price for financial transactions.

1.5 Status of OECD Transfer Pricing Guidelines

The OECD published the updated OECD Transfer Pricing Guidelines in January 2022, the most recent update to the OECD Transfer Pricing Guidelines. The OECD Transfer Pricing Guidelines provides guidelines on how to apply the transfer pricing principles.

Although South Africa is not a member state of the OECD, Practice Note 7 does state that in the absence of specific guidance in Practice Note 7, section 31 of the Income Tax Act or any tax treaty entered into by South Africa, that the OECD Transfer Pricing Guidelines should be followed.[42] Practice Note 7 makes reference to an earlier version of the OECD Transfer Pricing Guidelines, however in practice, SARS has continued to apply the latest version of the OECD Transfer Pricing Guidelines.[43] As previously stated, where a taxpayer follows the guidance of Practice Note 7, the OECD Transfer Pricing Guidelines may still be of persuasive force in determining an arm’s length price where there is not any specific guidance under Practice Note 7, or binding rule under section 31 of the Income Tax Act.

In 2020, the OECD published its transfer pricing guide on financial transactions, which guide has since been incorporated into the OECD Transfer Pricing Guidelines, to provide guidance on how to accurately describe financial transactions. Chapter 2 discusses the OECD Transfer Pricing Guidelines in relation to financial transactions. Furthermore, the OECD Transfer Pricing Guidance is discussed in chapter 6. The OECD Transfer Pricing Guidance is examined to mitigate transfer pricing risks and controlled foreign company risks in relation to intra-group loans, and thereafter the author of this research report provides recommendations to mitigate transfer pricing risks and controlled foreign company risks between a resident company and a controlled foreign company in relation to it.

1.6 Research questions

How do the transfer pricing and controlled foreign company rules interact and target intra-group loans between a resident and a controlled foreign company, and how can the risks associated with each set of rules be managed?

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[42] Practice Note 7 para 3.2.

[43] Horak W ‘South Africa – Transfer Pricing’ in *IBFD Country tax guides - Transfer pricing* (2021) 22.

This research examines the relationship between the South African transfer pricing rules under section 31 of the Income Tax Act and the controlled foreign company rules contained under section 9D of the Income Tax Act, with the aim of analysing and managing the transfer pricing risks and controlled foreign company risks for South African residents, with a focus on financial transactions in the form of cross-border intra-group loans. Therefore, to answer the research question, the following sub-questions are addressed –

- What is contemplated by cross border intra-group loans?
- How do the transfer pricing rules apply in terms of the Income Tax Act?
- How do the controlled foreign company rules apply in terms of the Income Tax Act?
- How do the transfer pricing rules, and the controlled foreign company rules, as contained in the Income Tax Act, interact with each other in relation to cross-border intra-group loans?
- What are the risks arising from the transfer pricing rules and the controlled foreign company rules, and how can these be managed, specifically in relation to cross-border intra-group loans between a South African tax resident and a controlled foreign company in relation to the South African tax resident?

1.7 **Research methodology**

The research design is qualitative in nature. The primary sources to be used in this research report comprise legislation and interpretation and practice notes issued by relevant tax authorities, books and articles written by academics and practitioners in the fields of transfer pricing and controlled foreign companies, and relevant case law.

1.8 **Importance of this research report**

Transfer pricing has become a focus area of SARS, specifically in relation to financial transactions.[44]

The intention of this research report is to provide practitioners and scholars with greater understanding of the overlap between the transfer pricing legislation and controlled foreign

[44] Wiesener C & Gosai N 'Chapter 9 – Specific Transaction Types' in *Africa Transfer Pricing Practice Guide: A South African Perspective* (2021) 14.

company legislation, specifically in relation to certain types of financial transactions. This research report may further enable SARS with the development of new guidance on financial transactions. Furthermore, this research report may assist taxpayers in complying with relevant transfer pricing and controlled foreign company provisions, specifically in relation to financial transactions. In this regard, the documentary requirements of each are discussed in chapter 6 below. Compliance will assist taxpayers in defending their position to prevent penalties and interest which may be imposed for non-compliance.

1.9 Scope and limitations of the research report

This research report does not evaluate withholding taxes, value-added tax and indirect tax, double taxation treaties, exchange control, the use of tax havens, and the application of the transfer pricing rules and controlled foreign company rules, save for cross border intra-group loans, to specific transactions such as the price at which the use, right of use or permission to use should be granted for the use of intellectual property.

2 CHAPTER 2: TRANSFER PRICING ON FINANCIAL TRANSACTIONS

Multinational enterprises are organisationally structured to ensure they maintain and grow their international footprint. A primary consideration is how a multinational enterprise can maximise or enhance its profits and cost savings.[45] A key element to how a multinational enterprise can maximise or enhance its profits and cost savings is the funding of various operations, as well as which functions are performed by particular entities within the group in order to maximise or enhance its profits and cost savings.[46] In order for multinational enterprises to maximise or enhance profits and cost savings, transfer pricing becomes relevant as multinational enterprises may structure their supply chains to maximise the profits or cost savings from their various operations and activities.[47] A well-structured multinational enterprise may result in that particular multinational enterprise paying a reduced amount for tax. Failure to take transfer pricing tax provisions into account could result in non-deductible interest expense, double taxation, penalties, or other more serious sanctions.[48]

To understand the transfer pricing implications on certain financial transactions, it is also useful to understand the background behind intra-group services. Multinational enterprises may be structured in such a way that services may be performed which relate to a financial transaction. The discussion in this chapter 2 examines the OECD's guidance on financial transactions, however, the OECD Transfer Pricing Guidelines should also be considered where the circumstances of a transaction requires it, such as the provision of intra-group financial advice where related party financial transactions are entered into. However, a discussion of the OECD guidance in relation to services generally fall outside the scope of this research report. This research report is limited to services performed, which relate to financial transactions.

2.1 Overview of intra-group services in relation to financial transactions

A member or members of multinational enterprises often perform intra-group services, to another for the benefit of a related member in the group. These services may either be the primary business of the multinational enterprise, or ancillary functions related to the entity's

[45] Okten R & Drenth M 'Chapter 1 – The Treasury Functions' in Bakker, A & Kale, S (eds) *Transfer Pricing and Intra-Group Financing* (2021) 2.

[46] Okten R & Drenth M 'Chapter 1 – The Treasury Functions' in Bakker, A & Kale, S (eds) *Transfer Pricing and Intra-Group Financing* (2021) 4.

[47] Okten R & Drenth M 'Chapter 1 – The Treasury Functions' in Bakker, A & Kale, S (eds) *Transfer Pricing and Intra-Group Financing* (2021) 10.

[48] DLA Piper *Intra-group loans under the arm's length principle – 10 things to know* (2018). Available URL: https://www.dlapiper.com/en/uk/insights/publications/2018/07/intra-group-loans-under-the-arms-length-principle/, accessed on 17 December 2021.

primary business operations. Services can be obtained from subsidiaries of the group, affiliate entities or independent entities, or may be performed internally.[49]

The following examples of intra-group services are services a multinational enterprise may render within its group:

- financial activities e.g., loan funding;
- technical services e.g., research and development activities;
- manufacturing or assembly operations; and
- management services e.g., administrative functions.[50]

The type of services rendered within a multinational enterprise group will depend on the corporate strategy of the multinational enterprise. This would typically entail that a multinational enterprise group decide on which services/operations it wishes to perform internally and which it wishes to outsource. The result may be that the multinational enterprise maintains a sustainable competitive advantage. Examples which a multinational enterprise may consider in developing its corporate strategy may include:

- how to efficiently allocate resources within the multinational enterprise group;
- whether to employ low cost or differentiation strategies;
- how to streamline the performance of professional services or delivery of goods;
- would a centralised or decentralised approach to management increase the profitability and operating efficiency of the multinational enterprise group.

An important consideration for a multinational enterprise is determining whether they wish to centralise or decentralise their treasury function or have a combination of both. At a basic level, a centralised treasury function is responsible for the financing of the group and responsible for the financial operations of the group, whereas in a decentralised treasury function, the local subsidiary would be responsible for its own treasury function. It may be prudent to centralise the treasury function activities to better manage liquidity, currency, and

[49] Berger R *Transfer pricing considerations for intra-group services* (2015) 5.
[50] Paragraph 7.2 of the *OECD Transfer Pricing Guidelines*, 2022.

debt risk within the multinational enterprise group. Which system a multinational enterprise employs would however, be dependent on the business model or organisational model the multinational enterprise adopts.

This research report focuses on financing activities performed within a multinational group, specifically on loan funding arrangements. Where a multinational enterprise transacts through a treasury operation, how that treasury operation is compensated for services performed in relation to intra-group financial transactions should also be considered.

2.2 **Intra-group financing structures**

The financing options available to a particular multinational enterprise group is dependent on the various forms of financial transactions which take place in a particular jurisdiction, and may include:

- intra-group loans and credit facilities;
- hybrid financing;
- intra-group guarantees, including performance guarantees;
- cash optimised structures (cash pooling); and
- other treasury services, such as foreign exchange risk management, factoring or forfeiting, commodity risk management and captive insurance.[51]

Furthermore, equity financing may also be a financing option available to a particular multinational enterprise.[52] Multinational enterprises need to monitor how their intra-group treasury function is structured and whether they are compliant with transfer pricing rules and regulations.[53] The optimisation of capital structures within a multinational enterprise group can ensure that return on investments is realised for investors.[54] Whilst multinational groups may focus on the optimisation of capital structures, the multinational enterprise group would need to structure and design their treasury function in a manner which ensures they remain

[51] Russo A & Dekker A 'Chapter 2 – Accurate Delineation of intra-group financial transactions' in Bakker, A & Kale, S (eds) *Transfer Pricing and Intra-Group Financing* (2021) 28.
[52] Gutuza, T 'Legal aspects of financing corporates' (2019) 25.
[53] Chwala U & Lukosz K'Chapter 6 – Accurate Delineation of intra-group financial transactions' in Bakker, A & Kale, S (eds) *Transfer Pricing and Intra-Group Financing* (2021) 167.
[54] Okten R & Drenth M 'Chapter 1 – The Treasury Functions' in Bakker, A & Kale, S (eds) *Transfer Pricing and Intra-Group Financing* (2021) 10.

compliant with applicable tax laws and transfer pricing regulations. Some of the most common set-ups of treasury centres and intra-group financial flows are as follows:

- Central. Under this structure, the parent entity arranges and enters into transactions on behalf of group entities;

- Central and regional. Under this structure, in addition to the central treasury function, there will be regional treasury functions which transact with the central treasury but also with certain group entities;

- Central and head office. Under this structure, financial transactions are entered into between the local head offices and group entities, in terms of which the local head offices receive support services from the corporate treasury team;

- Central and in-house bank. Under this structure, group entities transact with an in-house banking organisation.[55]

Furthermore, treasury operations may be further supported by back-office support which may provide administrative support in an intra-group financial transaction. These support functions must be factored into the transfer pricing analysis when assessing the arm's length nature of the remuneration and the appropriate functional and risk analysis allocated to treasury support centres.[56]

Operations structured by multinational enterprises, for transfer pricing purposes, which involve intra-group treasury operations, are typically characterised as one or more of the following:

- Routine service provider, such as back office or mid-office support;

- Strategic service provider performing front end services;

- Investment manager, pooling and investing funds of the group externally or internally;

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[55] Chwala U & Lukosz K'Chapter 6 – Accurate Delineation of intra-group financial transactions' in *Transfer Pricing and Intra-Group Financing* (2021) 169.

[56] Chwala U & Lukosz K'Chapter 6 – Accurate Delineation of intra-group financial transactions' in *Transfer Pricing and Intra-Group Financing* (2021) 169.

- Limited or full risk treasury centre (in-house bank). Under this structure, the group entities would transact with the in-house bank as if it were an independent financial institution.[57]

One, or a combination of the above, treasury operations may be adopted by a multinational enterprise. The overall group strategy, assumption of risks, roles, and functions within a multinational enterprise group play a role in determining which model to employ. To effectively structure a multinational enterprise group financial strategy, specialised multidisciplinary knowledge of financial markets, corporate finance, exchange control regulations and other financial regulations, amongst other specialised knowledge, is required.[58]

Some of the most common jurisdictions in which to establish financing companies include Hong Kong, Ireland, Luxembourg, the Netherlands, Singapore, Switzerland, and the United Kingdom.[59]

2.3 **OECD guidance on financial transactions**

On 11 February 2020, the OECD released the Transfer Pricing Guidance on Financial Transactions. The OECD Transfer Pricing Guidance on Financial Transactions provides recommendations to determine an arm's length price for financial transactions between related parties.[60] On 20 January 2022, the OECD released the updated OECD Transfer Pricing Guidelines which incorporated the OECD Transfer Pricing Guidance on Financial Transactions in chapter X. Therefore, the guidelines have now been consolidated into the OECD Transfer Pricing Guidelines and for the first time, the OECD Transfer Pricing Guidelines provide guidance on financial transactions.

The OECD Transfer Pricing Guidelines discusses transfer pricing methods in relation to intercompany loans, cash-pooling, financial guarantees, hedging transactions and captive insurers.[61]

The rationale behind the release of the OECD Transfer Pricing Guidelines was in accordance with the OECD/G20's BEPS Project where it was agreed that the OECD and G20 countries

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[57] Chwala U & Lukosz K'Chapter 6 – Accurate Delineation of intra-group financial transactions' in *Transfer Pricing and Intra-Group Financing* (2021) 170.
[58] Chwala U & Lukosz K'Chapter 6 – Accurate Delineation of intra-group financial transactions' in *Transfer Pricing and Intra-Group Financing* (2021) 171.
[59] Okten R & Drenth M 'Chapter 1 – The Treasury Functions' in *Transfer Pricing and Intra-Group Financing* (2021) 1.
[60] Para 10.1 of the *OECD Transfer Pricing Guidelines*, 2022.
[61] Chapter X of the *OECD Transfer Pricing Guidelines*, 2022.

will continue to develop transfer pricing recommendations in relation to financial transactions.[62] The purpose of the OECD Transfer Pricing Guidelines is for consistent application of the arm's length principle, avoiding transfer pricing disputes and preventing double taxation.[63]

The OECD Transfer Pricing Guidance on Financial Transactions is broken up into six sections which are set out below:

- Section A provides general guidance for determining whether the conditions of certain financial transactions between related parties are consistent with the arm's length principle;

- Section B elaborates on the concepts contained in section D.1 of chapter 1 of the OECD Transfer Pricing Guidelines, specifically in relation to accurately describing financial transactions. These concepts are:

    - Identifying the commercial or financial relations; and

    - Identifying the economically relevant characteristics of actual financial transactions;

- Section C provides guidance on determining the arm's length conditions for the treasury activities of a multinational enterprise which include intra-group loans, cash pooling, and hedging.

- Section D examines financial guarantees on certain intra-group transactions. A financial guarantee provides for the guarantor i.e., the party that gives or acts as a guarantor, to meet certain financial obligations in the event of a failure to do so by the borrower;

- Section E examines captive insurance companies, which in this context, is a company within a multinational enterprise whose primary function is to provide insurance policies for risks within the multinational enterprise group; and

- Section F provides guidance on how to determine a risk-free rate of return and a risk-adjusted rate of return where a related party is entitled to a return under Section F and

[62] OECD/G20 *Explanatory Statement* 10.
[63] Preface of the *OECD Transfer Pricing Guidelines*, 2022 para 15.

under Chapter VI of the OECD Transfer Pricing Guidelines (which relates to special considerations for intangibles).

The discussion in this research report is limited to sections A, B C and F of the OECD Transfer Pricing Guidance on Financial Transactions.

2.4 Conclusion

In the case of intra-group funding, it is generally not difficult to establish whether the loan has been advanced given that there may be a documentary trail which evidences the terms of the arrangement as well as proof of advancement of the funds. The transfer pricing issues which arise in relation to intra-group funding is generally twofold: 1) whether the loan advanced is an arm's length amount, and 2) how to determine an arm's length consideration for the interest rate applicable to the loan.[64] This research report provides guidance on these issues, including the impact they may have on the South African controlled foreign company rules.

[64] Moerer O, Mavrodiev G & S Kale 'Chapter 5 – Common types of intra-group financing arrangements' in Bakker, A & Kale, S (eds) *Transfer Pricing and Intra-Group Financing* (2021) 103.

3 CHAPTER 3: TRANSFER PRICING

3.1 Overview

Transfer pricing is the price at which goods, services or intangible property is transferred between associated enterprises.[65] Transfer prices are significant for both tax administrations and taxpayers as they determine to a large extent, the income and expense and therefore the taxable profit of associated enterprises in different tax jurisdictions.[66]

The arm's length principle is the basis for acceptable transfer pricing and is a common starting point in almost all jurisdictions.[67] The author of this research report submits that the arm's length principle approximates a price at which related parties ought to transact. Furthermore, that an arm's length price sets out to reflect the economic and commercial realities of intra-group transacting, whilst ensuring that price abuse does not occur in the form of artificial profit-shifting arrangements.

The OECD Transfer Pricing Guidelines provides comprehensive guidelines on determining an arm's length price, how to resolve transfer pricing disputes, documentary requirements, and provides specific guidance in relation to certain transactions, such as financial transactions.[68]

Most jurisdictions have enacted their own regulatory provisions based primarily on the OECD Transfer Pricing Guidelines. South Africa, although not a member state of the OECD, has adopted its own set of transfer pricing rules which has substantially been aligned with the OECD Transfer Pricing Guidelines.[69] On 6 August 1999, SARS published Practice Note 7. Practice Note 7 is largely outdated, however in the absence of specific guidance provided in Practice Note 7, section 31 of the Income Tax Act or any tax treaty entered into by South Africa, Practice Note 7 states that the OECD Transfer Pricing Guidelines should be followed.[70] Although South Africa does have specific provisions in sections 31(6) and 31(7) of the Income Tax Act which deal with financial transactions, these provisions do not provide guidance on how to accurately describe the financial transaction. Therefore, the guidance provided by the OECD in the OECD Transfer Pricing guidelines may present a suitable approach for South

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65 Preface of the *OECD Transfer Pricing Guidelines*, 2022 para 11.
66 Preface of the *OECD Transfer Pricing Guidelines*, 2022 para 12.
67 Wiesener C & Gosai N 'Chapter 2 – The arm's length principle' in *Africa Transfer Pricing Practice Guide: A South African Perspective* (2021) 3.
68 See the *OECD Transfer Pricing Guidelines*, 2022.
69 Wiesener C & Gosai N 'Chapter 3 – Legislation and supplementary guidelines' in *Africa Transfer Pricing Practice Guide: A South African Perspective* (2021) 26.
70 Practice Note 7 para 3.2.

African multinational enterprises to adopt when determining an arm's length price in relation to financial transactions.

The transfer pricing rules contained in section 31 do not exclude the application of the general anti-avoidance rules contained in the Income Tax Act.[71] Therefore, the Commissioner may adjust transfer prices using the general anti-avoidance measures contained in section 80A – 80L of the Income Tax Act. A discussion of the general anti-avoidance provisions falls outside the scope of this research report and is not considered further.

Sections 31(2) and (3) of the Income Tax Act requires that the arm's length principle be applied to determine an appropriate transfer price, as well as whether a taxpayer is thinly capitalised. Given that the 2022 Draft Interpretation Note has not been finalised, SARS may rely on the OECD Transfer Pricing Guidelines to develop a methodology to describe financial transactions. Therefore, the OECD Transfer Pricing Guidelines are discussed below, where applicable.

In order for the transfer pricing provisions in section 31 of the Income Tax Act to apply, the transaction must constitute an 'affected transaction' and that affected transaction results or will result in a tax benefit being derived by a party to that transaction. A tax benefit includes any avoidance, postponement, or reduction of any liability for tax.[72] Where a transaction does not fall within the definition of an affected transaction or a tax benefit is not derived by a party to the transaction, the transfer pricing rules in section 31 of the Income Tax Act must not apply. Part of determining whether a transaction would fall in the transfer pricing provisions would be to determine whether the parties to the transaction are connected persons. This would entail assessing whether a connected party relationship exists. Whilst the current transfer pricing rules require that the assessment applies to connected persons, it is proposed that with effect from 1 January 2023, the definition of associated enterprise will be included in section 31 of the Income Tax Act to operate in conjunction with the definition of connected person.[73] The effect of this amendment is that section 31 of the Income Tax Act will be more aligned with the OECD Model Tax Convention, as the concept of associated enterprises, as contemplated in article 9 of the OECD Model Tax Convention, will be contained in section 31 of the Income Tax Act.

[71] Practice Note 7 para 12.7.1.
[72] Definition of 'Tax Benefit' in section 1 of the Income Tax Act.
[73] Section 66(1) of the Taxation Laws Amendment Act 20 of 2021.

3.2 What is an 'Affected Transaction'?

The transfer pricing provisions apply to affected transactions. An affected transaction is defined as:

> '*"affected transaction" means any transaction, operation, scheme, agreement or understanding where—*
>
> *(a) that transaction, operation, scheme, agreement or understanding has been directly or indirectly entered into or effected between or for the benefit of either or both—*
>
> *(i) (aa) a person that is a resident; and*
>
> *(bb) any other person that is not a resident;*
>
> *(ii) (aa) a person that is not a resident; and*
>
> *(bb) any other person that is not a resident that has a permanent establishment in the Republic to which the transaction, operation, scheme, agreement or understanding relates;*
>
> *(iii) (aa) a person that is a resident; and*
>
> *(bb) any other person that is a resident that has a permanent establishment outside the Republic to which the transaction, operation, scheme, agreement or understanding relates; or*
>
> *(iv) (aa) a person that is not a resident; and*
>
> *(bb) any other person that is a controlled foreign company in relation to any resident,*
>
> *and those persons are connected persons in relation to one another; and*
>
> *(b) any term or condition of that transaction, operation, scheme, agreement or understanding is different from any term or condition that would have existed had those persons been independent persons dealing at arm's length;*'[74]

[74] Definition of 'affected transaction' in terms of section 31(1) of the Income Tax Act.

The definition of affected transaction contemplates transactions which have been entered into directly or indirectly. Therefore, the definition covers transactions which have been entered into directly or indirectly for the benefit of one or more parties specified in the above definition.[75]

The definition of affected transaction is two-fold for section 31 of the Income Tax Act to be triggered: 1) there needs to be a cross-border transaction where the parties to the transaction are connected persons and 2) any term or condition of that transaction needs to be a term or condition which would not have arisen had the connected persons to the transaction been persons dealing at an arm's length. The parties to the transaction would need to be either:

- a resident and a non-resident;
- two non-residents where one of the non-residents has a permanent establishment in South Africa to which the transaction relates;
- two residents where one of the residents has a permanent establishment outside of South Africa to which the transaction relates;
- a non-resident and any controlled foreign company in relation to any resident; or
- a non-resident and any controlled foreign company in relation to any resident, in which the resident derives or will derive a tax benefit (only applicable to years of assessment commencing after 1 January 2021).[76]

Where a transaction constitutes an affected transaction for the purposes of the transfer pricing rules and the transaction gives rise to a tax benefit, the taxable income of any person to the transaction or a resident in relation to a controlled foreign company contemplated in the sub-paragraph (iv) definition of 'affected transaction' must be calculated as if the transaction was entered into at arm's length, unless certain exemptions from the transfer pricing provisions exist.

Given that section 31 of the Income Tax Act does not contain any provision which requires a corresponding adjustment to be made for South African tax purposes, where a foreign jurisdiction applies the arm's length principle which results in more income being received in South Africa, no tax benefit would arise and accordingly, no adjustment in terms of section 31

[75] Oguttu A 'International Tax Law' 1st Ed (2015) 247.
[76] Definition of 'affected transaction' in s 31(1) of the Income Tax Act.

of the Income Tax Act would be required.[77] This poses the risk of double taxation.[78] Many of the double taxation agreements entered into by South Africa do not contain a provision which requires a corresponding adjustment.[79] A discussion of double taxation relief falls outside the scope of this research report.

3.3 Connected person for the purposes of section 31 of the Income Tax Act

In order to ascertain whether there is a connected person relationship, certain criteria need to be met. Section 31 of the Income Tax Act currently only applies to connected persons, but it is proposed that the provision also applies to associated enterprises with effect from 1 January 2023. Therefore, a taxpayer will be required to consider these concepts when determining whether a connected party relationship exists for the purposes of the transfer pricing rules.

3.3.1 Connected Person

For the purposes of this research report, the connected person definition is discussed in relation to companies. The definition of connected person is contained in section 1 of the Income Tax Act and must be read together with section 31(4) of the Income Tax Act where an affected transaction constitutes the granting of financial assistance. The definition of connected person in relation to a company is set out below:

'*"Connected person" means –*

(d) in relation to a company –

(i) any other company that would be part of the same group of companies as that company if the expression 'at least 70 per cent of the equity shares in' in paragraphs (a) and (b) of the definition of 'group of companies' in this section were replaced by the expression 'more than 50 per cent of the equity shares or voting rights in'

(ii) …

[77] Horak W 'South Africa – Transfer Pricing' in *IBFD Country tax guides - Transfer pricing* (2021) 17.
[78] Horak W & Bouwer A 'South Africa –Transfer Pricing and Dispute Resolution' in A Bakker and M Levey *Transfer Pricing and Dispute Resolution* (2021) para 1.2.2.4.
[79] Horak W & Bouwer A 'South Africa –Transfer Pricing and Dispute Resolution' in A Bakker and M Levey *Transfer Pricing and Dispute Resolution* (2021) para 1.2.2.4.

(iii) …

(iv) any person, other than a company as defined in section 1 of the Companies Act that individually or jointly with any connected person in relation to that person, holds, directly or indirectly, at least 20 per cent of –

(aa) the equity shares in the company; or

(bb) the voting rights in the company;

(v) any other company if at least 20 per cent of the equity shares or voting rights in the company are held by that other company, and no holder of shares holds the majority voting rights in the company;

(vA) any other company if such other company is managed or controlled by –

(aa) any person who or which is a connected person in relation to such company; or

(bb) any person who or which is a connected person in relation to a person contemplated in item (aa); and

(cc) any other close corporation or company which is a connected person in relation to –

(i) any member contemplated in item (aa); or

(ii) the relative or trust contemplated in item (bb)…'

Section 1 of the Income Tax Act provides a comprehensive definition of a connected person which, in relation to a company, extends to natural persons, trusts, partnerships, close corporations, and companies. By way of a practical example, Company A will be a connected person to Company B if Company A holds at least 50% of the equity shares or voting rights in Company B (whether directly or indirectly).[80] Furthermore, the definition of connected person extends to companies which do not exercise control over another company.[81] Therefore, in such instance, Company A may still be a connected person to Company B if Company A holds

[80] Paragraph (d)(i) of the definition of 'connected person' in section 1 of the Income Tax Act.
[81] See, for example, paragraph (v) of the definition of 'connected person' in section 1 of the Income Tax Act.

at least 20% of the equity shares or voting rights in Company B, and no other holder of shares in Company B holds the majority of the voting rights in Company B.[82]

Section 31(4) of the Income Tax Act provides that the words '*and no holder of shares holds the majority voting rights in the company*' must be disregarded when reading paragraph (d)(v) of the definition of connected person when the transaction comprises the granting of financial assistance or intellectual property in terms of section 23I(1) of the Income Tax Act,[83] or knowledge. Consequently, a company may still be connected to another company notwithstanding the fact that another shareholder holds the majority interest in that company, provided that the transaction comprises the granting of financial assistance or intellectual property. Lastly, the definition also applies to trusts, partnerships, and individuals. An individual or a trust will be connected to a company if that individual or trust individually or jointly with a connected person in relation to such individual or trust holds at least 20% of the equity shares or voting rights in the company.

3.3.2 Associated Enterprise

The proposed definition of associated enterprise in section 31 of the Income Tax Act refers to the definition of associated enterprise as it is contemplated in the OECD Model Tax Convention.[84] Article 9 of the OECD Model Tax Convention defines an associated enterprise as follows –

> '*Where:*
>
> > *a) an enterprise of a Contracting State participates directly or indirectly in the management, control, or capital of an enterprise of the other Contracting State; or*
> >
> > *b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,*
>
> *and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to*

[82] Paragraph (d)(v) of the definition of 'connected person' in section 1 of the Income Tax Act.

[83] For a transaction to constitute financial assistance, there must be the presence of a loan, security or guarantee.

[84] The proposed definition of 'associated enterprise' in section 31(1) of the Income Tax Act provide that an associated enterprise is *an associated enterprise as contemplated in Article 9 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development*.

one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.'

Essentially, the associated enterprise definition concerns itself with the elements of management or control. SARS suggests that the reason for the inclusion of associated enterprises is certain associated enterprises may not be regarded as connected persons.[85]

It is proposed that, with effect from 1 January 2023, the definition of associated enterprise will operate in conjunction with the definition of connected person which may broaden the application of whom may be a related party for transfer pricing purposes.

3.4 Calculating an arm's length price

South African transfer pricing legislations follows the arm's length principle.[86] Section 31(2) of the Income Tax Act requires that a transfer price and whether a taxpayer is thinly capitalised is to be determined in accordance with the arm's length principle. South African transfer pricing legislation has shifted to a more traditional arm's length analysis which does not allow SARS to make use of safe harbours to determine an arm's length price.[87] Rather, the analysis is required to take into account the facts and circumstance of the particular taxpayer.

South African transfer pricing legislation does not contain specific legislation which sets out how taxpayers must determine an arm's length price. Section 31 of the Income Tax Act does not make any reference to the transfer pricing methods adopted by the OECD, however Practice Note 7 specifically does. Given the status of Practice Note 7 not being law, it cannot be relied upon, unless it is a 'practice generally prevailing' which both the taxpayer and SARS recognise. Practice Note 7 can therefore only serve as a tool or guidance on how SARS will interpret section 31 of the Income Tax Act.

In South Africa, the transfer pricing methods approved by the OECD are commonly used to determine an arm's length price.[88] In this regard, the OECD Transfer Pricing Guidelines may provide guidance on the application of the arm's length principle.

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[85] National Treasury *Explanatory Memorandum on the Revenue Laws Amendment Bill* (2019) 41. Available URL: https://www.sars.gov.za/wp-content/uploads/Legal/ExplMemo/LAPD-LPrep-EM-2020-01-Explanatory-Memorandum-on-the-TLAB-of-2019.pdf, accessed on 6 June 2022.

[86] See discussion at paragraph 3.1 of chapter 3.

[87] In 2022, SARS released an updated draft interpretation note which provides guidance on how to determine an arm's length amount in relation to intra-group loans between related parties. The Draft Interpretation Note does not provide for the use of safe harbours to determine an arm's length amount.

[88] See Practice Note 7.

The OECD recognises five methods to calculate an arm's length price, which can be categorised in either the traditional transaction methods or the transactional profit methods.[89] Whilst this research report discusses all five methods recognised by the OECD, the relevant methods which can be applied to financial transactions are discussed at paragraph 3.5. The traditional transaction methods comprise the comparable uncontrolled price method, resale method, and cost-plus method, and is the preferred method of use by the OECD, whereas the transactional profit methods comprise the transactional net margin method and profit split method, which methods should only be used where the use of the traditional transaction methods is not appropriate. Although the traditional transaction methods are the preferred methods of the OECD, the OECD does not propose a hierarchy of methods. The appropriate method to be used is dependent on a particular situation and the extent that reliable data can be obtained to enable the effective application of a particular method. The Commissioner for SARS has endorsed these five methods as acceptable transfer pricing methods in Practice Note 7, with the most appropriate depending on the factual matrix and availability of reliable data.[90] Practice Note 7 provides that section 31 of the Income Tax Act does not impose a hierarchy in which pricing method to use, as a general rule the traditional transaction methods are preferred, with the comparable uncontrolled price method the most preferred as it provides the most accurate and reliable information, as it relates to direct costing.[91]

The various pricing methods accepted by SARS in Practice Note 7 are set out and discussed below. As previously stated, South Africa is not a member state of the OECD, however, South Africa has, to a significant extent, adopted the OECD Model Convention on Income and Capital, as well as the OECD Transfer Pricing Guidelines.[92] Accordingly, SARS' guidance in Practice Note 7 is discussed and where appropriate, reference is made to the OECD Transfer Pricing Guidelines where Practice Note 7 is silent.

3.4.1 Comparable uncontrolled price method

The arm's length price is determined by comparing prices in an open market using the comparable uncontrolled price method. The comparable uncontrolled price method is optimal for decision-making and performance evaluation purposes where the product is similar to other products and no individual buyer or seller can affect the market price.[93] This is typical of markets with quoted price exchanges. An example of this would be the pricing of commodities

[89] Paragraph 2.1 of the *OECD Transfer Pricing Guidelines*, 2022.
[90] Practice Note 7 para 9.2.4.
[91] Practice Note 7 para 9.3.1.
[92] See discussion at paragraph 3.1 of Chapter 3 above.
[93] Drury C *Management and Cost Accounting* 527.

as commodities are generally homogenous goods with little to no material differences. Furthermore, the most appropriate method of use for intercompany loans is the comparable uncontrolled price method using data from proprietary commercial databases such as Bloomberg or Loan Connector.[94] The comparable uncontrolled price method is a traditional method which is the most direct and reliable method to determine an arms' length price.[95]

The difficulty in application of the comparable uncontrolled price method is that where comparable transactions exist which contain material differences, the comparable uncontrolled price method of determining arms' length would not be suitable.[96] However, where material differences exist, the comparable uncontrolled price method may still be suitable to use where reasonable adjustments can be made to eliminate these material differences[97]

The comparable uncontrolled price method may be used for internal comparable transactions or external comparable transactions.[98] An internal comparable transaction involves one party to the controlled transaction and a third party, whereas an external comparable transaction involves two third parties, neither of whom are party to the controlled transaction.[99] SARS prefers residents to make use of internal comparable transactions as more reliable data can be obtained.[100] This is so because it is often difficult for companies to provide information on third party transactions where insufficient comparable information exists in relation to theirs.

The difficulty in the application of the comparable uncontrolled price method is that it is often difficult to find a comparable transaction similar enough to the controlled transactions, where differences exist which would not materially affect the price, or where reasonable adjustments can be made to these differences to eliminate the effect on the price.[101]

[94] Okten R & Drenth M 'Chapter 1 – The Treasury Functions' in Bakker, A & Kale, S (eds) *Transfer Pricing and Intra-Group Financing* (2021) 13. Also, see discussion at paragraph 3.5 of chapter3 on the application of this method to intra-group loans.
[95] Paragraph 2.15 of the *OECD Transfer Pricing Guidelines*, 2022.
[96] Practice Note 7 para 9.4.3.
[97] Paragraph 2.15 of the *OECD Transfer Pricing Guidelines*, 2022.
[98] Practice Note 7 para 9.4.2.
[99] Practice Note 7 para 9.4.2.
[100] Practice Note 7 Annexure B para 1.6.
[101] Practice Note 7 para 9.4.3.

3.4.2 Cost-orientated methods

The cost orientated methods comprise the cost-plus method and the resale method. The cost orientated methods focus on cost of sales. Therefore, cost-orientated methods include the direct costs, indirect costs, and an appropriate mark-up.

3.4.2.1 *Cost Plus Method*

The cost-plus method is a transfer pricing method where an appropriate mark-up is added to the costs incurred by the supplier of a product in a controlled transaction.[102] In order for the supplier in a controlled transaction to achieve an appropriate profit, the mark-up applied must take into account functions performed, such as assets used and risks assumed, as well as the relevant market conditions to obtain an appropriate arms' length price.[103]

The cost-plus method is appropriate where semi-finished goods are sold between related parties.[104] An appropriate mark-up should be determined using internal comparables where the taxpayer is a party to the controlled transaction.[105] If this is not possible, then external comparables should be considered between two third parties. An example of where this method can be used is where a treasury centre co-ordinates or arranges financial transactions on behalf of related parties, and the treasury centre incurs fees (e.g. management or handling fees).[106]

The cost-plus method is cost sensitive. The difficulty in the application of the cost-plus method is the inconsistent treatment of costs in accounting policies.[107] Different costing methods applied from company to company may impact on the mark-up arrived at by a particular company, as different costs may be included to arrive at a particular mark-up, or a more efficient costing strategy is employed by a particular company which has the effect of lowering costs incurred to that of a similar company.[108] Furthermore, SARS notes that the application of the cost-plus method may require access to segregated product data which is ordinarily not available for third party transactions which are used for benchmarking purposes.[109] The effect

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[102] Practice Note 7 para 9.6.1.
[103] Practice Note 7 para 9.6.1.
[104] Practice Note 7 para 9.6.2.
[105] Practice Note 7 para 9.6.2.
[106] Okten R & Drenth M 'Chapter 1 – The Treasury Functions' in Bakker, A & Kale, S (eds) *Transfer Pricing and Intra-Group Financing* (2021) 13. Also, see discussion at paragraph 3.5 of chapter3 on the application of this method to intra-group loans.
[107] Practice Note 7 para 9.6.3.
[108] Practice Note 7 para 9.6.3.
[109] Practice Note 7 para 9.6.3.

of the abovementioned difficulties in the application of the cost-plus method may result in comparable data not being available or the cost-plus method being unsuitable for use.[110]

3.4.2.2 *Resale Method*

The resale method determines an arm's length price with reference to the gross margin realised in a comparable uncontrolled transaction.[111] The resale price, which is the price at which a related party on-sells a product to an independent third party, is reduced by an appropriate gross margin, to cover the reseller's selling and other operating expenses.[112]

The resale price is aimed at covering the reseller's selling and other operating expenses, which costs depend on the functions performed, assets used, and risks assumed by the seller,[113] whilst still ensuring the reseller obtains a profit on the sale to third parties. The resale price, less the gross margin, and less any associated costs of the reseller with the purchase of the product is the arm's length amount. An example of an associated cost would be customs duty.[114]

The resale gross margin can be obtained using internal or external comparables.[115] Where an internal comparable is used, the gross margin is determined by comparing the gross margin used between the same reseller and a third party in a comparable uncontrolled transaction.[116] Where an external comparable is used, the gross margin is determined by comparing the gross margin used between two independent parties in a comparable uncontrolled transaction.[117]

Given that a gross compensation is targeted in the resale method, the cost of sales for specific functions, after taking into account assets used and risks assumed, are less significant.[118] Therefore, products with immaterial differences may still be compared and the appropriate adjustments made, provided the product does not possess unique underlying operating expenses which would inhibit appropriate adjustments to be made.[119]

[110] Practice Note 7 para 9.6.3.
[111] Practice Note 7 para 9.5.1.
[112] Practice Note 7 para 9.5.1.
[113] Practice Note 7 para 9.5.1.
[114] Practice Note 7 para 9.5.1.
[115] Practice Note 7 para 9.5.2.
[116] Practice Note 7 para 9.5.2.
[117] Practice Note 7 para 9.5.2.
[118] Practice Note 7 para 9.5.2.
[119] Practice Note 7 para 9.5.2.

The resale method is most appropriate where the reseller does not add substantially to the value of the product or does not possess valuable marketing intangibles.[120] Therefore, the resale method may not be appropriate where unique products are sold as the comparison may contain material irreconcilable differences. An example of where the resale method may be of use is for marketing operations conducted by a multinational enterprise.

The difficulties in application of the resale method are similar to that of the cost-plus method. Much like the cost-plus method, the resale method is also cost sensitive because a gross margin is targeted.[121] Furthermore, a further difficulty in the application of the resale method is the inconsistent treatment of costs in accounting policies.[122] Different costing methods applied from company to company may impact on the gross margin arrived at by a particular company, as different costs may be included to arrive at a particular gross margin, or a more efficient costing strategy is employed by a particular company which has the effect of lowering costs to those of a similar company. Furthermore, SARS notes that the application of the resale method may require access to segregated product data which is ordinarily not available for third party transactions which are used for benchmarking purposes.[123] The effect of the abovementioned difficulties in the application of the resale method may result in comparable data not being available or the resale method unsuitable for use.[124]

3.4.3 Profit-orientated methods

The profit-orientated methods comprise the profit split method and the transactional net margin method. The profit-orientated methods examine the profits of a controlled party transaction. The result of this analysis often requires a taxpayer to make retroactive transfer pricing adjustments to bring the profit margin back in line with the group's targeted profit margin for particular controlled transactions. The profit-orientated methods therefore serve as a good method to corroborate the results of transactional method analysis, in particular for complex transactions.[125]

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[120] Practice Note 7 para 9.5.2.
[121] Practice Note 7 para 9.5.3.
[122] Practice Note 7 para 9.5.3.
[123] Practice Note 7 para 9.5.3.
[124] Practice Note 7 para 9.5.3.
[125] Ernst & Young *Transactional profits transfer pricing method: Comments on a series of draft issues notes* (2008) 3. Available URL: https://www.oecd.org/tax/transfer-pricing/40580595.pdf, accessed on 17 December 2021.

3.4.3.1 *Profit Split Method*

The profit split method requires a taxpayer to identify the combined profit to be split between related parties, resulting from a controlled transaction. The profit is split between the related parties according to an economically viable basis which would have been determined in an agreement made at arm's length.[126] The profit split method seeks to eliminate special conditions which related parties would impose in a controlled transaction, the effect of which special conditions may result in an arm's length price not being achieved and profits being extracted.

The profit split method is a suitable method where both parties to a controlled transaction make unique and valuable contributions. Therefore, both parties can earn an appropriate profit based on their respective contributions to the integrated operations.[127] This analysis may be based on actual profits or projected profits to which independent parties would have agreed. Accordingly, the profit split method would typically not be a suitable method where only one party makes unique and valuable contributions to a controlled transaction.

The OECD Transfer Pricing Guidelines notes two methods, which are not necessarily exhaustive or mutually exclusive, which may be used to determine the profit split, namely the contribution analysis method or the residual profit method. Both these sub-methods are accepted in Practice Note 7 as a means to determine the profit split and are discussed below.

a) Residual profit method

The residual profit split method focuses on evaluating economies of scale, whilst ensuring that each party to the transaction obtains a basic return prior to the actual profit split.[128] Therefore, the residual profit split method follows a two-stage process. First, a basic return is allocated to the parties, based on what independent firms would obtain for performing similar functions and undertaking similar risks.[129] Thereafter, the residual profit remaining after this allocation, is then further allocated between the parties based on what the residual profit split would have been between independent firms.[130] The surrounding circumstance would determine how the residual profit is allocated in the second leg and would include factors such as the contributions each party makes and

[126] Practice Note 7 para 9.8.1.
[127] Practice Note 7 para 9.8.2.
[128] Practice Note 7 para 9.8.2.
[129] Practice Note 7 para 9.8.2.
[130] Practice Note 7 para 9.8.2.

the bargaining power of the specific party. Therefore, in order to practically determine the relative contribution, there is a degree of subjectivity in determining the relative contributions, given that the facts and circumstances of each case must be considered.[131]

b) *Contribution analysis method*

Given that multinationals are organisationally different to domestic entities in that they often contain various business units or operations which streamline overall costs incurred by the multinational, it becomes difficult to evaluate economies of scale. The contribution analysis method focuses on evaluating economies of scale. The traditional transaction methods cannot readily evaluate economies of scale; therefore, the profit split method is of use in determining whether a multinational enterprise's transfer price is at arm's length.[132]

The combined gross profit of the parties to the transaction is allocated to the parties, on the basis of their respective contributions to that profit.[133] The contribution analysis method differs from the residual profit method in that there is not first an allocation of basic returns to each party before the profit split, rather this step is eliminated, and the parties are solely rewarded on their respective contributions.

In the profit split method, both parties to the controlled transaction are evaluated to determine if an appropriate profit split was achieved. An advantage of the profit split method is that this two-sided approach may achieve an appropriate division of profits based on economies of scale or other joint efficiencies that satisfy both the taxpayer and tax administration.[134] This therefore may provide a solution to determining an appropriate transfer price for highly integrated operations, such as the global trading of financial instruments between related parties where both parties to the transaction make valuable contributions.

The difficulty in application of the profit split method is that it relies on the accessibility of world-wide group data which is often difficult to obtain.[135] Furthermore, a limitation of the profit split method is that the profit allocation is subjective.[136] The effect of the abovementioned

[131] Practice Note 7 para 9.8.2.
[132] Practice Note 7 para 9.8.2.
[133] Practice Note 7 para 9.8.2.
[134] Paragraph 2.119 of the *OECD Transfer Pricing Guidelines*, 2022.
[135] Practice Note 7 para 9.8.3.
[136] Practice Note 7 para 9.8.3.

difficulties in the application of the profit split method may result in comparable data not being available or unreliable.[137]

3.4.3.2 *Transactional Net Margin Method*

The transactional net margin method requires a taxpayer to select net profit as the profit indicator, in relation to an appropriate base, such as sales, costs or assets, to determine the net profit margin that the taxpayer realises from a controlled transaction.[138]

The transactional net margin method focuses on the functions performed by a taxpayer, therefore it operates similar to the cost-orientated methods and must be applied in a consistent manner to that of the cost-orientated methods. [139] The difference in the transactional net margin method to that of cost-orientated methods is that it focuses on net profit, rather than gross profit to determine an appropriate margin.[140] Simply put, the transactional net margin method targets an operating margin, rather than a gross margin. Therefore, an appropriate margin should be determined using internal comparables where the taxpayer is a party to the controlled transaction. If this is not possible, then external comparables should be considered between two third parties. Similar to the cost-plus method, an example of where this method can be used is where a treasury centre co-ordinates or arranges financial transactions on behalf of related parties, and the treasury centre incurs fees (e.g., management or handling fees).[141]

The transactional net margin method is however not as reliable as the traditional transaction methods, as by using operating expenses in their calculations, the transactional net margin method becomes more sensitive to cost structures.[142] Operating expenses often contain expenses which cannot easily be adjusted, such as where the parties to a controlled transaction make unique and valuable contributions.[143] Furthermore, a targeted net margin may be affected by factors that do not necessarily have an influence on the price or gross margin.[144] For the transactional net margin method to be more reliable, the third party and the party to the controlled transaction would need to be structurally similar. It is for this reason

[137] Practice Note 7 para 9.8.3.
[138] Practice Note 7 para 9.7.1.
[139] Paragraph 2.64 of the *OECD Transfer Pricing Guidelines*, 2022.
[140] Practice Note 7 para 9.7.2.
[141] Okten R & Drenth M 'Chapter 1 – The Treasury Functions' in Bakker, A & Kale, S (eds) *Transfer Pricing and Intra-Group Financing* (2021) 13.
[142] Practice Note 7 para 9.7.2.
[143] Practice Note 7 para 9.7.2.
[144] Practice Note 7 para 9.7.2.

that the transactional net margin method, along with the profit split method, is considered methods of last resort in international practice.[145]

A weakness in the transactional net margin method is that it involves a one-sided analysis, as it does not take into account the effect a price may have on the other party to the transaction.[146] Given that the transactional net margin method factors in operating expenses, it is less likely to be as reliable than if one of the traditional transaction methods is used. Therefore, close attention must be paid to the profit resulting from the application of the transactional net margin method to ensure it accords with an arm' s length price.

3.5 Application to financial transactions

Entities should use the method most appropriate in the circumstances. Intra-group loan transactions may be complex and therefore the method used will be dependent on a particular case. An appropriate arm's length amount must be determined for both the capital sum and interest portion of the loan. Different loan pricing approaches are used internationally being the comparable uncontrolled price method, cost of funds method, economic modelling approach and safe harbours.[147]

Owing to the complexity of multinational enterprise group structures, it may be the case that services are integrated, such that an agent or intermediary is part of the supply chain to obtain the loan. In such an instance, the cost-plus method or the transactional net margin method may be better suited to determine an arm's length price for the services portion of the transaction. An example of such as instance would be where a group shared service cost centre is remunerated on a cost-plus basis.[148] The interplay with other intra-group transactions would require intra-group financing transactions to be scrutinised more closely to ensure that the intra-group financing transaction is at arm's length and that the operational transfer pricing approach used for the services is also at arm's length.[149]

[145] Practice Note 7 para 9.7.2.
[146] Practice Note 7 para 9.7.3.
[147] Moerer O, Mavrodiev G & S Kale 'Chapter 5 – Common types of intra-group financing arrangements' in Bakker, A & Kale, S (eds) *Transfer Pricing and Intra-Group Financing* (2021) 111.
[148] Chwala U & Lukosz K'Chapter 6 – Accurate Delineation of intra-group financial transactions' in *Transfer Pricing and Intra-Group Financing* (2021) 169.
[149] Moerer O, Mavrodiev G & S Kale 'Chapter 5 – Common types of intra-group financing arrangements' in Bakker, A & Kale, S (eds) *Transfer Pricing and Intra-Group Financing* (2021) 118.

Comparable uncontrolled price

The comparable uncontrolled price method is the method most used in intra-group loans due to the availability of financial information from lending markets.[150]

Cost of funds approach

Where comparable third-party information cannot be obtained and the comparable uncontrolled price method cannot be used, the cost of funds approach may provide an alternative method of use. The cost of funds approach focuses on the activities of the lender. Under this approach, a loan is priced based on the cost to the lender, with an appropriate mark-up or interest spread added to the cost of the funds.[151] The cost of funds approach will reflect the borrowing cost of the lender.[152] The funds may be externally or internally obtained, which is on-lent to a connected person.[153]

The cost of funds can significantly differ between different financial institutions and therefore under this approach careful attention should be paid to ensure the funds are advanced at arm's length.[154] A lender would need to carefully consider all the costs it intends charging to ensure that it charges a cost which an independent third party would charge the borrower.

Economic modelling approach

Under this method individual risk components can be used to determine an appropriate price for the intra-group loan.[155] Typically, this approach starts with the use of a reference or risk-free rate, which are then adjusted for the risk premium.[156]

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[150] Moerer O, Mavrodiev G & S Kale 'Chapter 5 – Common types of intra-group financing arrangements' in *Transfer Pricing and Intra-Group Financing* (2021) 111. See discussion at paragraph 6.4 of Chapter 6 for a discussion on the application of the OECD Transfer Pricing Guidelines on Pricing Intra-Group Loans.

[151] Moerer O, Mavrodiev G & S Kale 'Chapter 5 – Common types of intra-group financing arrangements' in *Transfer Pricing and Intra-Group Financing* (2021) 112.

[152] Moerer O, Mavrodiev G & S Kale 'Chapter 5 – Common types of intra-group financing arrangements' in *Transfer Pricing and Intra-Group Financing* (2021) 112.

[153] Moerer O, Mavrodiev G & S Kale 'Chapter 5 – Common types of intra-group financing arrangements' in *Transfer Pricing and Intra-Group Financing* (2021) 112.

[154] Moerer O, Mavrodiev G & S Kale 'Chapter 5 – Common types of intra-group financing arrangements' in *Transfer Pricing and Intra-Group Financing* (2021) 112.

[155] Moerer O, Mavrodiev G & S Kale 'Chapter 5 – Common types of intra-group financing arrangements' in *Transfer Pricing and Intra-Group Financing* (2021) 113.

[156] Moerer O, Mavrodiev G & S Kale 'Chapter 5 – Common types of intra-group financing arrangements' in *Transfer Pricing and Intra-Group Financing* (2021) 113. See discussion at paragraph 6.5 of Chapter 6 for a discussion on the use of risk-free rates.

Safe harbours

Safe harbours entail the use of a base interest rate and applicable allowable margins, for both local and foreign denominated loans. A safe harbour would contain an interest rate range or projection which would be an acceptable interest rate to be used for transfer pricing purposes. Under the guidance provided by SARS in the 2022 Draft Interpretation Note, South African transfer pricing guidance no longer contains safe harbour provisions. Rather, taxpayers are required to follow the guidance of the arm's length principal to justify their transfer prices. The lack of guidance in this regard increases the risk for taxpayers to comply with the transfer pricing and thin capitalisation provisions under section 31 of the Income Tax Act.

If South Africa were to adopt safe harbours, a taxpayer would be provided certainty in relation to the interest rates to use for pricing intra-group loans, as it would enable taxpayers to comply with the provisions of section 31 of the Income Tax Act.

3.6 **Primary adjustment and secondary adjustment**

Section 31(2) of the Income Tax Act requires a taxpayer to adjust a transfer price to an arm's length amount to calculate its taxable income where the amount was not initially an arm's length amount. The onus is thus on the taxpayer to disclose to SARS an arm's length price. This adjustment takes the form of a self-assessment made by the taxpayer. Where the adjustment is made prior to the finalisation of the financial statements and submission of the income tax return, this would be a 'self-adjustment' typically where a credit note, or additional invoice is issued to reflect an arm's length price.[157] An adjustment in this circumstance would not constitute a 'primary adjustment'. Where the taxpayer makes an adjustment prior to the submission of its tax return, but after the finalisation of the financial statements, the taxpayer will be regarded as having made a primary adjustment for purposes of section 31(2) of the Income Tax Act.[158] The practical effect of the primary adjustment is that a taxpayer would be required to increase its taxable income to reflect an arm's length amount. The primary adjustment in section 31(2) of the Income Tax Act made by the taxpayer serves as a necessary antecedent to a secondary adjustment. Secondary adjustments in terms of section 31(3) of the Income Tax Act are discussed below.

[157] Wiesener C & Gosai N 'Chapter 10 – Non-compliance with transfer pricing law and regulations' in *Africa Transfer Pricing Practice Guide: A South African Perspective* (2021) 9.

[158] Wiesener C & Gosai N 'Chapter 10 – Non-compliance with transfer pricing law and regulations' in *Africa Transfer Pricing Practice Guide: A South African Perspective* (2021) 9.

In terms of section 31(3) of the Income Tax Act, a secondary adjustment would arise if the requirements of section 31(2) of the Income Tax are met. Stated differently, for a secondary adjustment to arise, there must be a difference between the arm's length amount and the amount used to calculate the taxable income and that amount must or will result in a tax benefit being derived.[159] The secondary adjustment is a constructive adjustment.[160] The secondary adjustment creates a secondary transaction consistent with the primary adjustment.[161] The secondary adjustment concerns itself with the actual allocation of the excess profits resulting from the primary adjustment.[162] In terms of the secondary adjustment, any difference in taxable income resulting from a transfer pricing adjustment will constitute a deemed dividend or a donation as follows:

1. In the case the resident being a company, the secondary adjustment is in the form of a dividend in *specie*. The dividend in *specie* is treated as a distribution paid by a resident company to a non-resident person. The dividend in *specie* would attract dividends tax at 20% in terms of section 64E of the Income Tax Act; and

2. In any other case, the secondary adjustment is in the form of a donation, which attracts donations tax at 20%.

Furthermore, as previously stated, section 31 of the Income Tax Act does not provide for corresponding adjustments.[163] Article 9(2) of the OECD Model Tax Convention provides that profits between contracting states must be allocated using the arm's length principle and that where a contracting state must make a transfer pricing adjustment to achieve an arm's length price, the other state will be required to make a corresponding adjustment to prevent the potential for double taxation.[164] There would need to be a 'tax benefit' for a corresponding adjustment to be made for South African purposes. [165]

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[159] Wiesener C & Gosai N 'Chapter 10 – Non-compliance with transfer pricing law and regulations' in *Africa Transfer Pricing Practice Guide: A South African Perspective* (2021) 9.

[160] The OECD defines a 'constructive dividend as '*A variety of payments whether in cash or in kind made by companies to shareholders or associated persons, which are not expressed as dividends, may nevertheless be regarded by the tax law as distributions of profits and treated for tax purposes as if they were dividends.'*

[161] Strauss C *The Availability of Treaty Relief for Secondary Transfer Pricing Adjustments Taking The Form of a Deemed Distribution of an Asset in Specie in South Africa* (2017) iii.

[162] Wiesener C & Gosai N 'Chapter 10 – Non-compliance with transfer pricing law and regulations' in *Africa Transfer Pricing Practice Guide: A South African Perspective* (2021) 5.

[163] See discussion at paragraph 3.2 of Chapter 3 above.

[164] This poses the risk of double taxation. Section 31 of the Income Tax Act does not contain any provision which requires a corresponding adjustment to be made for South African tax purposes. For a further discussion, see discussion at paragraph 3.2 of chapter 3.

[165] Horak W 'South Africa – Transfer Pricing' in *IBFD Country tax guides - Transfer pricing* (2021) 17.

3.7 Conclusion

Chapter three examined the arm's length principle which is used to determine the transfer prices of cross-border transactions with connected persons. The OECD Guidelines recommends five transfer pricing methods when determining a transfer price, which comprise the comparable uncontrolled price method, cost-plus method, resale price method, profit split method and transaction net margin method. Furthermore, the OECD Transfer Pricing Guidelines recommends four loan pricing approaches being the comparable uncontrolled price method, cost of funds method, economic modelling approach and safe harbours.

Chapter three further examined the loan pricing approaches which could be used to determine an arm's length price for a loan. The concepts in this chapter are used to discuss the interaction between the transfer pricing provisions and the controlled foreign company provisions in chapter 5.

4 CHAPTER 4: CONTROLLED FOREIGN COMPANIES

4.1 Overview

The controlled foreign company rules are to avoid the deferral of tax through South African owned foreign entities.[166] The aim of these rules are to protect the South African tax base. A South African company which owns shares in an offshore entity should consider the controlled foreign company rules, particularly when engaging in cross-border exchange between the entities as this may give rise to unforeseen tax consequences. The failure to properly disclose these transactions may result in interest and/or penalties being payable on the amounts owed to SARS.

The South African controlled foreign company rules can be found in section 9D of the Income Tax Act. The rules set out when a foreign company meets the definition of a controlled foreign company and the tax implications for such classification. The effect of the controlled foreign company rules is that a South African tax resident must include a proportionate amount of the net income earned by that controlled foreign company, in its own income, as if it was earned by the South African tax resident. In certain instances, the South African company need not include this income if certain exclusions contained in Section 9D of the Income Tax Act apply.

To determine the applicability of section 9D of the Income Tax Act, it must be determined whether an entity constitutes a controlled foreign company. Where an entity does not fall within the definition of a controlled foreign company, the controlled foreign company rules contained in section 9D of the Income Tax Act must not apply. The controlled foreign company rules are specific anti-avoidance rules contained in the Income Tax Act; therefore, it should be noted that where a South African resident enter into a transaction which does not trigger the controlled foreign company rules, SARS may still attack the transaction using the general anti-avoidance rules contained in the Income Tax Act.[167]

For the purposes of this research report, the focus is on intra-group loans and therefore the tax implications applicable to any income or exemptions applicable to a controlled foreign company in relation to any intra-group loans entered into is considered below.

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[166] Para B at pg 1 of National Treasury's *Detailed Explanation to section 9D of the Income Tax Act* (June 2002).
[167] See Part IIA of the Income Tax Act.

4.2 Controlled foreign company

A resident is required to include its proportionate share of the net income of the controlled foreign company in its own income. The controlled foreign company rules currently only apply to foreign companies.[168]

A controlled foreign company is defined as:

'"Controlled foreign company" means –

(a) any foreign company where more than 50 per cent of the total participation rights in that foreign company are directly or indirectly held, or more than 50 per cent of the voting rights in that foreign company are directly or indirectly exercisable, by one or more persons that are residents other than persons that are headquarter companies: Provided that—

(i) no regard must be had to any voting rights in any foreign company—

(aa) which is a listed company; or

(bb) if the voting rights in that foreign company are exercisable indirectly through a listed company;

(ii) any voting rights in a foreign company which can be exercised directly by any other controlled foreign company in which that resident (together with any connected person in relation to that resident) can directly or indirectly exercise more than 50 per cent of the voting rights are deemed for purposes of this definition to be exercisable directly by that resident; and

(iii) any voting rights in a foreign company which can be exercised directly by any other controlled foreign company in which that resident (together with a person is deemed not to be a resident for purposes of determining whether residents directly or indirectly hold more than 50 per cent of the participation rights or voting rights in a foreign company, if—

(aa) in the case of a listed company or a foreign company the participation rights of which are held by that person indirectly through a listed

[168] Stiglingh M, Koekemoer A, van Heerden L, Wilcocks J, van der Zwan P *Silke: South African Income Tax* (2022) 871. A 'foreign company' is defined as 'any company which is not a resident' in section 1 of the Income Tax Act.

company, that person holds less than five per cent of the participation rights of that listed company; or

(bb) *in the case of a scheme or arrangement contemplated in paragraph I (ii) of the definition of "company" in section 1 or a foreign company the participation rights of which are held and the voting rights of which may be exercised by that person indirectly through such a scheme or arrangement, that person—*

(A) *holds less than five per cent of the participation rights of that scheme or arrangement; and*

(B) *may not exercise at least five per cent of the voting rights in that scheme or arrangement,*

(b) *any foreign company where the financial results of that foreign company are reflected in the consolidated financial statements, as contemplated in IFRS 10, of any company that is a resident, other than a headquarter company.'*

A 'controlled foreign company' is any foreign company, subject to certain exclusions, where more than 50% of the total participation rights in that foreign company are held by, or more than 50% of the voting rights in that foreign company are directly or indirectly exercisable by, one or more residents of South Africa, or where the financial results of that foreign company are reflected in the consolidated financial statements, as contemplated in IFRS 10. Therefore, where South African tax residents hold exactly 50% of the total participation or voting rights in a foreign company, that foreign company will not be subject to the controlled foreign company rules, provided that the financial results of that foreign company are not reflected in the consolidated financial statements of that South African tax resident.[169]

An IFRS 10 consolidation requires an entity to consolidate its financial statements with one or more entities over which that entity exercises 'control'.[170] A discussion of the concept of control as contemplated in IFRS 10 falls outside the scope of this research report.

What is notable in the definition of controlled foreign company is that both participation rights and voting rights need to be viewed in total.[171] Therefore, voting rights and/or participation

[169] A discussion of the concept of 'participation rights' is discussed below at paragraph 4.3.
[170] IFRS 10 *Consolidated Financial Statements* (2015). Available URL: https://www.iasplus.com/en/standards/ifrs/ifrs10, accessed 4 June 2022.
[171] Kruger D & Brown N 'Controlled Foreign Company: Participation Rights' *Business Tax & Company Law Quarterly* Vol 12 (2021) 4 12.

rights which attach to a specific class of shares would not necessarily warrant that foreign company being classified as a controlled foreign company.

Furthermore, notwithstanding that a foreign company may be classified as a controlled foreign company, a South African tax resident would not have to apply the controlled foreign company provisions where the following exclusions exist:

- where a South African resident (together with any connected person in relation to that resident) in aggregate holds less than 10% of the participation rights and may not exercise at least 10% of the voting rights in a controlled foreign company, at the end of the last day of the foreign tax year of the controlled foreign company; or

- where the participation rights are held indirectly by that South African resident through another South African resident company; or

- where the participation rights are held by certain long-term insurers; or

- where the participation rights are held by certain portfolios of a collective investment scheme.[172]

The effect of the above exclusions is that even where a South African tax resident holds participation rights in a controlled foreign company, the South African tax resident will not be required to calculate its proportional amount of the net income of the controlled foreign company when determining its tax liability for the relevant year of assessment.[173] However, the disclosure requirements for a controlled foreign company must still be considered even where income is not required to be imputed.[174]

4.3 **Participation right**

Participation rights distinguish between shareholding and voting rights.[175] Participation rights contemplate the right to participate in all or part of the benefits of the rights attaching to a share, or the voting rights in a foreign company. Therefore, where a company does not have

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[172] Proviso to section 9D(2) of the Income Tax Act.
[173] Clegg D & Stretch R *Income Tax in South Africa* (2022) 141.
[174] See discussion at paragraph 6.2.2 of Chapter 6 for a discussion on the controlled foreign company disclosure requirements.
[175] De Koker A & Williams R *Silke on South African Income Tax* (2022) 5.44.

any shares, such as hybrid companies, one would look toward paragraph (b) of the definition of participation rights, which deals with voting rights in a foreign company.[176]

Participation rights are defined as:

> *'"**Participation rights**" in relation to a foreign company means:*
>
> *(a) the right to participate in all or part of the benefits of the rights (other than voting rights) attaching to a share, or any interest of a similar nature, in that company;*
>
> *(b) in the case where no person has any right in that foreign company as contemplated in paragraph (a) or no such rights can be determined for any person, the right to exercise any voting rights in that company.'*

As can be gathered from its definition, participation rights effectively extend to participation in the capital of the foreign company and participation in the profits of the foreign company. Furthermore, participation rights can extend to ordinary share capital or preference share capital, dependent on the rights that attach to such class of shares.[177] Therefore, to determine whether participation rights exists, regard needs to be had to who would be entitled to the share capital of the foreign company on liquidation of that foreign company.[178] Similarly, it must be determined who would benefit from the income rights attaching to a share of the foreign company where the foreign company actually distributes income (e.g. as a dividend) or income is available for distribution.[179]

4.4 Foreign business establishment

The purpose of the foreign business establishment exemption is to prevent income from a controlled foreign company being imputed for South African tax purposes.[180] Certain income would still be required to be imputed in the net income of the controlled foreign company in terms of the anti-diversionary income rules and passive income rules contained in section 9D(9A) of the Income Tax Act.[181] Examples of the anti-diversionary income rules apply to

[176] De Koker A & Williams R *Silke on South African Income Tax* (2022) 5.44.
[177] Kruger D & Brown N 'Controlled Foreign Company: Participation Rights' *Business Tax & Company Law Quarterly* Vol 12 (2021) 4 14.
[178] Kruger D & Brown N 'Controlled Foreign Company: Participation Rights' *Business Tax & Company Law Quarterly* Vol 12 (2021) 4 12.
[179] Bennett A & Roelofse L 'Chapter 3 – Controlled Foreign Companies' in *Silke on International Tax* (2009) para 3.3.
[180] Clegg D & Stretch R *Income Tax in South Africa* (2022) 268.
[181] For a discussion of the anti-diversionary rules and passive income rules, see discussion at paragraph 1.2 of chapter 1 above.

imported goods,[182] imported services[183] and in the case of passive (mobile) income, certain mobile income, such as income from financial instruments.[184] The foreign business establishment exemption extends to activities which pose no threat to the South Africa tax base.[185] The foreign business establishment exemption would not apply to income where there is no real economic nexus with the country in which the controlled foreign company is resident.[186] The general requirements for the foreign business establishment exemption to apply requires that there must be:

1) a fixed place of business;

2) a place of offshore prospecting, exploration, mining, or production of natural resources;

3) offshore construction or installing sites which lasts for a period of not less than 6 months;

4) agricultural land outside South Africa used for bona fide farming activities; or

5) a vessel, vehicle, rolling stock, or aircraft used for purposes of transport, fishing, or prospecting.[187]

In order to determine if a particular amount is attributable to a foreign business establishment, that foreign business establishment must be treated as if it is a separate and distinct business from the controlled foreign company.[188] Furthermore, that amount would be determined if that transaction was entered into on terms and conditions that would have existed had the parties been independent persons dealing at arm's length.[189] Generally, the foreign business establishment exemption is applied to establish whether a fixed place of business exists, however specific exemptions also exist for instances where there is not necessarily a fixed place of business, such as a place of offshore mining.[190] The definition of fixed place of business sets out further requirements which must be considered to

[182] Section 9D(9A)(a)(i) of the Income Tax Act.
[183] Section 9D(9A)(a)(ii) of the Income Tax Act.
[184] Section 9D(9A)(a)(ii) of the Income Tax Act.
[185] Stiglingh M, Koekemoer A, van Heerden L, Wilcocks J, van der Zwan P *Silke: South African Income Tax* (2022) 883.
[186] Clegg D & Stretch R *Income Tax in South Africa* (2022) 268.
[187] Definition of 'foreign business establishment' in section 9D(1) of the Income Tax Act.
[188] Clegg D & Stretch R *Income Tax in South Africa* (2022) 268.
[189] Section 9D(9)(b)(ii) of the Income Tax Act.
[190] Definition of 'foreign business establishment' in section 9D(1) of the Income Tax Act.

determine whether there is a fixed place of business, where such activities are being conducted from a fixed place of business and those activities have already been in use or will be in use for a period of at least a year. In addition to a fixed place of business, there needs to be on site managerial and operational employees and those employees must conduct the primary operations of the business, the fixed place of business must be suitably equipped to perform the primary operations of that business of the controlled foreign company, the fixed place of business must have suitable facilities for conducting the primary operations of that business, and that fixed place of business cannot be located outside of South Africa solely or for the main purpose of postponing or reducing its South African tax burden.[191]

The controlled foreign company rules would not apply to income of the controlled foreign company where that income is attributable to the foreign business establishment exemption. The income of the controlled foreign company would not, save for where section 9D(9A) of the Income Tax Act applies, be required to be included in the income of the South African resident.

Notwithstanding that there is a foreign business establishment exemption, there are specific exclusions from the foreign business establishment exemption where a controlled foreign company is still required to impute income.[192] These relate to income derived from transactions between controlled foreign companies and connected persons who are South Africa tax residents which relate to the supply of goods or services, the income derived from the controlled foreign company falls within scope of the anti-diversionary transaction rules contained in section 9D(9A) of the Income Tax Act, or the income derived by the controlled foreign company is characterised as passive income, such as royalty payments or certain income derived from financial instruments.[193]

4.5 **Net income and exemptions**

Once it is determined that a foreign company falls within the definition of a controlled foreign company and none of the exclusions from imputation exists, it must then be determined which income must be imputed in that South African tax resident's income and further, which income is exempt from imputation.

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[191] Definition of 'foreign business establishment' in section 9D(1) of the Income Tax Act.
[192] Section 9D(9A)(a) of the Income Tax Act.
[193] Section 9D(9A)(a) of the Income Tax Act. See discussion at paragraph 4.5 of Chapter 4 below.

Where any resident holds any participation rights in a controlled foreign company, subject to the *de minimis* rules contained in the definition of controlled foreign company,[194] the resident will be required to include in its income an amount proportional to its interest in such controlled foreign company, for the relevant year of assessment. However, there is a further proviso to this. The net income of the controlled foreign company will be deemed to be nil where:

- the aggregate amount of taxes on income payable by that controlled foreign company in any country other than South Africa is at least 67,5% of the normal tax that the controlled foreign company would pay in South Africa in the relevant year of assessment (commonly known as the 'high tax' exemption); or

- where all the income and receipts of that controlled foreign company are attributable to the foreign business establishment of that controlled foreign company and those amounts are not required to be taken into account for purposes of section 9D(9A) of the Income Tax Act.

Given South Africa has a high corporate tax rate,[195] any controlled foreign companies in a jurisdiction which has more favourable corporate tax rates would not reach the 67,5% threshold i.e., a minimum corporate tax rate of 18,9% (28% x 67,5%), to deem the net income to be *nil*. In such an instance, a taxpayer would need to look to the foreign business establishment exemption to deem the net income to be *nil*.

Any income which is subject to interest withholding tax is excluded from the computation when calculating the net income of a CFC.[196]

Section 9D(9A) of the Income Tax Act contains the anti-diversionary income rules and the passive income rules. In terms of section 9D(9A), income is required to be taken into account for purposes of determining the net income of a controlled foreign company, notwithstanding the fact that that controlled foreign company has a foreign business establishment.[197] The effect of this section is that income would need to be included in the net income of the controlled foreign company, and that the net income cannot be deemed to be *nil*.

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[194] See discussion at paragraph 4.2 of Chapter 4 above.
[195] National Treasury *Budget Review* (2021) 45. Available URL: http://www.treasury.gov.za/documents/national%20budget/2021/review/FullBR.pdf, accessed 6 June 2022.
[196] Section 9D(9)(d) of the Income Tax Act.
[197] De Koker A & Williams R *Silke on South African Income Tax* (2022) 5.44.

Section 9D(9A)(a)(iii) of the Income Tax Act contains passive income rules related to financial instruments. Section 1 of the Income Tax Act provides that a *'financial instrument'* includes:

> '*(a)* *a loan, advance, debt, bond, debenture, bill, share, promissory note, banker's acceptance, negotiable certificate of deposit, deposit with a financial institution, a participatory interest in a portfolio of a collective investment scheme, or a similar instrument;'*

The definition of financial instrument is very broad and applies to various instruments that are created, traded, modified, or settled. The instruments include cash instruments, derivative instruments, as well as debt-based financial instruments.

In terms of Section 9D(9A)(a)(iii) of the Income Tax Act, where a controlled foreign company derives income from a financial instrument, the resident is required to include a proportionate share of the income of the controlled foreign company in its own income, unless:

- that financial instrument is attributable to principal trading activities of that foreign business establishment and those principal activities constitute the activities of a bank, financial services provider, or insurer and do not constitute the activities of a treasury function or captive insurer;[198]

- that amount is attributable to exchange differences in respect of that financial instrument, the exchange differences arise in the ordinary course of business of that foreign business establishment, and the principal trading activities of that foreign business establishment do not constitute the activities of a treasury function or captive insure;[199] or

- those amounts arising in respect of financial instruments is attributable to the foreign business establishment and amounts arising from exchange gains exceed 5% of the total amount received by or accrued to that foreign business establishment (commonly known as the working capital exemption). This is further qualified in that certain amounts taken into account under section 9D(9) of the Income Tax Act as well as income from a treasury operation or captive insurer should not be considered when making this determination.[200]

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[198] Section 9D(9A)(a)(iii)(aa) of the Income Tax Act.
[199] Section 9D(9A)(a)(iii)(bb) of the Income Tax Act.
[200] Section 9D(9A)(a)(iii)(cc) of the Income Tax Act.

The author of this research report submits that immediately what becomes clear is that income derived from financial instruments by a controlled foreign company would be required to be imputed where that controlled foreign company conducts a treasury operation but may escape such imputation if the 5% working capital exemption applies in certain instances. The working capital exemption is a form of relief provided under the controlled foreign company rules for tainted income which relates to income of an active operating business.[201]

The Income Tax Act does not define what a treasury function is, however, the controlled foreign company rules do provide guidance on when a treasury function will be deemed to be a treasury function.[202] Where the principal trading activities of the foreign business establishment do not constitute the activities of a treasury operation, section 9D(9A)(b)(iii) of the Income Tax Act contains a provision deeming certain income to still be income of a treasury operation. These are where:

- less principal trading activities are conducted in the country where the foreign business establishment is located, than in another country;[203]

- the principal trading activities do not involve the regular and continuous acceptance of deposits from or provision of credit to clients who are not connected persons in relation to that controlled foreign company;[204] or

- less than 50% of the amounts attributable to the activities of the foreign business establishment are derived from clients who are not connected persons in relation to that controlled foreign company.[205]

Therefore, income attributable to principal trading activities of a foreign business establishment where those principal activities constitute the activities of a bank, financial services provider, or insurer,[206] and instances where the amount, in respect of an exchange difference, arises in the ordinary course of business of the principal trading activities of that foreign business establishment would not be taxable under the controlled foreign company rules.[207] It must be determined whether in these instances, the activities undertaken are

[201] Roeleveld J & Johnson T 'Chapter 34: Controlled Foreign Company Legislation in South Africa' in Kofler G, Krever R, Lang M, Owens J, Pistone P, Rust A, Schuch J, Spies K & Staringer C (eds) *Controlled Foreign Company Legislation* (2020) 667.
[202] Section 9D(9A)(b)(iii) of the Income Tax Act.
[203] Section 9D(9A)(b)(iii)(aa) of the Income Tax Act.
[204] Section 9D(9A)(b)(iii)(bb) of the Income Tax Act.
[205] Section 9D(9A)(b)(iii)(cc) of the Income Tax Act.
[206] Section 9D(9A)(a)(iii)(aa) of the Income Tax Act.
[207] Section 9D(9A)(a)(iii)(bb) of the Income Tax Act.

deemed to be of a treasury function. The provisions in section 9D(9A)(b)(iii) of the Income Tax Act requires that the principal trading activities of a foreign business establishment needs to relate to activities primarily with unconnected persons that do not involve the regular and continuous acceptance of deposits or provision of credit from connected persons, and the activity must primarily arise in the country in which that foreign business is located.

4.6 **Conclusion**

Chapter four examined the controlled foreign company rules which is an anti-avoidance provision used to impute income into the South African tax base. Save for the exemptions from imputation, the controlled foreign company rules require that a resident impute in its own income the income of a controlled foreign company in relation to that resident where one or more residents hold, in aggregate, more than 50% of the total ‘participation rights’ in the controlled foreign company or if the financial results of that controlled foreign company are reflected in the consolidated financial statements of that resident.

Chapter four further examined the foreign business establishment exemption and the ‘high tax‘ exemption which exempt income from imputation. Furthermore, this chapter examined the passive income rules which could apply to intra-group loans where a South African resident would be required to impute in its income, in its proportionate share, the income from a controlled foreign company, notwithstanding that the controlled foreign company may have a foreign business establishment.

The concepts in this chapter are used to discuss the interaction between the transfer pricing provisions and the controlled foreign company provisions in chapter 5.

5 CHAPTER 5: THE INTERACTION BETWEEN THE TRANSFER PRICING PROVISIONS AND CONTROLLED FOREIGN COMPANY PROVISIONS: INBOUND AND OUTBOUND LOAN TRANSACTIONS

5.1 Overview

Both the transfer pricing rules, and the controlled foreign company rules target income from related party transactions, however how this is achieved, differs.[208] The controlled foreign company rules do not require that shareholders of a foreign company are connected persons to that foreign company for that foreign company to qualify as a controlled foreign company and the rules of section 9D of the Income Tax Act to apply. All that is required is that the resident shareholder alone, or together with other residents, hold participation rights which in aggregate, exceed 50% of the participation rights in that controlled foreign company.

The controlled foreign company rules, particularly through section 9D(9A), target:

- passive income, such as interest, royalties, dividends, rentals, annuities, exchange differences, insurance premiums or similar income and associated capital gains;[209] and

- diversionary income from a South African tax resident to a controlled foreign company in relation to it and requires imputation of that income in the South African tax resident's income. As previously mentioned,[210] diversionary income is income derived from suspect transactions between a controlled foreign company and a resident that may likely lead to transfer pricing transgressions. [211]

Tainted (passive or diversionary) income is fully taxable in South Africa because controlled foreign company ownership of this income poses a high risk to the South African tax base.[212]

The transfer pricing rules target connected party transactions, however there is further scope for their application as they apply to affected transactions which could apply to connected persons which are not controlled foreign companies.[213]

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[208] Holliday T *Assessment of the Purpose of South Africa's Controlled Foreign Company Rules* (2020) 44.
[209] De Koker A & Williams R Silke on South African Income Tax (2022) 5.43.
[210] See discussion at paragraph 1.2 of chapter 1 above.
[211] National Treasury *Explanatory Memorandum on the Taxation Laws Amendment Bill* (2011) para 4.5.
[212] National Treasury *Explanatory Memorandum on the Taxation Laws Amendment Bill* (2011) para 4.5.
[213] Mohokare T 'South Africa' in Bakker, A & Kale, S (eds) *Transfer Pricing and Intra-Group Financing* (2021) 755.

Furthermore, the transfer pricing provisions may apply to both inbound and outbound transactions,[214] whereas the controlled foreign company rules apply in situations where the controlled foreign company earns income which its resident shareholder/s are required to include, in its proportionate share, in its own income. The controlled foreign company rules attempt to not capture transactions which are transactions which are conducted through a foreign business establishment, and where that income is taxed at the minimum threshold of 18,9% (18.225% for years of assessment commencing 1 April 2022),[215] in that foreign company.[216] This is however qualified where certain forms of passive income and diversionary income is required to be imputed in the net income of the controlled foreign company, notwithstanding that it conducts its operations through a foreign business establishment.[217] The transfer pricing provisions are not limited in their application by a foreign business establishment exemption, high-tax exemption and certain passive income constraints (i.e. qualification for when passive income may be imputed under the controlled foreign company provisions). The transfer pricing provisions contain certain exemptions from its application to certain outbound financial transactions and intellectual property transactions, as well as transactions with headquarter companies.[218] However, that being said, the transfer pricing provisions enjoy greater application than that of the controlled foreign company rules as the transfer pricing provisions applies to all categories of connected person income, the rate at which that income is taxed and the source of the entity's income.[219]

A necessary antecedent for the two sets of rules to be triggered is that none of the exemptions from the application of the controlled foreign companies and transfer pricing rules must exist. Each set of rules may be applicable to a transaction, dependent on the factual matrix. Therefore, both sets of rules would need to be considered to determine the possible application thereof.

It is important to differentiate between outbound and inbound loans, as each may attract different tax consequences in relation to the transfer pricing rules and the controlled foreign company rules. Where a South African resident advances a loan to a controlled foreign company in relation to it, i.e., outbound loan, the controlled foreign company rules will generally not be triggered, as the controlled foreign company would not earn income from the advancement of the loan. As previously stated, section 31(6) of the Income Tax Act provides

[214] Holliday T *Assessment of the Purpose of South Africa's Controlled Foreign Company Rules* (2020) 36.
[215] The corporate tax rate will be lowered from 28% to 27% per National Treasury *Budget Speech* (2021) 9.
[216] Holliday T *Assessment of the Purpose of South Africa's Controlled Foreign Company Rules* (2020) 45.
[217] See section 9D(9A) of the Income Tax Act.
[218] See Sections 31(4), (5) and (6) of the Income Tax Act.
[219] Holliday T *Assessment of the Purpose of South Africa's Controlled Foreign Company Rules* (2020) 45.

for the relaxation of the transfer pricing rules where a South African tax resident provides financial assistance to a controlled foreign company, provided certain requirements are met, for example, where that controlled foreign company has a foreign business establishment'. Therefore, the definition of foreign business establishment contemplated in section 9D of the Income Tax Act must be consulted to determine whether the available exemption from the transfer pricing provisions is applicable.[220]

The controlled foreign company rules contained in section 9D of the Income Tax Act target passive income, such as interest income. Therefore, the controlled foreign company rules will apply to interest income arising from inbound loans advanced from that controlled foreign company to a South African resident shareholder.[221] The transfer pricing provisions contained in section 31 of the Income Tax Act may apply where there is an advancement of an outbound loan by the South African resident shareholder to a controlled foreign company in relation to it, or receipt of an inbound loan from a controlled foreign company in relation to it, provided that in both instances, the resident and the controlled foreign person are 'connected persons' in relation to each other. The transfer pricing provisions may apply to both the capital sum and the interest portion of an inbound loan[222] and an outbound loan,[223] provided that a transaction results in, or will result in, a tax benefit being obtained.[224]

Lastly, where a controlled foreign company in relation to a resident enters into a connected-party transaction with another non-resident related party, the transfer pricing rules may still be triggered for the South African taxpayer.[225]

5.2 Co-existence of the controlled foreign company provisions and the transfer pricing provisions

The controlled foreign company rules are specific anti-abuse rules in the Income Tax Act. Where these rules are applicable, they must be applied.[226] The transfer pricing provisions are

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220 For a discussion on section 31(6) of the Income Tax Act, please see discussion at paragraph 5.2 of chapter 5 below. Furthermore, for a discussion on 'foreign business establishment', please see discussion at paragraph 4.4 of chapter4 below.

221 See section 9D(9A)(a)(iii) of the Income Tax Act.

222 See section 31(4), read with section 31(2) of the Income Tax Act.

223 See sections 31(6) and 31(7) of the Income Tax Act. Where the exemptions in these sections do not apply, the transfer pricing provisions would need to be applied.

224 The transaction must constitute an 'affected transaction' and that affected transaction must result in a tax benefit being derived by a party to that transaction. For a discussion of affected transactions, see paragraph 3.2 of chapter 3 above.

225 Paragraph (a)(iv) of the definition of 'affected transaction' in section 31(1) of the Income Tax Act.

226 Roeleveld J & Johnson T 'Chapter 34: Controlled Foreign Company Legislation in South Africa' in *Controlled Foreign Company Legislation* (2020) 672.

similarly specific anti-abuse rules in the Income Tax Act. The transfer pricing rules apply to 'affected transactions' which are not limited to transactions between a controlled foreign company and its shareholders, provided that the parties to the transaction are connected persons.[227] Furthermore, the transfer pricing rules apply to all categories of connected person income.[228]

Conversely, the controlled foreign company rules focus on the relationship between a controlled foreign company and its shareholders, and taxes certain income which is earned in the hands of the controlled foreign company.[229] For the controlled foreign company rules to apply, more than 50% of the participation rights must be held (in aggregate) by residents in that controlled foreign company.[230] This is not the case for the transfer pricing rules. For the transfer pricing rules to apply, a connected person relationship must exist and a party to the transaction must obtain a tax benefit. A company may be connected to another company if at least 20% of the equity shares or voting rights in the company are held by that other company and no holder of shares holds the majority of the voting rights in that company.[231] This may result in the foreign company's financial results not being reflected in the resident's consolidated financial statements in terms of IFRS 10, as the resident may not exercise 'control', as contemplated in IFRS 10.

The author of this research report submits that, whilst a resident need not be a 'connected person' to a controlled foreign company for the controlled foreign company rules to apply, that resident shareholder would still need to hold, alone or together with other residents, more than 50% of the 'participation rights' in that foreign company for that foreign company to qualify as a controlled foreign company, or the foreign company's financial results must be reflected in the resident's consolidated financial statements in terms of IFRS 10. Therefore, the threshold for the controlled foreign company rules to apply is more difficult to meet as a greater shareholding or share of voting rights would be required.

The transfer pricing rules can be applied simultaneously with the controlled foreign company rules.[232]The reason why transfer pricing legislation and controlled foreign company rules do not eliminate the need for each other include:

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[227] Holliday T *Assessment of the Purpose of South Africa's Controlled Foreign Company Rules* (2020) 44.
[228] Holliday T *Assessment of the Purpose of South Africa's Controlled Foreign Company Rules* (2020) 45.
[229] Holliday T *Assessment of the Purpose of South Africa's Controlled Foreign Company Rules* (2020) 44.
[230] See discussion on 'participation rights' at paragraph 4.3 of chapter 4 above.
[231] See paragraph (v) of the definition of 'connected person' in section 1 of the Income Tax Act.
[232] Roeleveld J & Johnson T 'Chapter 34: Controlled Foreign Company Legislation in South Africa' in *Controlled Foreign Company Legislation* (2020) 672. Furthermore, see discussion in chapter 5.

- South Africa's controlled foreign company rules focus on certain transactions for which attribution is required. Controlled foreign company rules have either a full inclusion system or a partial inclusion system.[233] In a partial inclusion system such as South Africa's, not all income would be capable of being captured from transfer pricing manipulation under the controlled foreign company rules.[234]

- controlled foreign company legislation restores the taxing right to a parent company's jurisdiction only, therefore the controlled foreign company rules would not be able to restore the taxing right to all countries involved in foreign-to-foreign base erosion.[235]

- A MNE group which has a profitable subsidiary in one jurisdiction and a loss-making subsidiary in another jurisdiction may be incentivised to transfer profits to the loss-making subsidiary in order to achieve a tax efficient outcome.[236] The transfer of profits with the intention of making use of losses may only have the effect of deferring tax on income, however multinational enterprises may be incentivised to defer tax on income in elaborate structures to obtain an advantage,[237] which may include a tax benefit. Controlled foreign company legislation would not be able to deter a multinational enterprise from mispricing a controlled transaction.[238] In such an instance, only the transfer pricing rules would be capable of capturing such transactions.[239]

- Some countries allow taxpayers to cross-credit taxes on foreign-sourced income.[240] The incentive to benefit from foreign credits may incentivise multinational enterprises to transfer profits.[241]

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233 Burkadze E 'Interaction of transfer pricing rules and CFC provisions' *International Transfer Pricing Journal* Vol 23 (2016) 374.

234 See Burkadze E 'Interaction of transfer pricing rules and CFC provisions' *International Transfer Pricing Journal* Vol 23 (2016) 374.

235 Burkadze E 'Interaction of transfer pricing rules and CFC provisions' *International Transfer Pricing Journal* Vol 23 (2016) 375. See discussion on the inclusion in the transfer pricing provisions at paragraph 5.6 of transactions between a controlled foreign company and another foreign person.

236 Burkadze E 'Interaction of transfer pricing rules and CFC provisions' *International Transfer Pricing Journal* Vol 23 (2016) 375.

237 Burkadze E 'Interaction of transfer pricing rules and CFC provisions' *International Transfer Pricing Journal* Vol 23 (2016) 375.

238 Burkadze E 'Interaction of transfer pricing rules and CFC provisions' *International Transfer Pricing Journal* Vol 23 (2016) 375.

239 Burkadze E 'Interaction of transfer pricing rules and CFC provisions' *International Transfer Pricing Journal* Vol 23 (2016) 375.

240 Burkadze E 'Interaction of transfer pricing rules and CFC provisions' *International Transfer Pricing Journal* Vol 23 (2016) 374.

241 Burkadze E 'Interaction of transfer pricing rules and CFC provisions' *International Transfer Pricing Journal* Vol 23 (2016) 375.

- controlled foreign company legislation focuses on a parent-subsidiary relationship.[242] It does not focus on sister company relationships.[243] Therefore, in such instance the transfer pricing provisions are better equipped to combat base erosion.[244]

The two sets of rules do not always apply to the same income. Given that there are instances where the controlled foreign company legislation would not apply, the controlled foreign company provisions cannot be said to be a backstop to transfer pricing rules in all transactions.[245] Both sets of rules aid in combating base erosion.

5.3 Outbound loans from a South African tax resident to a controlled foreign company in relation to it

An outbound loan is a loan in terms of which a South African resident advances funds cross border to a foreign person. For the purposes of this discussion, the foreign person contemplated is assumed to be a controlled foreign company. The following illustration illustrates that interest may be payable by the controlled foreign company to the South African resident, however it should be noted that the loan need not attract interest. The terms of the loan would be dependent on the transaction contemplated.

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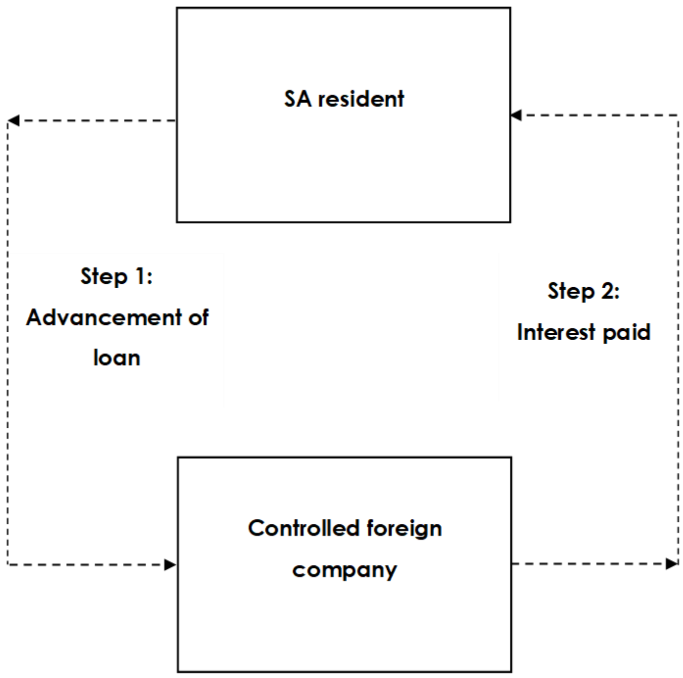
[242] Burkadze E 'Interaction of transfer pricing rules and CFC provisions' *International Transfer Pricing Journal* Vol 23 (2016) 374.
[243] Burkadze E 'Interaction of transfer pricing rules and CFC provisions' *International Transfer Pricing Journal* Vol 23 (2016) 374.
[244] Burkadze E 'Interaction of transfer pricing rules and CFC provisions' *International Transfer Pricing Journal* Vol 23 (2016) 374.
[245] See discussion at paragraph 5.6 of chapter 5 below.

The flow of funds in an outbound loan is illustrated below:



Section 31(6) of the Income Tax Act provides that where a transaction is entered into between a controlled foreign company and a South African tax resident, and that transaction constitutes the granting of financial assistance by the South African tax resident to that controlled foreign company, section 31 of the Income Tax Act must not be taken into account when calculating the taxable income of the South African tax resident, provided certain requirements are met. For the transfer pricing rules not to apply to the South Africa tax resident, the controlled foreign company must have a foreign business establishment and the aggregate amount of tax payable to the government of any country other than South Africa by that controlled foreign company in respect of any foreign tax year during which that transaction exists is at least 67.5% of the amount of normal tax that would have been payable if that controlled foreign company was a resident.[246] Stated differently, the foreign tax payable by the controlled foreign company in that foreign country would need to be a minimum of 18,9% of normal tax payable in South Africa, being 67.5% of South Africa's corporate tax rate of 28%, for that foreign tax year. It is proposed that the corporate tax rate be changed to 27% with effect from 1 April 2022, therefore the minimum normal tax for tax years after 1 April 2022 would be 18,225% (27% x 67,5%). To determine the amount of tax payable by that controlled foreign company, the controlled foreign company must take into account any applicable double

[246] For a detailed discussion on the foreign business establishment exemption, see discussion at paragraph 4.4 in chapter 4.

taxation agreement and credit, rebate, or other right to the recovery of tax in any other country than South Africa and must disregard any loss outside of that foreign year of assessment and any loss from a company which is not that controlled company.[247]

Where the provisions of section 31(6) of the Income Tax are not met, provided that the exemption provided in section 31(7) of the Income Tax Act to equity loans also does not apply,[248] the transfer pricing provisions are applicable as a tax benefit may arise which would require the South African tax resident to make an adjustment to its taxable income to reflect an arm's length price for the outbound loan. This may require an adjustment be made to both the capital portion and interest portion of the loan.

5.4 Outbound equity loans

Section 31(7) of the Income Tax Act provides relief from the South African transfer pricing rules to certain equity loans, provided certain requirements are met. An equity loan is a loan that has strong characteristics of equity.[249] In terms of section 31(7), any transaction entered into between a South African company that is resident (or any company that forms part of the same group of companies as that resident company) and a foreign company in which:

- the South African tax resident company (or any company that forms part of the same group of companies as that resident company) directly or indirectly holds at least 10% of the equity shares and voting rights of that foreign company, and that transaction constitutes the granting of financial assistance in the form of a debt owed by the foreign company to the resident company (or any company forming part of the same group of companies as that resident);

- that foreign company is not obliged to redeem that debt in full within 30 years from the date of incurrence of the debt;

- the redemption of the debt in full by the foreign company is conditional upon the market value of the assets of such foreign company not being less than the market value of the liabilities of that foreign company; and

[247] Section 31(6) of the Income Tax Act.
[248] See paragraph 5.4 of chapter 5 for a discussion of section 31(7) of the Income Tax Act.
[249] Werksmans *2013/2014 Draft Tax Amendments – international highlights* (2013). Available URL: https://www.werksmans.com/wp-content/uploads/2013/09/314057-WERKSMANS-Tax-legal-brief.pdf, accessed 5 June 2022.

- no interest accrued in respect of that debt in that year of assessment,

then the transfer pricing rules contained in section 31 of the Income Tax Act will not apply to such debt. Notably from the requirements of this section, a South African company need not hold its interest in a controlled foreign company for this section to apply, however the provisions of this section may still apply to a debt owed by a controlled foreign company.

The purpose behind this exemption is contained in the Explanatory Memorandum on the Taxation Laws Amendment Bill,[250] which provides that the purpose for extending the relief to outbound loans is that South African companies often enter into cross border transactions where they make loan advancements to companies uncontrolled by that South African shareholder and therefore without the relief, the South African shareholder would be left in a compromised tax position.[251] For example, the Explanatory Memorandum on the Taxation Laws Amendment Bill states that often the South African shareholder is part of a joint venture arrangement, whereby a consortium of multinational shareholders are capitalising a foreign company with loans with quasi-equity features.[252] Without relief, potential transfer pricing concerns leave the South African shareholder in a compromised tax position vis-à-vis that shareholder's multinational counterparts.[253] The application of the exemption provided in section 31(7) of the Income Tax Act came up in South Africa's first transfer pricing case of *Crookes Brothers Limited v Commissioner for SARS*.[254] In this case, the taxpayer, Crookes Brothers, advanced shareholder loans to its 99% owned Mozambican subsidiary. The terms of the loan agreements were identical to each other, and therefore the salient terms of the loans were as follows:

- the Mozambican company would not be obliged to redeem the debt within 30 years;

- any repayment or redemption of the loan amount in full by the Mozambican company shall only take place where the market value of the assets of the Mozambican company are not less than the market value of its liabilities, at the date of payment or redemption; and

- no interest would be payable on the debt.[255]

[250] National Treasury *Explanatory Memorandum on the Taxation Laws Amendment Bill*, 2013.
[251] National Treasury *Explanatory Memorandum on the Taxation Laws Amendment Bill* (2013) para 5.8.
[252] National Treasury *Explanatory Memorandum on the Taxation Laws Amendment Bill* (2013) para 5.8.
[253] National Treasury *Explanatory Memorandum on the Taxation Laws Amendment Bill* (2013) para 5.8.
[254] [2018] ZAGPHC 311.
[255] *Crookes Brothers* para 4.

Furthermore, the loan agreement contained a clause which allowed for the early termination of the agreement, in the event of an application being made to place the Mozambican company in liquidation, the Mozambican company going bankrupt, business rescue or any similar proceedings, or judgement having been taken against the Mozambican company and the judgement remained unsatisfied for a period of 14 days.[256] In such an event, the loan amount would become immediately due and payable. Further to this, Crookes Brothers and the Mozambican company entered into a subordination agreement, in terms of which the loans owing to Crookes Brothers were subordinated in favour of claims of creditors of the Mozambican company, so as to enable the claims of the creditors to be preferred over the claim of Crookes Brothers. The subordination agreement further contained a provision which subordinated the Crookes Brothers shareholder loan claims for so long as the market value of the Mozambican company's liabilities exceeded the market value of the assets, and that Crookes Brothers shall not be entitled to demand or sue for or accept repayment of the whole or part of the shareholder loans owing to them for so long as the value of the Mozambican company's liabilities, fairly valued, exceeded the value of its assets.[257]

Louw J concluded that section 31(7) of the Income Tax Act requires that the nature of the transaction be considered and not necessarily the prevailing facts.[258] Louw J agreed with SARS' view that the agreement provided for the existence of an eventuality which may result in the debt being redeemed prior to the expiry of the loan term and accordingly did not meet the requirements of sections 31(7)(b) of the Income Tax Act.[259]

Accordingly, the author of this research report submits that a South African company may be exempt from the application of the transfer pricing rules under section 31 of the Income Tax Act where that South African company advances a non-interest bearing loan to an offshore company in which it holds at least 10% of the equity shares or voting rights, provided that foreign company is not obliged to redeem the debt in full within 30 years of its incurrence and the foreign company may not redeem the debt unless the market value of its assets are not less than the market value of its liabilities.

Furthermore, the author of this research report submits, in accordance with current legislative interpretation of section 31(7) of the Income Tax Act, that a condition which deems a loan advanced by a South African company to a foreign company immediately due and payable in an event of default (bankruptcy, business rescue or any similar proceedings, or judgement

[256] *Crookes Brothers* para 4.
[257] *Crookes Brothers* para 5.
[258] *Crookes Brothers* para 16.
[259] *Crookes Brothers* para 17.

having been taken against the controlled foreign company and the judgement remained unsatisfied for a period stipulated in the loan agreement), prior to the redemption date of the loan of 30 years of such agreement would trigger the transfer pricing rules. In such an instance, an arms' length price adjustment in terms of the transfer pricing rules for the capital portion of the loan and interest portion would need to be made.

This case illustrates the need for guidance from SARS relating to outbound financial assistance, or an amendment to section 31(7) of the Income Tax Act. Louw J took a narrow interpretation of section 31(7) of the Income Tax Act.[260] A redemption clause relating to uncertain events occurring, such as liquidation of the borrower, is a common clause in shareholder loan agreements.[261] Nonetheless, Louw J took the view that such a clause constitutes an obligation to redeem, resulting in the exemption not applying.[262] It is unclear what would constitute an obligation to redeem a debt within 30 years, as Louw J in this instance, seemingly includes uncertain events which may result in the loan being redeemed before the prescription of the 30 year period. Such an uncertain event may never occur during the duration of the 30-year period, however applying the decision of *Crookes Brothers*,[263] taxpayers would still be disqualified from using the relief provided under section 31(7) of the Income Tax Act even under such circumstances. Therefore, the lack of guidance in relation to this section inhibits taxpayers from ensuring they remain compliant with the provisions of section 31(7) of the Income Tax Act.

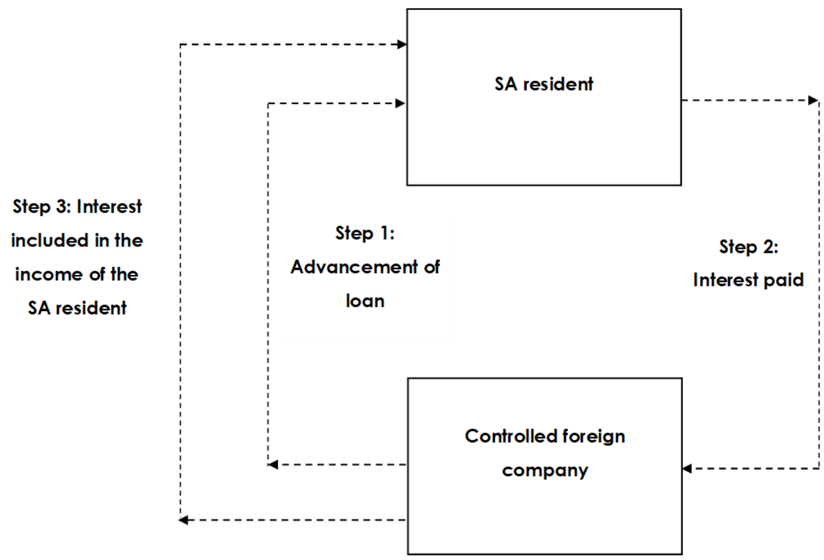
Where the provisions of section 31(7) of the Income Tax are not met, provided that the exemption provided in section 31(6) of the Income Tax Act to financial transactions with controlled foreign companies also does not apply, the transfer pricing rules are applicable, and the South African tax resident would be required to make an adjustment to its taxable income to reflect an arm's length price for the outbound loan. This may require an adjustment to both the capital sum of the loan as well as the interest rate applied.

[260] See *Crookes Brothers* para 17.
[261] Brink J *South Africa's first transfer pricing case?* (2018). Available URL: https://www.cliffedekkerhofmeyr.com/export/sites/cdh/en/news/publications/2018/Tax/Downloads/Tax-Exchange-Control-Alert-13-July-2018.pdf, accessed 21 March 2022.
[262] Crookes Brothers para 17.
[263] See *Crookes Brothers* para 17.

5.5 Inbound loans from a controlled foreign company to a South African tax resident in relation to it

An inbound loan is a loan in terms of which a foreign person advances funds cross border to a South African resident. For the purposes of this discussion, the foreign person contemplated is assumed to be a controlled foreign company.

The flow of funds in an inbound loan is illustrated below:



The passive income rules contained in section 9D(9A) of the Income Tax Act are of importance. As stated at paragraph 1.2 above, in terms of these rules, certain transactions, whether pitched at arm's length, or not, are required to be imputed in the controlled foreign company's net income regardless of whether that controlled foreign company has a foreign business establishment.[264] The passive income rules extend to interest income earned by a controlled foreign company.[265] The passive income rules are used to prevent residents from abusing the foreign business establishment exemption rule.

Where the controlled foreign company advances an inbound loan to a South African resident, the controlled foreign company rules would need to be considered, given the application of the passive income rules which relates to financial instruments. In such instance, in terms of Section 9D(9A)(a)(iii) of the Income Tax Act, certain income is exempt from imputation for banks, financial service providers, and insurers, provided the requirements for exemption are

[264] Benetello M 'Chapter 10 – Transfer Pricing and Thin Capitalisation' in *Silke on International Tax* (2009) 10.8.
[265] Section 9D(9A)(a)(iii) of the Income Tax Act.

met.[266] The exemptions from imputation must also be considered to determine whether there is an available exemption from imputation of this income in the net income of the controlled foreign company.

The author of this research report submits that where a controlled foreign company derives income from a financial instrument, provided that none of the exemptions from imputation are available to the controlled foreign companies, the resident is required to include a proportionate share of the income of the controlled foreign company in its own income.

Furthermore, the transfer pricing and thin capitalisation rules may still need to be considered to the extent that the resident and the controlled foreign company are 'connected persons'. The resident will need to ensure that the capital portion and the interest rate is at arm's length. The thin capitalisation provisions in section 31(4) of the Income Tax Act requires that the debt capacity of the borrower is at a level that an independent third party would have considered appropriate to extend a loan in comparable circumstances, and at the same cost.[267] To the extent that the interest rate is too high, the excess interest will be disallowed as a deduction and deemed to be a dividend *in specie* (in the case of the resident being a company) subject to dividends tax at 20% (in any other case).[268] Similarly, where it is determined that the resident is thinly capitalised, the interest attributable to the excess portion of the debt would similarly be disallowed as a deduction and deemed to be a dividend *in specie* subject to dividends tax at 20% (in the case of the resident being a company) or a donation subject to donations tax at 20% (in any other case).[269]

5.6 Loans between a controlled foreign company and a foreign person

A loan between a controlled foreign company and a foreign person is a loan in terms of which a controlled foreign company advances funds cross border to another foreign person. Note that both parties are non-resident in South Africa.

The South African government identified transactions in which the transfer pricing rules were limited in their application.[270] The identified transactions were transactions concluded

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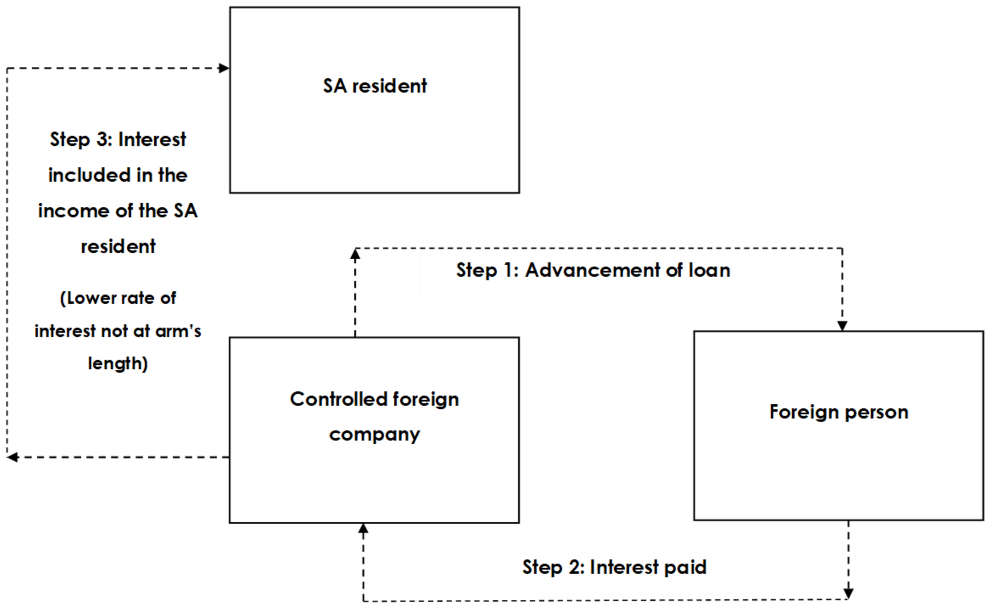
[266] For a detailed discussion on the when a controlled foreign company is required to impute income in relation to financial instruments, see discuss at paragraph 4.5 in chapter 4.
[267] Wiesener C & Gosai N 'Chapter 9 – Specific Transaction Types' in *Africa Transfer Pricing Practice Guide: A South African Perspective* (2021) 15.
[268] Geach W, Buba Z & Mollagee O *Taxation: A Transaction-Based Approach* 1st Ed (2021) 209.
[269] Geach W, Buba Z & Mollagee O *Taxation: A Transaction-Based Approach* 1st Ed (2021) 210.
[270] National Treasury *Draft Explanatory Memorandum on the Draft Taxation Laws Amendment Bill* (July 2020) 36.

between a controlled foreign company in relation to a resident and a non-resident connected person.[271] For the purposes of the identified transactions, it would be the controlled foreign company and the non-resident that would be connected persons. In these transactions, the controlled foreign company included a lower amount in its net income in accordance with section 9D of the Income Tax Act, which resulted in a tax benefit being derived by the resident and not the controlled foreign company or the non-resident.[272]

The flow of funds in the loan transactions identified by the South African government between a controlled foreign company and a foreign person, [273] is illustrated below:



In order to address this anomaly, the definition of affected transaction was amended to extend to transactions between a non-resident and a controlled foreign company in relation to a resident.[274] Section 31(2) of the Income Tax Act provides as follows:

[271] National Treasury *Draft Explanatory Memorandum on the Draft Taxation Laws Amendment Bill* (July 2020) 36.

[272] National Treasury *Draft Explanatory Memorandum on the Draft Taxation Laws Amendment Bill* (July 2020) 36.

[273] See National Treasury *Draft Explanatory Memorandum on the Draft Taxation Laws Amendment Bill* (July 2020) 36.

[274] National Treasury *Draft Explanatory Memorandum on the Draft Taxation Laws Amendment Bill* (July 2020) 37.

(2) Where—

(a) any transaction, operation, scheme, agreement or understanding constitutes an affected transaction; and

(b) any term or condition of that transaction, operation, scheme, agreement or understanding—

(i) is a term or condition contemplated in paragraph (b) of the definition of "affected transaction"; and

(ii) results or will result in any tax benefit being derived by a person that is a party to that transaction, operation, scheme, agreement or understanding <u>*or by any resident in relation to a controlled foreign company*</u> [emphasis added] *contemplated in subparagraph (iv) of the definition of "affected transaction",*

the taxable income or tax payable by any person contemplated in paragraph (b) (ii) that derives a tax benefit contemplated in that paragraph must be calculated as if that transaction, operation, scheme, agreement or understanding had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm's length.'

Section 31(2) of the Income Tax Act was amended to include the words 'or by any resident in relation to a controlled foreign company'. The implication of this amendment is that for years of assessment commencing on or after 1 January 2021, where a resident derives a tax benefit under a transaction entered into between a controlled foreign company in relation to it, and a non-resident (albeit indirectly), the resident would be required to make a transfer pricing adjustment in accordance with section 31 of the Income Tax Act. Thus, both the controlled foreign company rules and the transfer pricing rules may enjoy application to these types of transaction.

This inclusion is rather onerous on South African taxpayers, as South African taxpayers are now required to assess the connected person transactions entered into between controlled foreign companies in relation to them and a non-resident connected person, to ensure that the amount of any interest income which that South African tax resident ought to have imputed in their income is in fact, an arm's length amount for South African tax purposes, alternatively that where such a transaction is entered into, that the South African taxpayer ensures that the transaction provides for an arm's length interest rate.

5.7 **Conclusion**

Chapter five examined the application of the transfer pricing rules and the controlled foreign company rules in relation to intra-group transactions between a resident and a controlled foreign company in relation to it. The chapter considers both outbound and inbound loan transactions.

This chapter demonstrates that there is an overlap between transfer pricing provisions and controlled foreign company rules. Both sets of rules seek to tax income which reduces South Africa's tax base through artificial price manipulation. This chapter sets the scene to introduce the topic in the next chapter.

The ways to manage transfer pricing risks and controlled foreign company risks are discussed in the next chapter, which includes a discussion of the reporting requirements for each.

6 CHAPTER 6: REDUCING TRANSFER PRICING RISKS AND CONTROLLED FOREIGN COMPANY RISKS

6.1 Overview

Given the possible application of both the transfer pricing provisions and the controlled foreign company rules to intra-group financial transactions, the onus falls on the taxpayer to adopt robust policies which mitigate the risks involved. From the analysis in chapter 5, it was established that the transfer pricing provisions and controlled foreign company provisions both target income from intra-group loans.[275] A taxpayer would need to be able to substantiate the arm's length nature of the amounts in its intra-group financial transactions for transfer pricing purposes, to the extent that the resident and controlled foreign company are 'connected persons'. Furthermore, a taxpayer would also need to be aware of the implications that section 9D(9A) of the Income Tax Act has on its intra-group financial transactions, which deals with tainted income (diversionary income and passive income) which would require that income from legitimate business income still be included in the net income of a controlled foreign company.

Key risks for a taxpayer would be the risks related to reporting from both a transfer pricing and controlled foreign company perspective, and risks related to accurately describing the financial transactions. As a measure to simplify the risks associated with transfer pricing and controlled foreign companies, a taxpayer would need to document these transactions to accurately reflect the arm's length nature thereof, as well as adhere to reporting requirements for both transfer pricing and for its controlled foreign company. A future measure which could mitigate the application of both sets of rules would be the introduction of an advance pricing agreement programme in South Africa. Compliance will assist taxpayers in defending their position to prevent penalties and interest which may be imposed for non-compliance.

Therefore, in this chapter, the various means of managing transfer pricing risks of a resident are considered. In this regard, the transfer pricing and controlled foreign company reporting requirements are discussed, as well as the transfer pricing guidance provided by the OECD to define financial transactions. This discussion also includes a discussion on the use of an advance pricing agreement programme in South Africa.

[275] See discussions at paragraphs 5.5 and 5.6 of chapter 5 above.

6.2 **Reporting requirements**

Both the transfer pricing rules and controlled foreign company rules have reporting requirements. The transfer pricing provisions do not make reference to the documentary requirements, rather, the documentary requirements are contained in Government Gazette No. 40375, published under section 29 of the Tax Administration Act. Similarly, the controlled foreign company rules also do not make reference to the documentary requirements, rather the documentary requirements are contained in section 72A of the Income Tax Act.

The transfer pricing and controlled foreign company reporting requirements are discussed below,[276] whereafter the overlap of the reporting requirements are discussed.

6.2.1 Transfer pricing reporting requirements

In line with Article 13 of the OECD's BEPS recommendations to curb transfer pricing abuse, SARS published a notice under Government Gazette No. 40375 in terms of section 29 of the Tax Administration Act, which sets out the transfer pricing documentary retention requirements for taxpayers. The Government Gazette No. 40375 applies to years of assessment after 1 October 2016.

In terms of Government Gazette No. 40375, taxpayers with potentially affected transactions over R100 million with connected persons are required to keep transfer pricing documentation.[277] The transfer pricing documentation, in this instance, is the master file and the local file, but taxpayers would not be required to submit a Country-by-Country Report. The local file sets out the benchmarking analysis for the local entity part of the multinational enterprise group which includes the functional analysis, risks assumed, and assets used for benchmarked transactions, whereas the master file sets out a high-level overview of the multinational enterprise's global business, which includes its business activities, structure, and global transfer pricing policy. Government Gazette No. 40375 further provides that a taxpayer who meets the R100 million threshold is required to keep records for all potentially affected transactions that exceed R5 million.[278]

Government Gazette No. 40375 sets out the documentary requirements to be kept in respect of structure and operations.[279] The general documentary requirements for a transaction

[276] See paragraphs 6.2.1 and 6.2.2 of chapter 6 below.
[277] Section 2 of Government Gazette No. 40375.
[278] Section 4 of Government Gazette No. 40375.
[279] Section 3 of Government Gazette No. 40375.

include keeping adequate record of the nature and terms of the transaction, copies of any agreements, such as distribution agreements, royalty agreements, and/or funding agreements (and relevant transaction documents, such as minutes or resolutions authorising the transaction) relating to the potentially affected transaction, and exchange control applications and approvals.[280]

Additionally, Government Gazette No. 40375 also requires taxpayers to keep the following additional records where potentially affected transactions are a financial assistance transaction which exceed a term of 12 months:

- A description of the funding structures, including the dates of the transactions, a clear statement of the source of the funds, the repayment terms, the reason for obtaining the funds, and how the funds were used or are to be used.

- Copies of the financial statements and management account prepared most recently before the transaction in which financial assistance was provided as well as the financial statements and management accounts after the financial assistance has been granted.

- A group structure which sets out the relevant companies and any changes to the structure taking place during the period that the financial assistance transactions have taken place.[281]

Furthermore, SARS published guidance on country-by-country reporting for multinational enterprises which requires multinational enterprises with a consolidated group revenue of over R10 billion during the financial year immediately preceding the reporting financial year, to submit their Country-by-Country Reports to SARS.[282] In terms of Article 2 of the CBC reporting regulations published under the Tax Administration Act, multinational enterprises must file a Country-by-Country Report in South Africa where the multinational enterprise is resident for tax purposes in South Africa and one of the following conditions exists:

- the ultimate parent entity is not obligated to file a Country-by-Country Report in its own tax jurisdiction;

[280] Section 4 of Government Gazette No. 40375.
[281] Section 4(n) of Government Gazette No. 40375.
[282] Government Gazette No. 40516, published in terms of section 257 of the Tax Administration Act.

- South Africa does not have an international agreement in place with the jurisdiction of the ultimate parent entity for the exchange of Country-by-Country Reports of the multinational enterprise by the time filing of the Country-by-Country Report is required to be filed; or

- South Africa does have an international agreement in place with the ultimate parent entity for the exchange of Country-by-Country Reports of the multinational enterprise, but the jurisdiction of the ultimate parent company failed to automatically provide SARS with the Country-by-Country Reports, for reasons not provided for in the international agreement.

SARS has also amended the ITR 14, which is the corporate income tax return for companies registered with the Companies and Intellectual Property Commission, which further requires the taxpayer to provide additional information in relation to its transfer pricing activity. The further disclosure requires the taxpayer disclose, *inter alia*, the total number of jurisdictions where potentially affected transactions have been entered into, the top five jurisdictions of these transactions, and the transaction value per the top five countries. Notably the corporate tax return requires that each potentially affected transaction be categorised according to its activity, such as guarantee fees paid and/or interest paid, for example. In furtherance of assessing transfer pricing risk in relation to financial transactions, the corporate tax return also requires the disclosure of various financial assistance ratios relating to financial assistance transactions. Lastly, the corporate tax return sets out specific questions to obtain further information in relation to the transfer pricing activities of the taxpayer which includes transfer pricing documentation and disclosing whether transfer pricing adjustments occurred in the relevant year of assessment.

It is submitted that a failure to comply with the documentary requirements imposed under the Tax Administration Act may result in administrative penalties, a criminal offence and/or interest levied on any outstanding tax debts. Of notable importance to the retention of documents is the burden of proof contained in section 102 of the Tax Administration Act. In terms of section 102(1) of the Tax Administration Act, the burden of proof is on the taxpayer to effectively prove to SARS that the circumstances of a particular transaction are based on commercially realistic results, i.e., that transfer pricing abuse did not occur, whether intentionally or negligently. A failure to satisfy the burden of proof in section 102 of the Tax Administration Act may result in SARS making a primary adjustment to the transfer price.

Therefore, in order to prevent any administrative penalties,[283] a criminal offence[284] and/or interest levied on any outstanding tax debts being levied,[285] a taxpayer would need to prepare transfer pricing documentation for each year of assessment that it meets the reporting threshold. Furthermore, it is recommended that a taxpayer keep detailed records of all financial transactions to be able to satisfy the burden of proof that the transaction was conducted at arm's length.

6.2.2 Reporting requirements for a controlled foreign company

A resident is required to submit a return to the Commissioner where the resident either directly or indirectly, together with any connected person, holds at least 10% of the participation rights in a controlled foreign company.[286]

The Commissioner has prescribed form IT10B for this purpose. The IT10B is a separate schedule that SARS requires taxpayers to complete where the relevant company alone or together with any other connected person holds more than 10% of the participation rights in a controlled foreign company. The IT10B accompanies the corporate income tax return as supporting information.[287] The IT10B is used to assess whether any income should be taxed in the hands of a shareholder, i.e., imputed for controlled foreign company purposes and the South African resident taxed by virtue of the application of the controlled foreign company rules. It should however be noted that the computation will still need to be done even if income is not taxable in the hands of the South African shareholder.[288]

The schedule requires that certain details of the controlled foreign company be disclosed, such as the registered business address, the contact details, foreign tax number, place of effective management, country of incorporation, primary activities of the controlled foreign company, the number of employees, the income imputed (if applicable).[289] Furthermore, the schedule contains specific disclosures in relation to whether the controlled foreign company qualifies for the foreign business establishment exemption and whether the controlled foreign company is making use of the high tax exemption.[290] Lastly, the schedule requires that the controlled foreign company disclose any income required to be imputed under the tainted income

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[283] See chapter 15 of the Tax Administration Act.
[284] See chapter 17 of the Tax Administration Act.
[285] See chapter 15 of the Tax Administration Act.
[286] Section 72A of the Income Tax Act.
[287] De Jager A *Completing The Corporate Tax Return* (2019). Available URL: https://www.thesait.org.za/news/news.asp?id=469245, accessed 21 March 2022.
[288] Holliday T *Assessment of the Purpose of South Africa's Controlled Foreign Company Rules* (2020) 42.
[289] SARS IT10B form. Available URL: https://www.sars.gov.za/find-a-form/, accessed 20 June 2022.
[290] SARS IT10B form. Available URL: https://www.sars.gov.za/find-a-form/, accessed 20 June 2022.

(diversionary income and passive income) rules contained under section 9D(9A) of the Income Tax Act.[291]

Therefore, a taxpayer would need to prepare schedule IT10B for each year of assessment that it meets the reporting requirements. Failing to comply with the reporting requirement will result in:

- The proportional amount which must be included in that shareholders income will be determined with reference only to the receipts and accruals of that controlled foreign company; and

- The provisions of section 6*quat* of the Income Tax Act (i.e., rebate on foreign taxes) shall not apply in respect of any tax proved to be payable to any government other than South Africa with respect to the proportional amount of the net income of the controlled foreign company.[292]

6.2.3 Overlap between the transfer pricing and controlled foreign company disclosure requirements

There is an overlap in what information is disclosed for transfer pricing purposes, and what information is disclosed for a controlled foreign company. The master file, local file and Country-by-Country Report provide a high-level overview of the information generally disclosed in the IT10B as well as may provide insight into what ought to have been disclosed in the IT10B.

The disclosures in the master file of the business structure and financing activities within a group, provides further insight into whether a particular company within a multinational enterprise group is set up as a treasury operation and the nature of such treasury operation. If this treasury operation is a controlled foreign company in relation to a resident, this disclosure may indicate the applicability of the income imputation rules and the tainted income rules (diversionary income and passive income). Furthermore, the various disclosures relating to the group structure in the master file provide better insight into the supply chain and overall group structure.

The local file discloses related party financial transactions for transfer pricing purposes. The related party transactions disclosed in the local file may indicate whether income was imputed

[291] SARS IT10B form. Available URL: https://www.sars.gov.za/find-a-form/, accessed 20 June 2022.
[292] Section 72A(3) of the Income Tax Act .

or provide *prima facie* insight into whether income ought to have been imputed under section 9D(9A) of the Income Tax Act.

With the disclosure requirements required in the above-mentioned documents, this enables SARS to build a more complete tax profile of the taxpayer, providing SARS a more complete understanding of a taxpayer's cross-border transactions, which includes its financial transactions.[293] It therefore becomes prudent that taxpayers pay careful attention to how they describe these transactions for transfer pricing purposes, and where applicable, if they are correctly recorded under the controlled foreign company rules.

6.3 Application of the OECD Transfer Pricing Guidelines to financial transactions

As previously mentioned, South Africa is not a member state to the OECD, however SARS, in Practice Note 7, provides that the OECD Transfer Pricing Guidelines must apply where the practice note is silent. Furthermore, the 2022 Draft Interpretation Note has been amended to align to the guidance provided in the OECD Transfer Pricing Guidelines on financial transactions. It is clear that SARS does not intend to ignore the OECD Transfer Pricing Guidelines. Therefore, the OECD Transfer Pricing Guidelines may still provide guidance where the Practice Note 7 and section 31 of the Income Tax Act are silent. The Draft Interpretation Note has been the only guidance for taxpayers on thin capitalisation and intra-group loans since the removal of the separate thin capitalisation provisions from section 31 of the Income Tax Act and replacement of the thin capitalisation provisions with the arm's length principle. Given its draft status, the 2022 Draft Interpretation Note is not useful for taxpayers to ensure their compliance with the transfer pricing rules. Therefore, the OECD Transfer Pricing Guidelines may provide SARS and taxpayers with specific guidance relating to financial transactions.[294]

The OECD Transfer Pricing Guidelines describe the transfer pricing aspects of financial transactions. The purpose of the OECD Transfer Pricing Guidelines is to provide guidance on how to accurately describe financial transactions. The OECD Transfer Pricing Guidelines will enable taxpayers to ensure they remain compliant with the arm's length principle and mitigate any risk of administrative penalties, criminal offence imposed and/or interest levied

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[293] Holliday T *Assessment of the Purpose of South Africa's Controlled Foreign Company Rules* (2020) 45.

[294] On 11 February 2022, SARS published the 2022 Draft Interpretation Note for public comment. A draft interpretation note on thin capitalisation was published in the past before in 2013 and 2017, but due to legislative changes the note has been substantially revised. The 2022 Draft Interpretation Note follows the guidance provided in the OECD Transfer Pricing Guidelines. The 2022 Draft Interpretation Note is a draft, therefore the guidance in the OECD Transfer Pricing Guidelines is discussed, given that this is the guidance upon which the note is based.

on any outstanding tax debts. The OECD Transfer Pricing Guidelines do not intend to prevent countries from implementing their own approach to address the balance of debt and equity funding on an entity, and interest deductibility under their own domestic legislation.[295]

From a transfer pricing perspective, a resident taxpayer would need to ensure they transact at arm's length to ensure that in instances where the controlled foreign company provisions are triggered, e.g., for imputing interest income in the resident's income, that the amount imputed is in accordance with an arm's length interest rate, for instance. Therefore, the guidance provided in the OECD Transfer Pricing Guidelines is discussed below.

6.3.1 Classification of loan transactions

It may be the case that the classification of debt or equity funding by a borrowing entity of a multinational enterprise group may differ from that of an independent entity operating under the same or similar conditions to that of the borrowing entity. As such, this may have implications for the amount of interest payable by the borrowing entity, which may impact on the amount of profits accruing in a particular jurisdiction.

The purpose under this particular section is to provide guidance on whether a purported loan ought to be regarded as such, or if it should be regarded as another kind of payment, e.g., a contribution to equity capital.[296] Labels or descriptions assigned to particular financial transactions do not circumvent a transfer pricing analysis being undertaken.[297] Each case must be decided on its own merits, regardless of the labels or descriptions assigned to the financial transaction.[298]

The OECD Transfer Pricing Guidelines provide that it must be determined whether the amount constitutes debt or equity.[299] It is recommended that SARS make use of the factors indicated in the OECD Transfer Pricing Guidelines to determine the classification of the amount. The OECD Transfer Pricing Guidelines provide the following economically relevant characteristics which may be useful indicators to determine if an amount constitutes debt or equity:

- the presence or absence of a fixed repayment date;

[295] Paragraph 10.9 of the *OECD Transfer Pricing Guidelines*, 2022.
[296] Paragraph 10.10 of the *OECD Transfer Pricing Guidelines*, 2022.
[297] Paragraph 10.11 of the *OECD Transfer Pricing Guidelines*, 2022.
[298] Paragraph 10.11 of the *OECD Transfer Pricing Guidelines*, 2022.
[299] Paragraph 10.10 of the *OECD Transfer Pricing Guidelines*, 2022.

- the obligation to pay interest;
- the right to enforce payment of principal and interest;
- the status of the funder in comparison to regular corporate creditors;
- the existence of financial covenants and security;
- the source of interest payments;
- the ability of the recipient of the funds to obtain loans from unrelated lending institutions;
- the extent to which the advance is used to acquire capital assets; and
- the failure of the purported debtor to repay on the due date or to seek a postponement.[300]

The above factors would serve as an indicator that an amount advanced between related parties which is purported to be classified as a loan where, for instance, the borrower would be unable to repay the loan within the stipulated loan period, should rather be classified as a contribution to equity capital, to the extent that the amount advanced is not an amount which an unrelated party would advance. In such an instance, it is recommended that the provisions of section 31(7) of the Income Tax Act which relate to outbound equity loans be considered for possible application.[301]

6.3.2 Identifying the 'commercial or financial relations' of financial transactions

To accurately describe any financial transaction, consideration must be given to the factors which affect the performance of the business in the industry in which the multinational enterprise group operates.[302] The factors which affect the performance of the business need to be taken into account, given that certain industries which are more capital intensive, may require different amounts and types of financing due to different commercial needs.[303] Debt to equity ratios therefore play an important part in this step. Furthermore, the overall strategy of the multinational enterprise group is important as factors, such as the multinational

[300] Paragraph 10.12 of the *OECD Transfer Pricing Guidelines*, 2022.
[301] See discussion of section 31(7) of the income Tax Act at paragraph 5.4 of chapter 5.
[302] Paragraph 10.15 of the *OECD Transfer Pricing Guidelines*, 2022.
[303] Paragraph 10.15 of the *OECD Transfer Pricing Guidelines*, 2022.

enterprise group's targeted credit rating or debt/equity ratio, funding strategy adopted by the multinational enterprise which may not accord to the industry practice, and prioritisation of funding in relation to the multinational enterprises projects, should all be taken into account to accurately describe a financial transaction.[304] This assessment would then need to be compared to independent parties in comparable circumstances. This comparison would need to consider the perspective of both the lender and the borrower, as both parties to the transaction would realistically consider all other options available to them, and not just the entity's ability to service the debt.[305]

6.3.3 The economically relevant characteristics of actual financial transactions

The guidance provided below in relation to the economically relevant characteristics needs to be given consideration in conjunction with the documentary requirements imposed under the Tax Administration Act on financial transactions.[306]

To accurately describe a financial transaction, the OECD Transfer Pricing Guidelines recommends that the following economically relevant characteristics be considered:

- contractual terms;
- functional analysis;
- characteristics of financial instruments;
- economic circumstances; and
- business strategies.[307]

The economically relevant characteristics are discussed below.

[304] Paragraph 10.16 of the *OECD Transfer Pricing Guidelines*, 2022.
[305] Paragraph 10.19 of the *OECD Transfer Pricing Guidelines*, 2022.
[306] See discussion at paragraph 0 of Chapter 6 above for the documentary requirements relating to transfer pricing, specifically in relation to financial transactions.
[307] See paragraphs 10.21 to 10.38 of the *OECD Transfer Pricing Guidelines*, 2022.

6.3.3.1 *Characteristic 1: ‘Contractual terms’*

The terms and conditions of a financial transaction between unrelated parties are usually contained in a written agreement, however this is not always the case for related parties.[308]

Where there is a written agreement, the ideal scenario would be that the agreement captures the responsibilities, obligations and rights, assumptions and identified risks, pricing arrangement, and any other information which may be relevant to accurately perform a transfer pricing analysis, although this is rarely the case. Where there is a written agreement, the written agreement may not contain all the relevant information required to perform a transfer pricing analysis or contain sufficient information in relation to the contracted terms of the agreement.[309] Therefore, the OECD Transfer Pricing Guidelines recommend that the actual conduct of the parties also be considered.[310] The OECD Transfer Pricing Guidelines recognise that this analysis may conclude that the conduct of the related parties aligns to the written agreement, but it still relevant to consider the conduct in determining the actual terms between the related parties, to accurately describe the transaction.[311]

6.3.3.2 *Characteristic 2: ‘Functional Analysis’*

A prerequisite to a transfer pricing analysis is performing a functional analysis. To accurately describe a transaction, a functional analysis which seeks to identify the functions performed, assets used, and risks assumed by the parties to the controlled transaction, is necessary.[312] The functional analysis must go one step further in that it should also identify comparables which would need to be adjusted. The structure and organisation are of relevance as this may inform how value is created within the group, the inter-dependence of certain functions within the group, and the contribution the particular related party makes to the value creation in a group context.[313]

In the case of intra-group loans, a typical functional analysis would include an analysis of the inherent risks to the loan transaction, the capability to commit the capital of the business to the investment, determine the loan terms and ‘*organising and documenting*’ the loan.[314]

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[308] Paragraph 10.22 of the *OECD Transfer Pricing Guidelines*, 2022.
[309] Paragraph 10.22 of the *OECD Transfer Pricing Guidelines*, 2022.
[310] Paragraph 10.22 of the *OECD Transfer Pricing Guidelines*, 2022.
[311] Paragraph 10.22 of the *OECD Transfer Pricing Guidelines*, 2022.
[312] Paragraph 10.23 of the *OECD Transfer Pricing Guidelines*, 2022.
[313] Paragraph 1.51 of the *OECD Transfer Pricing Guidelines*, 2022.
[314] Paragraph 10.24 of the *OECD Transfer Pricing Guidelines*, 2022.

Furthermore, the ongoing monitoring and periodical review of the loan transaction should also be conducted as this may provide insight into:

- the creditworthiness of the borrower during the loan period;
- collateral constraints and/or fluctuations;
- the ability of the borrower to fulfil its duties and responsibilities in terms of the loan transaction; and
- where further adjustments may be required to describe the loan transaction.[315]

The OECD Transfer Pricing Guidelines recommend that where the lender does not exercise control over certain risks associated with the advancement of the loan, that the risk be allocated to the entity which exercises control in this regard.[316] In a group context, this may be the case where the ultimate parent company is the true entity that exercises control over the risks assumed in relation to an intra-group loan, and as a result of this, the risk must be allocated to the ultimate parent company and not the lender.[317]

Typically, in a multinational enterprise group where a centralised treasury function is maintained, a particular entity within the group may be responsible for both raising and providing funds to companies within the multinational enterprise group. The functional analysis should therefore also consider the applicability of the guidance on treasury function provided for in the OECD Transfer Pricing Guidelines.[318]

6.3.3.3 *Characteristic 3: 'Characteristics of financial instruments'*

The characteristics of a financial instrument should be considered to determine the impact they may have on the price of those financial instruments.[319] It is important to consider and document the attributes and features of a financial instrument to accurately price it. In the case of a loan transaction, the OECD Transfer Pricing Guidelines identify the following characteristics:

[315] Paragraph 10.26 of the *OECD Transfer Pricing Guidelines*, 2022.
[316] Paragraph 10.25 of the *OECD Transfer Pricing Guidelines*, 2022.
[317] Paragraph 10.25 of the *OECD Transfer Pricing Guidelines*, 2022.
[318] See discussion at paragraph 6.4 of Chapter 6 below.
[319] Paragraph 10.28 of the *OECD Transfer Pricing Guidelines*, 2022.

- the amount of the loan;
- The maturity date of the loan;
- the schedule of repayment;
- the nature or purpose of the loan;
- level of seniority and subordination (if applicable);
- geographical location of the borrower;
- the currency the loan is in;
- whether any collateral is provided for the loan;
- the presence and quality of any guarantee; and
- whether the interest rate (if any) is fixed or floating.[320]

Dependent on the transfer pricing method employed, the characteristics of financial instruments must be given more or less weight. The comparable uncontrolled price method is particularly sensitive to this factor given that direct costing is used. Any difference in the nature of the business activities undertaken may materially impact on the ability to make reliable adjustments to determine an arm's length price.

6.3.3.4 *Characteristic 4: 'Economic circumstances'*

Macroeconomic trends may impact on the arm's length price.[321] Therefore, the OECD Transfer Pricing Guidelines identify the following circumstances which are of importance in determining an arm's length price:

- the geographical locations;
- local regulations;

[320] Paragraph 10.29 of the *OECD Transfer Pricing Guidelines*, 2022.
[321] Paragraph 10.32 of the *OECD Transfer Pricing Guidelines*, 2022.

- the business sector of the borrower;
- timing of the transaction; and
- currencies.[322]

Furthermore, bank lending rates or interbank lending rates, financial market events, inflation rates, volatility of exchange rates, and growth rates may affect the arm's length price.[323]

6.3.3.5 *Characteristic 5: 'Business strategies'*

The business strategy employed must also be examined in accurately describing a financial transaction.[324] The analysis also includes the multinational enterprise group's global financing policy, and the existence of existing financial relationships within the multinational enterprise group, such as pre-existing loans and/or shareholder interests.[325] The reason for this is that a significant difference in business strategies between the unrelated party and the party to the controlled transaction may result in the comparable data being less reliable in determining an arm's length price.

6.4 **Application of the OECD Transfer Pricing Guidelines on pricing intra-group loans for treasury functions**

The management of a multinational enterprise group's finances is a complex activity. The approach adopted by an individual business will depend on the group's overall structure, its business strategy, place in the business cycle, industry sector, and currency operation, amongst other considerations.[326] The organisation of the multinational enterprise group will depend on the complexity of its operation, and the degree of centralisation of its treasury function. The treasury function is generally part of the financing of the commercial operations of the multinational enterprise group, and as such, will usually be a support service to the main operations. Accordingly, activities undertaken in this instance may require a closer analysis of the other intra-group service categories for pricing guidance. A treasury function may perform other complex functions, such as co-ordinating the financing activities within the multinational enterprise group and as a result, would need to be compensated appropriately.

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[322] Paragraph 10.32 of the *OECD Transfer Pricing Guidelines*, 2022.
[323] Paragraph 10.33 of the *OECD Transfer Pricing Guidelines*, 2022.
[324] Paragraph 10.34 of the *OECD Transfer Pricing Guidelines*, 2022.
[325] Paragraph 10.35 of the *OECD Transfer Pricing Guidelines*, 2022.
[326] Paragraph 10.39 of the *OECD Transfer Pricing Guidelines*, 2022.

Section 31 of the Income Tax Act and Practice Note 7 do not contain any provisions which describe how to accurately describe intra-group loans for treasury functions. Therefore, the OECD Transfer Pricing Guidelines may be considered to determine an appropriate arm's length amount. The OECD Transfer Pricing Guidelines provide specific guidance on the transfer pricing considerations relevant to treasury activities performed within a multinational enterprise group. The provisions relating to the accurate describing of intra-group loans (general considerations and determining the arm's length interest rate of intra-group loans) are considered below.

6.4.1 General considerations

6.4.1.1 *Lender and borrower's perspective*

The OECD Transfer Pricing Guidelines recommend that both the lender and borrower's perspective be taken into account when evaluating the '*commercial or financial relations'*, and economically relevant characteristics between the related parties, given that the perspective of each may vary from that of the other.[327] A lender's perspective would involve evaluating the risks inherent in lending to the particular related party borrower, the economic factors affecting the lender and borrower, and the forgone opportunity cost for advancing the funds to the borrower, as opposed to utilising the funds elsewhere.[328] Furthermore, an independent lender would conduct a credit assessment of the borrower with the aim of managing the risks associated with the particular borrower, which may include understanding the nature of the business the borrower operates, the purpose of the loan, the structure of the loan and source of repayments thereof, and the cash flow forecast and borrower's financial position.[329] This is not necessarily the case for a related party lender, given that the related party lender may already have this information readily available.[330]

Borrowers, on the other hand, seek to optimise their cost of capital by meeting short-term and long-term objectives.[331] This may entail a borrower weighing up its required rate of return against its weighted average cost of capital where the loan is advanced for a particular project or investment. A borrower would want to also ensure that changes in economic circumstances do not materially affect its ability to fulfil its obligations in terms of a loan transaction.[332]

[327] Paragraph 10.51 of the *OECD Transfer Pricing Guidelines*, 2022.
[328] Paragraph 10.53 of the *OECD Transfer Pricing Guidelines*, 2022.
[329] Paragraph 10.54 of the *OECD Transfer Pricing Guidelines*, 2022.
[330] Paragraph 10.55 of the *OECD Transfer Pricing Guidelines*, 2022.
[331] Paragraphs 10.41 and 10.42 of the *OECD Transfer Pricing Guidelines*, 2022.
[332] Paragraph 10.58 of the *OECD Transfer Pricing Guidelines*, 2022.

Therefore, a borrower would seek to be to be able to renegotiate terms in such a case, which must also be taken into account when performing a transfer pricing analysis.[333]

The above illustrates that a related party lender and borrower, although part of the same multinational enterprise group, would consider different factors regarding entering the loan transaction, which ordinarily would align to the particular lender and the particular borrower's business.

6.4.1.2 *Use of credit ratings*

Credit ratings are very useful tools used by independent lenders to determine the appropriate interest rate to charge a particular borrower.[334] Furthermore, credit ratings are used by independent lenders to determine the capital sum which a borrower may be eligible for in relation to its ability to service the loan and interest fees.[335] Group membership may impact on the credit rating of a particular entity within a multinational enterprise group and is discussed in paragraph 6.4.1.3.

Information on different rates of interest charged is available in lending markets for various enterprises, which may be useful for comparability purposes.[336] The financial transactions within a multinational enterprise group may also be useful if reliable comparables exist which do not materially affect the interest rate charged, or appropriate adjustments can be made.[337] The credit rating adopted by a multinational enterprise in a financial transaction should be recorded to substantiate the reason for the particular interest rate charged.

6.4.1.3 *Effect of group membership and use of the multinational enterprise group credit rating*

Group membership is an important consideration in accurately describing an intra-group loan between related parties.[338] The external funding policies and practices of the group will aid in outlining the terms and conditions which the multinational enterprise would ordinarily enter into with an independent lender, which may include aspects related to interest rate paid, the loan term, whether the loan is secured or unsecured, and the currency of the loan.[339] Furthermore,

[333] Paragraphs 10.59 &10.60 of the *OECD Transfer Pricing Guidelines*, 2022.
[334] Paragraph 10.62 of the *OECD Transfer Pricing Guidelines*, 2022.
[335] Paragraph 10.62 of the *OECD Transfer Pricing Guidelines*, 2022.
[336] Paragraph 10.65 of the *OECD Transfer Pricing Guidelines*, 2022.
[337] Paragraph 10.65 of the *OECD Transfer Pricing Guidelines*, 2022.
[338] Paragraph 10.76 of the *OECD Transfer Pricing Guidelines*, 2022.
[339] Paragraph 10.76 of the *OECD Transfer Pricing Guidelines*, 2022.

the borrower within a multinational enterprise group may receive implicit financial support from a member of the multinational enterprise group to meet its financial obligations, which may impact on the credit rating of the borrower.[340]

It is therefore appropriate to determine whether the credit rating of the borrower must be used on a stand-alone basis or if the prevailing facts require that a credit rating more closely linked to that of the multinational enterprise group be used.

6.4.1.4 *Covenants*

A loan covenant provides protection to a lender as it limits the risk and exposure of a lender.[341] A loan covenant may be in the form of incurrence covenants or maintenance covenants.[342] An incurrence covenant requires or prohibits the borrower from performing certain actions without the prior consent of the lender.[343] An example of this would be a prohibition from the incurrence of additional debt or disposal of a particular asset. The underlying rationale is that the balance sheet of the borrower would not be affected materially, to the possible detriment of the lender, unless consent is given by a lender.[344] A maintenance covenant refers to financial indicators which a borrower would need to meet at regular predetermined intervals during the lifetime of the loan.[345] The rationale behind a maintenance covenant is to protect the financial wellbeing of the borrower, as well as to serve as an indicator to the lender of the borrower's ability to fulfil its obligations in terms of the loan.[346]

Information relating to the performance of an entity within a multinational enterprise group is not particularly of issue, given that the multinational enterprise group would most likely have access to the financial information of the particular entity.[347] There is therefore not an information disconnect between the lender and the borrower, and as such, a related party may be less inclined to impose a loan covenant restricting the activities of a related party borrower or requiring the related party borrower to meet certain financial objectives in relation to its ability to perform in terms of the loan.[348] Notwithstanding that the terms and conditions of a written agreement do not contain a loan covenant, the actions of the parties and other relevant

[340] Paragraphs 10.76 & 10.77 of the *OECD Transfer Pricing Guidelines*, 2022.
[341] Paragraph 10.83 of the *OECD Transfer Pricing Guidelines*, 2022.
[342] Paragraph 10.83 of the *OECD Transfer Pricing Guidelines*, 2022.
[343] Paragraph 10.84 of the *OECD Transfer Pricing Guidelines*, 2022.
[344] Paragraph 10.84 of the *OECD Transfer Pricing Guidelines*, 2022.
[345] Paragraph 10.85 of the *OECD Transfer Pricing Guidelines*, 2022.
[346] Paragraph 10.85 of the *OECD Transfer Pricing Guidelines*, 2022.
[347] Paragraph 10.86 of the *OECD Transfer Pricing Guidelines*, 2022.
[348] Paragraph 10.86 of the *OECD Transfer Pricing Guidelines*, 2022.

information must be considered to ascertain whether there is in fact the equivalent of a loan covenant which impacts upon the pricing of the loan.

6.4.1.5 *Guarantees*

A guarantee provided by another party may be used to support a borrower's credit rating. A lender wishing to place reliance on a guarantee would need to evaluate the guarantor in a similar manner in which it would assess the borrower.[349] For the terms and conditions of the loan to be adjusted, the lender would need to satisfy itself that the guarantor can assume and fulfil the obligations of the borrower, in the event of a default.[350]

6.4.2 Determining the arm's length interest rate of intra-group loans

The widespread availability of financial information in relation to both lenders and borrowers make it easier to apply the comparable uncontrolled price method, however each transaction should be considered on an individual basis, as there may be rare instances where the comparable uncontrolled price method is not the most appropriate method to apply.[351]

Given the widespread availability of information on lending markets, external comparables may prove to be more reliable than internal comparables.

Furthermore, the search for comparable data to determine an arm's length interest rate may extend to the multinational enterprise group and not necessarily only look at the borrower on a stand-alone basis.[352] The OECD recommends loan fees and charges, cost of funds, credit default swaps, economic modelling, and the use of bank opinions be considered when determining an arm's length interest rate.

6.4.2.1 *Loan fees and charges*

Independent lenders would charge loan fees and costs associated with giving out a loan, whereas this is not necessarily the case with intra-group loans as these costs do not exist.[353] These fees may include cost to raise the loan or payment to satisfy regulatory costs, for instance. The OECD Transfer Pricing Guidelines recommend that if these costs do exist

[349] Paragraph 10.87 of the *OECD Transfer Pricing Guidelines*, 2022.
[350] Paragraph 10.87 of the *OECD Transfer Pricing Guidelines*, 2022.
[351] Paragraph 10.90 of the *OECD Transfer Pricing Guidelines*, 2022.
[352] Paragraph 10.92 of the *OECD Transfer Pricing Guidelines*, 2022.
[353] Paragraph 10.96 of the *OECD Transfer Pricing Guidelines*, 2022.

between related parties for intra-group loans, they be evaluated the same way as any other intra-group transaction.[354]

6.4.2.2 *Cost of funds*

In the absence of comparable uncontrolled transactions, the OECD recommends that only then could the cost of funds approach be used as an alternative to price intra-group loans.[355] The application of this method would depend on the options available to the borrower. The OECD recommends that this method may be used in some intra-group transactions where the capital is borrowed from an unrelated party to the borrower, which passes from the original borrower through to one or more related parties as a series of loans until it reaches the ultimate borrower. In such an instance, it is recommended that an arm's length mark-up be determined on the costs of the agency function itself, but only where agency or intermediary functions are performed.[356]

6.4.2.3 *Credit default swaps*

The OECD Transfer Pricing Guidelines recommend that credit default swaps may be used to determine the risk premium associated to intra-group loans, but due to its volatility should require careful consideration in its use to determine an arm's length interest rate.[357] A credit default swap is a financial swap agreement that the seller of a credit default swap will compensate the buyer in the event of a default. In the context of a loan, the lender would purchase the credit swap from a 3rd party to securely limit its risk in the case of the borrower on the loan defaulting.[358]

6.4.2.4 *Economic modelling*

Economic models are used by certain industries to determine an interest rate through a combination of various factors which may include liquidity risk, expected inflation and default risk.

Economic models do not represent actual transactions, therefore appropriate comparability adjustments to the price would be required to be made.[359] Where reliable comparable

[354] Paragraph 10.96 of the *OECD Transfer Pricing Guidelines*, 2022.
[355] Paragraph 10.97 of the *OECD Transfer Pricing Guidelines*, 2022.
[356] Paragraph 10.100 of the *OECD Transfer Pricing Guidelines*, 2022 (read with paragraph 7.34 of the *OECD Transfer Pricing Guidelines*, 2022).
[357] Paragraph 10.101 of the *OECD Transfer Pricing Guidelines*, 2022.
[358] Paragraph 10.102 of the *OECD Transfer Pricing Guidelines*, 2022.
[359] Paragraph 10.106 of the *OECD Transfer Pricing Guidelines*, 2022.

transactions cannot be identified, the author of this research report submits that only then should economic models be used.

6.4.2.5 *Bank opinions*

Bank opinions obtained by multinational enterprises to attest to an arm's length interest rate which an independent bank would charge a related party borrower should not be accepted as evidence to substantiate an arm's length interest rate, as it does not provide a comparison to an actual transaction. Bank opinions would be a departure from the arm's length principle based on comparability.[360]

6.5 **The OECD Transfer Pricing Guidelines on risk-free and risk-adjusted rates of return**

A risk-free rate is a hypothetical return which would be expected on an investment that carries no risk of loss.[361] A risk-free rate may be relevant as a component in calculating a risk adjusted rate of return on an investment or to determine a return to be allocated to an investor who has provided funding but has not assumed any of the risks relating to the advancement of the funds.[362] The OECD Transfer Pricing Guidelines propose an approach for determining a risk-free rate which does not necessary suggest that government issued rates on securities such as bonds be used as a reference rate, rather how a reference rate should generally be determined.[363]

The OECD Transfer Pricing Guidelines propose that where a lender does not perform any of the decision-making or lacks the capability to control the risks associated with investing in a financial asset that the lender should only be entitled to a risk-free return as a measure for the return the lender is entitled to retain.[364] The lender's costs should be taken into account to determine the risk-free rate and the borrower would still be entitled to a deduction up to an arm's length amount of the amount borrowed.[365] The difference between these amounts would be the amount that is allocated to the relevant person that exercises control over the investment risk.[366]

[360] Paragraph 10.108 of the *OECD Transfer Pricing Guidelines*, 2022.
[361] Paragraph 10.108 of the *OECD Transfer Pricing Guidelines*, 2022.
[362] Paragraph 10.116 of the *OECD Transfer Pricing Guidelines*, 2022.
[363] Paragraph 10.110 of the *OECD Transfer Pricing Guidelines*, 2022.
[364] Paragraph 10.108 of the *OECD Transfer Pricing Guidelines*, 2022.
[365] Paragraph 10.108 of the *OECD Transfer Pricing Guidelines*, 2022.
[366] Paragraph 10.108 of the *OECD Transfer Pricing Guidelines*, 2022.

An expected adjusted rate of return generally comprises two components, namely, the risk-free rate of return and a premium which reflects the risks assumed by the lender.[367] To determine an adjusted rate of return, it is important to identify and differentiate between the financial risks and operational risks assumed under the transaction to determine an appropriate adjusted rate of return.[368]

To determine an appropriate rate of return, the methodologies mentioned in the OECD Transfer Pricing Guidelines are the cost of funds approach and the return on realistic alternative investments with comparable economic characteristics. Whilst these methods are proposed in the guidelines, it does not constitute a closed list when adopting methodologies to determine an adjusted rate of return.[369] The author of this research report submits that taxpayers may therefore still determine an adjusted risk-free rate using different methodologies, provided that the methodologies can be substantiated.

6.6 Advance pricing arrangements

South Africa does not currently have an Advance Pricing Agreement programme in place. Although South Africa has an advanced tax ruling programme in Chapter 7 of the Tax Administration Act, section 80(1)(a)(iii) of the Tax Administration Act allows SARS to reject an application for an advanced tax ruling if that request requires SARS to make a determination regarding the pricing of goods or services supplied by or rendered to a connected person in relation to the applicant or class member.[370] This stance is currently being reviewed given that SARS indicated in a discussion paper that Advance Pricing Agreements may become available in South Africa in future with the planning and drafting of legislation for a bilateral Advance Pricing Agreement system.[371]

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[367] Paragraph 10.120 of the *OECD Transfer Pricing Guidelines*, 2022.
[368] Paragraph 10.118 of the *OECD Transfer Pricing Guidelines*, 2022.
[369] Paragraph 10.122 of the *OECD Transfer Pricing Guidelines*, 2022.
[370] 'Class members' means a member of the class to which a binding class ruling applies. Section 75 of the Tax Administration Act defines a 'class' as —

(a) shareholders, members, beneficiaries or the like in respect of a company, association, pension fund, trust, or the like; or
(b) a group of persons, that may be unrelated and—
    (i) are similarly affected by the application of a tax Act to a 'proposed transaction'; and
    (ii) agree to be represented by an 'applicant''.

[371] SARS *Discussion Paper on Advance Pricing Agreements*, dated 11 November 2020. Available URL: https://www.sars.gov.za/wp-content/uploads/Legal/DiscPapers/LPrep-DP-2020-02-Discussion-Paper-on-Advance-Pricing-Agreements.pdf, accessed on 17 December 2021.

On 10 December 2021, SARS released the proposed model for introducing an Advance Pricing Agreement programme in South Africa along with draft legislation.[372] The draft legislation intends amending Chapter 7 of the Tax Administration Act by creating an Advance Pricing Agreement programme, in addition to the already existing advanced tax ruling programme. It should be noted that the draft legislation does not amend SARS' power to reject an application for an advanced tax ruling in relation to transfer pricing; therefore, the proposed introduction of an Advance Pricing Agreement programme must not be confused with the already existing advanced tax ruling programme.

In terms of the proposed model, SARS intends implementing a pilot programme where only bilateral Advance Pricing Agreements may be entered into with OECD member countries.[373] A bilateral Advance Pricing Agreement would be an Advance Pricing Agreement amongst SARS, the South African taxpayer, a related party to the South African taxpayer, and the foreign tax authority in which that related party is located. The rationale behind this pilot programme is to enable SARS to learn from other jurisdictions before it expands the programme to include multilateral Advance Pricing Agreements.[374]

The proposed model will follow a flow through process where a pre-application consultation is undergone, whereafter a formal Advance Pricing Agreement application will be made should the taxpayer be eligible to enter into the Advance Pricing Agreement.[375] Once submitted, SARS will process the application whereafter negotiations with the foreign tax jurisdiction is envisaged to take place.[376] Once the terms of the Advance Pricing Agreement are agreed, the Advance Pricing Agreement will be finalised whereafter SARS will implement and monitor adherence to the Advance Pricing Agreement.[377] Once implemented, the Advance Pricing Agreement programme envisages placing a compliance obligation on the taxpayer where the taxpayer will be required to submit compliance reports to SARS, within 60 days of the end of the tax period within the duration of the Advance Pricing Agreement, or from the date on which

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[372] SARS *Proposed Model for Establishing an Advance Pricing Agreement Programme in South Africa and Release of Draft Legislation*, dated 10 December 2021. Available URL: https://www.sars.gov.za/wp-content/uploads/Legal/DiscPapers/LPrep-DP-2021-02-Proposed-Model-for-Establishing-APA-Progamme-in-SA-and-Release-of-Draft-Legislation.pdf, accessed 21 February 2022.

[373] SARS *Proposed Model for Establishing an Advance Pricing Agreement Programme in South Africa and Release of Draft Legislation* (2021) 1.

[374] SARS *Proposed Model for Establishing an Advance Pricing Agreement Programme in South Africa and Release of Draft Legislation* (2021) 1.

[375] SARS *Proposed Model for Establishing an Advance Pricing Agreement Programme in South Africa and Release of Draft Legislation* (2021) 2.

[376] SARS *Proposed Model for Establishing an Advance Pricing Agreement Programme in South Africa and Release of Draft Legislation* (2021) 2.

[377] SARS *Proposed Model for Establishing an Advance Pricing Agreement Programme in South Africa and Release of Draft Legislation* (2021) 2.

the Advance Pricing Agreement is terminated.[378] The rationale for the submission of compliance reports would be for SARS to confirm that there has not been any material changes during the year of assessment that impacts on the terms and conditions of the Advance Pricing Agreement.[379]

An Advance Pricing Agreement programme may aid in the stability of the South African tax base, if implemented correctly. Not only will tax base erosion be mitigated, but taxpayers will be provided certainty in relation to transactions which have transfer pricing implications. An example of where certainty may be provided in a financial transaction would be to link the company's credit rating to an appropriate risk-free reference rate. Advance Pricing Agreements entered into between a taxpayer and SARS would set out the criteria for a transaction under review, pricing methodology which includes comparability analysis, duration, and assumptions.

The key difficulty in implementing an Advance Pricing Agreement is that it should be bilateral or multilateral to avoid taxpayers being susceptible to being double taxed where a unilateral Advance Pricing Agreement is used.[380] This would require the collaborative efforts of more than one tax jurisdiction to come to a resolution on the pricing of goods, services, or intellectual property. This therefore makes the possible implementation of an advance pricing programme very onerous.

6.7 **Conclusion**

Chapter six examined the various means of managing transfer pricing risks and controlled foreign company risks, with a focus on intra-group loans. This chapter discussed the transfer pricing and controlled foreign company reporting requirements, as well as the transfer pricing guidance provided by the OECD to describe financial transactions with the aim of providing guidance on how to accurately describe financial transactions for transfer pricing purposes. This chapter also discussed the use of an advance pricing agreement programme in South Africa.

[378] SARS *Proposed Model for Establishing an Advance Pricing Agreement Programme in South Africa and Release of Draft Legislation* (2021) 9.

[379] Miller K & Chong J *Proposed model and legislation for an APA Programme in South Africa* (2021). Available URL: https://www.webberwentzel.com/News/Pages/proposed-model-and-legislation-for-an-apa-programme-in-south-africa.aspx, accessed 21 February 2022.

[380] Wiesener C & Gosai N 'Chapter 11 – Other topics' in *Africa Transfer Pricing Practice Guide: A South African Perspective* (2021) 9.

The purpose of this chapter was to examine the various means to mitigate transfer pricing and controlled foreign company risks to avoid the imposition of any administrative penalties, criminal offence and/or interest levied on any outstanding tax debts for failure to comply with the rules of each.

To minimise the transfer pricing risks when using a controlled foreign company, it is essential that the above discussion at paragraphs 6.2 to 6.6 (for example, the transfer pricing documentary requirements, the accurate describing of the loan transaction) be equally applied to controlled foreign companies, where applicable.

Furthermore, a consistent financing policy should be adopted and followed. It is recommended that the financing policy factor in the above recommendations provided by the OECD for treasury functions, as well as for accurately describing an intra-group loan (for example, requiring that all intra-group loans are in writing and credit ratings used to determine an arm's length interest rate is substantiated).[381] The financing policy must be aligned with the multinational enterprises' overall strategy. The loan should be considered from both the perspective of the lender and the borrower as there are different tax consequences which apply to both. This will enable the intra-group loan to be accurately described and the division of risks to be properly identified. In doing so, the risk of double taxation, interest and/or penalties will be significantly reduced.

Given that South Africa is yet to implement an Advance Pricing Agreement programme, it becomes imperative that accurate documentation be kept, substantiating pricing intra-group loans, not only for record keeping, but also for statutory filing purposes.

Until such time that SARS provides guidance in relation to outbound financial assistance, it is further recommended that where South African taxpayers have entered into loan agreements with a controlled foreign company which provides for the early termination of the loan agreement in the event of a default, that this be voluntarily disclosed to SARS and a transfer pricing adjustment affected for the relevant years.[382] Where the loan agreement may be terminated within 30 years, the loan will not qualify for the exemption from the transfer pricing provisions contained in section 31(7) of the Income Tax Act, which section deals with equity loans.[383] The voluntary disclosure may mitigate interest and/or penalties which SARS may

[381] See discussion at paragraphs 6.3, 6.4 and 6.5 of chapter 6.
[382] See discussion the exemption contained in section 31(7) of the Income Tax Act at paragraph 6.3 of Chapter 6.
[383] See discussion the exemption contained in section 31(7) of the Income Tax Act at paragraph 6.3 of Chapter 6.

levy should an audit be undertaken on the South African company or a controlled foreign company in relation to it.

Lastly, it is recommended that South African taxpayers continually assess related party loans entered into between a controlled foreign company in relation to it and a non-resident related party, as the South African taxpayer may be required to make an adjustment for transfer pricing purposes where the South African taxpayer derives a tax benefit in these transactions.

7 CHAPTER 7: CONCLUSION

7.1 Summary of findings

Chapter 1 states the objective of this research report. The objective of this research report was to examine the South African transfer pricing rules[384] and South African controlled foreign company rules,[385] and discuss where the two sets of rules interact with each other. The analysis went further in that this research report identified means to manage transfer pricing risk in relation to intra-group loans, specifically with controlled foreign companies.

Chapter 2 considered the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, which provide the OECD's recommendation to determine an arm's length price in relation to financial transactions. The recommendations of the OECD were used to accurately describe intra-group loans.

Chapter 3 established that:

- a South African taxpayer is required to calculate its tax liability in relation to its transactions with connected persons, in accordance with the arm's length principle using the transfer pricing methods adopted by the OECD and endorsed by SARS in Practice Note 7;

- SARS published Practice Note 7 which provides guidance on how SARS will interpret section 31 of the Income Tax Act. Practice Note 7 is largely outdated in relation to financial transactions, however the practice note provides that the OECD Transfer Pricing Guidelines should be followed to determine an arm's length price in the event that the practice note, section 31 of the Income Tax Act, or a double taxation agreement is silent; and

- lastly, this chapter discussed the application of the transfer pricing rules in relation to determining an arm's length price for the advancement of loan funding between connected persons or associated enterprises.

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[384] Section 31 of the Income Tax Act.
[385] Section 9D of the Income Tax Act.

Chapter 4 established:

- when a foreign company is to be classified as a controlled foreign company for purposes of section 9D of the Income Tax Act, and the implications for the South African tax resident shareholder/s in determining whether a proportionate amount of the income of that controlled foreign company must be included in its own income; and

- that, notwithstanding certain exclusions from inclusion in the controlled foreign company's net income in terms of section 9D(9A) of the Income Tax Act exist, income from financial instruments is required to be included in the net income of a controlled foreign company if that controlled foreign company is not a bank, financial services provider, or an insurer.[386]

Chapter 5 examined where the transfer pricing rules, and the controlled foreign company rules interact with each other. The examination was intended to determine the transfer pricing and controlled foreign company considerations and implications in relation to outbound and inbound loan transactions. Furthermore, this examination served as a base to discuss the means of identifying and managing transfer pricing risks, which was discussed in chapter 6.

Chapter 6 considered the means to manage transfer pricing risks and controlled foreign company risks, which included documentary disclosure requirements, advance pricing agreements, how to accurately describe intra-group loans, and briefly applied this to how a South Africa taxpayer can mitigate its transfer pricing risks with a controlled foreign company in relation to itself.

7.2 **Conclusion**

When a South African taxpayer is formulating its transfer pricing strategy, the South African taxpayer must be cognisant of the OECD Model Tax Convention and the OECD Transfer Pricing Guidelines which provide guidance on minimising transfer pricing abuse. Furthermore, the South African taxpayer must consider the impact the controlled foreign company rules have on transactions involving controlled foreign companies and whether interest income would be required to be imputed in the South African tax resident's income. Furthermore, double taxation treaties, exchange control and other international tax planning principles must be considered to properly structure these transactions.

[386] Section 9D(9A)(a)(iii) of the Income Tax Act.

7.3 **Recommendations and observations**

The purpose of this section is to conclude on the risks identified and provide recommendations which would be useful to the taxpayer, practitioners, and SARS on how to resolve these risks. The risks for a taxpayer would be the risks relating to reporting from both a transfer pricing and controlled foreign company perspective, and risks relating to accurately describing the financial transactions.[387] Chapter 6 discussed the transfer pricing and controlled foreign company reporting requirements,[388] as well as the transfer pricing guidance provided by the OECD to describe financial transactions with the aim of providing guidance on how to accurately describe financial transactions for transfer pricing purposes.[389]

Chapter 5 demonstrated that there is an overlap between transfer pricing provisions and controlled foreign company rules. Both sets of rules seek to tax income which reduces South Africa's tax base through artificial price manipulation. The purpose of chapter 6 was to examine the various means to mitigate transfer pricing and controlled foreign company risks, to avoid the imposition of any administrative penalties, criminal offence and/or interest levied on any outstanding tax debts for failure to comply with the rules of each.

Therefore, this section provides recommendations and observations for future transfer pricing legislation and controlled foreign company legislation. The discussion relates to advance pricing agreement programme, a new transfer pricing interpretation note, the use of safe harbours, deemed treasury operations under section 9D of the Income Tax Act, and the co-existence of the transfer pricing rules and the controlled foreign company rules.

7.3.1 Advance Pricing Agreement Programme[390]

The current lack of an Advance Pricing Agreement programme in South Africa creates a level of uncertainty when connected persons or associated enterprises are contracting. Where the taxpayer and SARS is able to agree on the tax treatment of a particular loan for transfer pricing purposes, the taxpayer will be provided certainty on how to continuously measure the loan transaction to avoid any possible transfer pricing risks. Furthermore, SARS will be able to agree on the treatment which may minimise the risk of transfer pricing audits or disputes. As previously stated, section 80(1)(a)(iii) of the Tax Administration Act allows SARS to reject an application for an advanced tax ruling if that request requires SARS to make a determination

[387] See discussion at chapter 6 above.
[388] See discussion at paragraph 6.2 of chapter 6 above.
[389] See discussion at paragraphs 6.3,6.4 and 6.5 of chapter 6 above.
[390] See discussion at paragraph 6.6 of chapter 6 above.

regarding the pricing of goods or services supplied by or rendered to a connected person in relation to the applicant or class member.[391] Given that transfer pricing disputes in South Africa are on the rise, with South Africa having had its first reported transfer pricing case in 2018,[392] it becomes imperative that a properly structured Advance Pricing Agreement programme be introduced to resolve this. This will also align with international practice regarding Advance Pricing Agreements and may act as a stimulus for investment in South Africa.

Furthermore, it is recommended that a new interpretation note[393] make provision for the use of safe harbours which are industry specific. In doing so, SARS will then be able to tailor the respective safe harbours for different companies in different industries. This will enable SARS and a taxpayer to agree on an appropriate financially leveraged position, based on the taxpayer's business.

7.3.2 Interpretation Note

Practice Note 7 is largely outdated. Furthermore, there is a lack of guidance provided for financial transactions, particularly in relation to outbound financial transactions.[394] For example, SARS applies the provisions of section 31(7) of the Income Tax Act strictly, therefore there is uncertainty amongst taxpayers on how to accurately comply with this provision. As the arm's length principle includes thin capitalisation under section 31 of the Income Tax Act, it is recommended that Practice Note 7 be discarded, and a new interpretation note be issued by SARS as a binding general ruling. The new interpretation note should include guidance on the interpretation of both inbound and outbound financial transactions, as well as provide guidance on the appropriate transfer pricing methodology to be applied.

7.3.3 Safe Harbours[395]

There is a lack of certainty amongst taxpayers relating to financial assistance. Interpretation Note 2, which has since been removed in its entirety used to contain safe harbours which enabled taxpayers to be compliant with the transfer pricing provisions, by ensuring that they fell within the limits of the safe harbour. This provided taxpayers with certainty in relation to their financial transactions. With the removal of safe harbours, a more onerous obligation is

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[391] See discussion of advance pricing arrangements at paragraph 6.6 of chapter 6 above.
[392] See discussion of the *Crookes Brothers* case at paragraph 5.4 of chapter 5 above.
[393] See discussion at paragraph 7.3.2 of chapter 7 below.
[394] See discussion at paragraphs 5.2 and 5.4 of chapter 5 above.
[395] See discussion at paragraph 3.5 of chapter 3 above.

placed on taxpayers to ensure compliance with the arm's length principle. It is recommended that SARS formally adopts safe harbours, as well as incorporates specific *de minimis* rules relating to low-risk, or low-value financial transactions.

If SARS provided safe harbours, taxpayers would be able to ensure compliance with the transfer pricing provisions. This would not prevent SARS from scrutinising a taxpayer's information which is required to be submitted under the documentary requirements. This would therefore minimise costs for taxpayers as well as SARS.

7.3.4 What constitutes a treasury operation for the controlled foreign company provisions?

It is recommended that the provisions in section 9D(9A)(b)(iii) of the Income Tax Act relating to deemed treasury operations be amended.[396] In its current form, certain income from legitimate transactions are still required to be imputed given that the provisions deem certain activities to be activities of a treasury operation.[397] Owing to the complex nature and structure of multinational enterprises, the implication of these provisions is that income derived from financial instruments may generally be captured under these provisions and will be required to be imputed. The deeming provision fails to take into account the structure of different businesses. For instance, certain businesses may operate primarily through permanent establishments which may then require imputation under paragraph (aa) of the provision as the principal trading activities would be deemed to be activities of a treasury operation. The provisions need to be limited in scope, as the provisions may result in legitimate activities being required to be imputed.

7.3.5 Co-existence of the controlled foreign company provisions and the transfer pricing provisions

The author of this research reports submits that the transfer pricing provisions and controlled foreign company provisions do not always apply to the same income, therefore the two sets of rules do not eliminate the need for each other.[398] Both are specific anti-avoidance provisions which are capable of being applied simultaneously.

[396] See discussion at paragraph 4.5 of chapter 4 above.
[397] See section 9D(9A)(b)(iii) of the Income Tax Act.
[398] See discussion at paragraph 5.2 of chapter 5 above.

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