STATUTORY POSITION

• South Africa’s transfer pricing legislation (section 31 of the Income Tax Act) has been in effect since 1995 - earnest TP audit activity started around 9 years ago.

• Adopted the arm’s length principle (ALP).

• Reliance placed on OECD TPG for guidance on application of ALP – OECD TPG not incorporated in section 31.
STATUTORY POSITION

In summary, current SA transfer pricing legislation (S 31):
• Is wide in scope;
• Requires the taxpayer to calculate its taxable income on an arm’s length basis as opposed to the Commissioner making that determination;
• Applies an arm’s length test for thin capitalisation;
• Specifically precludes downward adjustments
• Contains a secondary adjustment provision;
• Contains no specific TP rules for extractive industries.

South Africa currently has no APA programme, however APA research project currently undertaken.
TP LEGISLATION (S 31) – WHEN APPLY?

There must be an Affected Transaction where:

- transaction, operation, scheme, agreement or understanding directly or indirectly entered into between or for benefit of either or both: » Resident and non-resident;
  » Resident and offshore PE of another resident;
  » Non-resident and SA PE of another non-resident.
- Connected persons
- terms and conditions of that transaction, operation, scheme, agreement or understanding is not at arm’s length.

Affected Transaction results in any tax benefit being derived by a person that is party to the affected transaction.
OVERVIEW OF THE EXTRACTIVE INDUSTRY IN SOUTH AFRICA

• One of the largest sectors if not the largest;
• Major foreign currency earner through exports, reducing SA’s trade balance deficit (countering manufactured imports @ a weakening R$ exchange);
• Wield strong economic influence (job creation, giants of commerce, contribute to economic stimulus);
• Industry is plagued with problems ranging from relationship with Government, Unions and other stakeholders. Also cost pressures: electricity and fuel costs.
KEY TRANSFER PRICING RISKS

Currently conducting audits on oil and gas, petroleum refinery and mining companies – key risk identified during audits:

• Fragmentation of the supply chain in order to extract profits through:
  ▪ Offshore Marketing / procurement companies or branches
  ▪ Offshore hedging companies

• Thin Capitalisation

• Intra-Group Service Charges
KEY TRANSFER PRICING RISKS

Of the risks identified, often the most difficult to audit are the transactions involving fragmentation i.e. where MNE’s enter in convoluted structures involving the inter-positioning of multiple companies, generally in tax havens/ low tax jurisdictions, (splitting out of functions and risks) to divide profits.

Taxpayers using offshore marketing company to divide profits argue securing demand through customer relationships, smart contracting and high quality services is key to placing product in the market and to overall value creation.
**KEY TRANSFER PRICING RISKS**

- In these instances testing of substance is important.
- To look out for/understand:
  - Broader structure or supply chain and industry;
  - History of the transactions;
  - Elements of artificiality of transaction flows and/or agreements;
  - Number and experience/knowledge of employees;
  - Relevance of dates linked to changes in legislation/DTA;
  - Reliability of comparables used;
  - Use of third party marketing agents.
Case Study  - Extractive industry
Supply Chain

Mining SA Co

Extraction of commodity

Full risk marketer/ distributor

Mining Lux

End customer

= Physical flow

= Sales Invoice

SARS
South African Revenue Service
Facts

Mining Co (a SA company) extracts/ mines a commodity.
- Owns mining related technology and mining licence;
- Performs Research and Development;
- Production/ mining;
- 15 000 employees;
- Arrange logistics from mine to SA harbour;
- Maintains stockpile (inventory hold);
- Bears market risk, customer credit risk, foreign exchange risk, product liability risk, inventory risk and quality risk.
- Capital Intensive;
- Mining Co developed relationships directly with 12 key long term supply clients.
Facts

Mining Lux:

- 4 employees - 2 management and 2 admin staff;
- Responsible for customer relationships, markets commodities, negotiates and concludes contracts:
  » Outsources functions to 3rd party agent (earns 3% of FOB sales to 3rd party customers).
- Bears limited (no) risks;
- Earns 8% on FOB sales to 3rd party customers;
- Obtains 3rd party external benchmark (distribution of metals) Arm’s Length Range – 1.32% to 16.36%; median = 3.32%
Summary

- Taxpayer portrayed Mining Lux as a full risk marketer/distributor responsible for servicing 35% of the world’s demand of the specific commodity and growing the business for the entire Group.

- For the last 20 years, the 12 Key Clients originally procured by Mining Co remained the key foreign clients of the specific commodity. Few additional customers were established.

- Over a 10 year period Mining Lux took in excess R10 billion worth of profits as Mining Co maintained they performed such a strategic and vital role in the supply chain and was fully risk taking.
Summary

Based on facts and documentary evidence provided by the taxpayer, SARS views:

- Mining Lux functions in substance as a marketing agent;
- Mining Lux is not full risk taking;
- Taxpayer comparable data are not reliable.