Practical Nature of south African transfer pricing system

“Numerous fault lines”

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1. A developmental state BUT.....
1. A developmental state but....

- South Africa opted for the route of a “broad developmental state”.
- That is, other than the “rational and deliberate development and implementation of state-driven industrial policies, with cooperation between the government and private enterprises—it incorporated social development into the equation.
- A history of Apartheid, at the advent of democracy (1994), South Africa was faced with a number of short and long term constraints to development;
  - Among the short term challenges were: large budget deficit, low foreign exchange reserves, high interest rates, volatile exchange rates, massive currency outflows. The long-term challenges included low investment, low savings, high unemployment, high poverty, high income inequality and slow growth.
1. A developmental state but....

LSM categories 2001 and 2010

Number of people/LSM

Number of people getting grants

<table>
<thead>
<tr>
<th>Number of people</th>
<th>LSM categories 2001 and 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>2,000,000</td>
<td>4,000,000, 6,000,000, 8,000,000</td>
</tr>
<tr>
<td>3,000,000</td>
<td>5,000,000, 7,000,000, 9,000,000</td>
</tr>
<tr>
<td>4,000,000</td>
<td>10,000,000, 12,000,000, 14,000,000</td>
</tr>
<tr>
<td>5,000,000</td>
<td>16,000,000, 18,000,000, 20,000,000</td>
</tr>
</tbody>
</table>

SWR 2001

SWR 2010

2001

2010
1. A developmental state but....

- It informs the choice of fiscal policy which is anchored by the principles of counter cyclicality, debt sustainability and intergenerational fairness (National Treasury, 2013).
- Counter cyclicality means that spending supports the economy during downturns, even if revenue is insufficient, and the accumulation of debt is reversed to build fiscal space as the economy recovers.
- When tax revenue falls short of critical spending requirements, government is forced to resort to borrowing which may not only come at high cost but also lessen the amount of funds available for crucial expenditure requirements as well as increasing the risk of a loss of fiscal sovereignty to international creditors.
1. A developmental state but....

Budget deficit as a proportion of GDP
2. Why SA should worry about transfer pricing and illicit financial flows
2. Why SA should worry about transfer pricing and illicit financial flows

• Weak economic growth and revenue collections that have consistently come below the anticipated projections, have seriously undermined the fiscal environment.

• The limited fiscal space has necessitated the funding of new policy initiatives from savings and improved spending quality, prompting government to initiate a study to evaluate the robustness of the tax system with the main aim of assessing the tax system’s ability to support long-term policy objectives.

• Admittedly, the South Africa tax system is not fit for purpose
2. Why SA should worry about transfer pricing and illicit financial flows

- Financing of the South African developmental state is a function of a robust, efficient and sustainable taxation policy.

- Current efforts, such as the anticipated outcome proposals of the Tax Review Committee might miss the point by imposing more tax on the poor in the name of tax base broadening measures—letting loose the real culprits.

- That is if past trends of exclusive consultations, usually dominated by accounting firms and business lobbies are to be followed by the committee.

- This is no time to increase the tax intensity, which will eventually hit the poor more and increase already alarming income inequalities, but a time to focus on measures to curtail base erosion and profit shifting.

- Not only that, a review of the extensive incentive regime and sector specific dispensation is also due.
2. Why SA should worry about transfer pricing and illicit financial flows

Income inequality

<table>
<thead>
<tr>
<th>Share of population</th>
<th>0-50 000</th>
<th>50 000-100 000</th>
<th>100 000-300 000</th>
<th>300 000-500 000</th>
<th>500 000-750 000</th>
<th>750 000+</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share of each category</td>
<td>African</td>
<td>White</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Why SA should worry about transfer pricing and illicit financial flows

• The changing structure of South Africa’s GDP are also worrying signs

• Financialisation of the South African economy seems to be taking route, and this is at the expense of the real economic sectors.....such as manufacturing and agriculture

• Mining remains strong, in terms of employment contributions, export earnings and contribution to GDP except where it comes to its contribution to government revenues

• Value added tax, remained stable at 27% in terms of its contribution to total revenue by source between 2006/7 and 2010/11-corporate tax shrunk from 24% down to 20% over the same period
2. Why SA should worry about transfer pricing and illicit financial flows

Changing structure of GDP

- Agriculture
- Mining
- Manufacturing
- Finance
2. Why SA should worry about transfer pricing and illicit financial flows

Tax assessed by sector (all companies), 2007

- Other 20%
- Mining and quarrying 10%
- Wholesale trade 4%
- Vehicles, parts and accessories 4%
- Transport, storage and communication 8%
- Retail trade 6%
- Metal (including metal products) 5%
- Long term insurance 7%
- Food, drink and tobacco 3%
- Financing, insurance, real estate and business services 29%
- Coal and petroleum products 5%

Tax assessed by sector (all companies), 2010

- Other 28%
- Financing, insurance, real estate and business services 27%
- Transport, storage and communication 12%
- Retail trade 9%
- Metal (including metal products) 3%
- Vehicles, parts and accessories 2%
- Food, drink and tobacco 4%
- Long term insurance 2%
- Mining and quarrying wholesale trade 5%
- Food, drink and tobacco 3%
- Coal and petroleum products 5%
2. Why SA should worry about transfer pricing and illicit financial flows

- SA has a comprehensive tax incentive regime for both extractive and automobile industries.
- Mining benefits from a very lucrative royalty regime, even by regional standards, capital, depreciation allowances, loss carry over provisions.
- Because mining is export oriented, mining companies can claim most of the VAT tax they pay as input tax.
- Though muted is a resource rent tax, given the current environment, where revenues from mining continued to decline even during the mining boom years, there is little in the manner of revenue to be collected by introducing a RRT.
- Lots of damage to the economy as well, short term portfolio inflows, sucks investment away from real economic sector (jobs), exchange rate volatility, current account deficit.
3. Priority actions and milestones for South Africa
Improving transparency

• Information asymmetry is the major fault line in the tax treatment of cross border transactions
• EITI plus-across all of industry value chain, CABRI and ATAF
• Mandatory reporting of payments....and other key information on a country-by-country, and project-by-project by ALL transnational corporations
• Advancing the call for a multilateral automatic information exchange agreements
• Maintaining a public register of beneficial ownership compulsory
• The general statute of limitation should be increased from three to five years
Measures to curtail base erosion and profit shifting

- **Advance pricing agreements** - SARS must be able in-law to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among two or more commonly controlled businesses if necessary to reflect clearly the income of such businesses.

- APA’s are designed to resolve actual or potential transfer pricing disputes in a principled, cooperative manner, as an alternative to the traditional examination process.

- Legislation of detailed **transfer pricing documentation** rules - to include transfer pricing analysis which need to be documented or those documents which need to be produced by the taxpayer in order to demonstrate that their controlled transactions satisfy the arm’s length principle.
Intangible/Intellectual Property

Intangible Assets

Marketing Intangibles
  - Brand Name
  - Customer Lists
  - Distribution Channels

Know How & Processes

Business Model

Intangible Assets vs Intellectual Property

Intellectual Property
  - Trade Marks
  - Patents
  - Designs
  - Copyright
Measures to curtail base erosion and profit shifting

- Tax information management systems- It is wrong for African tax administrations to rely on European databases or the data bases of the “big five” for benchmarking comparables
  - Extractives such as diamond trade due to opaqueness
  - Where futures markets exists, these could be linked to establish local industry standards
- More clearer and broad definition of intangibles and more comprehensive valuation of intangibles such as intellectual property
- Audit capacity-there has to be a real chance that an entity could be selected for audit, sufficient capacity should exist to identify all TP risks from corporate tax, customs or even VAT esp. w.r.t limited risk distributors
- Freedom to restructure activities and move key functions and risks to low tax jurisdictions should be minimised
Characterisation: Manufacturing

Manufacturing Structures Hierarchy

- Consignment manufacturing
- Contract manufacturing
- Full fledged manufacturing
Characterisation: Distribution/Sales

Distribution / Sales Structures Hierarchy

Agent
Commissionaire
Limited risk distributor
Full-fledged buy/sell distributor
Policy and legislative certainty

- Transfer pricing risk very high-non attachment-could lead to fine or imprisonment of upto 24 months- Namibia, penalties of 200% of underpaid tax and 20% interest

- Consistent application of TP policy document, mandatory maintenance and filling of comprehensive TP documentation
  - Various methodologies are applied based on OECD model; traditional transaction methods- CUP, RP CP and profit methods such as TNMM and profit splits
  - Comparability is key, however unavailability of unrelated party information a major setback, some factors could exist that cause material differences

- Safe harbour provisions- to avert thin capitalisation arrangements-in South Africa interest cannot exceeds 30% of taxable income and cannot be above the equivalent South Africa prime rate in foreign exchange---can be characterised as dividend
Citizen involvement

• Pro-poor tax outcomes will require that ordinary citizens are also engaged at all stages tax policy from formulation to implementation to monitoring and evaluation

• MNE’s should also look at paying a fair and equitable tax as the contribution they make to keep society in a good state of repair-----something that contributes to business profitability and sustainability

• Citizens should be part of the process of deciding the mobilisation and use of domestic resources-need to strengthen democratic participation, and thus the social contract between states and citizens

• Free, prior and informed consent (FPIC) as part of local legislative practice will expand citizen participation at the local level as project affected people.....benefit sharing