

# What is the African Landscape for Transfer Pricing Audits?

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## *KPMG practitioners discuss the transfer pricing audit process in Nigeria and South Africa.*

Tasking, time consuming, tedious, these are some of the adjectives that a taxpayer may use to describe the experience with the Transfer Pricing (TP) audit process in Africa. Transfer Pricing audits have become a crucial aspect of ensuring that Multinational Enterprises (MNEs) pay appropriate taxes in all jurisdictions of incorporation. Several African countries have taken a front seat in this regard, hence a view into the Nigerian and South African TP audit process will provide valuable insights into the approach of TP audits in complex, aggressive, and diversified tax jurisdictions such as Nigeria and South Africa.

## The TP Audit Process in Nigeria and South Africa

### The First Phase

In Nigeria, TP audits are a pivotal function carried out by the Federal Inland Revenue Service (FIRS) in assessing taxpayer's adherence to the Nigerian TP regulations which are designed to ensure a taxpayer's compliance with the arm's length principle in respect of all related party transactions. The first phase of a Nigerian TP audit which is typically referred to as the Desk Review phase, requires conducting a deep scrutiny into each related party transaction as reported in the TP disclosure form along with other documents filed by the taxpayer to identify potential risk areas.

In contrast, there are no requirements within the South African TP regulations for taxpayers to submit TP returns in South Africa. However, the Income Tax Return for Companies (ITR14) requests the disclosure of cross-border transactions with connected persons/ associated enterprises. In addition, the South African Revenue Service (SARS) seeks to obtain additional information relating to the taxpayer's cross-border intragroup transactions and the relevant questions are also included in the annual Income Tax Return. The responses to these TP disclosures enable SARS to carry out an in-depth review to identify TP risks which may in turn trigger a TP audit. This common analysis in South Africa and Nigeria

provides the SARS and FIRS with firsthand information on the transactions between associated entities and the opportunity to take a closer look into the business of the taxpayer and the facts of the connected persons/ associated enterprises transactions.



## The Second Phase

The outcome from the initial review by both tax authorities in Nigeria and South Africa leads to the commencement of an investigation (TP review) or directly to a TP audit in both jurisdictions. This involves the issuance of a request letter to the taxpayer. In Nigeria, the receipt of an Information Document Request (IDR) letter from the FIRS serves as a clear indication that a TP audit exercise has begun. This letter indicates the period being covered for the TP audit and a list of documents necessary for further scrutiny of the identified related party transactions. A commonly requested document is the TP documentation for the periods under review as it provides a detailed breakdown of all related party transactions that occurred during the covered periods. The TP documentation is required to be submitted within 21 days of receiving the IDR letter. Failure to submit the TP documentation, will lead to an administrative penalty of ten million Naira or 1% of the total value of all controlled transactions, whichever is higher and ten thousand naira for everyday in which the default continues.

Comparably, after the notification of an audit letter, the SARS issues a request letter (request for relevant material) to the taxpayer which clearly lists all documents required for a more detailed review of the related party transactions over a specific time frame. The letter commonly includes a request for TP documentation. In South Africa, taxpayers are required to contemporaneously maintain TP documentation and, if the aggregate cross-border intragroup transactions are ZAR 100 million or above during a tax year, the taxpayer is also required to file local file and/ or master file documentation. In some instances, where the ultimate parent entity is a South African tax resident, local file and master file documentation may also need to be filed. Furthermore, if this threshold is met, additional TP documentation is required to be maintained, for all cross-border intragroup transactions of ZAR 5 million or above. The relevant documentation is expected to be provided by the taxpayer within 21 business days upon receipt of the request letter.

## The Third Phase

A further understanding and analysis of the substance of each cross-border intragroup transaction is of utmost importance to FIRS and SARS. In Nigeria, this involves a field visit to the premises of the business of the taxpayer with the aim of conducting a fact-finding exercise to interview key management staff and obtain accurate facts of the business. In line with ensuring proper understanding of the business, the FIRS typically requests for a presentation on the business model and operations of the company. Similarly, SARS requests for a presentation of the business operations of the company with the common goal of seeking to understand the business. This further aids SARS in identifying the relevant staff positions to be interviewed during a fact-finding exercise. The aim is to carry out an analysis

of the functions performed, the risks borne, and the assets employed in respect of the relevant cross-border intragroup transactions.



## The Fourth Phase

This can be regarded as the penultimate phase of the TP audit process. Here, the audit report is being issued by the FIRS. The audit report contains the FIRS' understanding of the facts and potential adjustments. The taxpayer can object in writing to the FIRS' position, after which reconciliation meetings will be held to align on the issues and clarify the FIRS' understanding of the facts.

Uniformly, a detailed audit report is also issued by SARS. However, if SARS is of the view that a taxpayer's TP arrangement does not satisfy the arm's length principle, SARS is required to make a primary TP adjustment, in the form of a revised assessment in respect of the taxpayer's year of assessment to reflect the arm's length consideration. This will give rise to company tax at 27% (28% for years of assessment commencing prior to April 1, 2022) on the primary TP adjustment.

Furthermore, there will generally be a secondary adjustment in the form of a deemed distribution of an asset in specie equal to the primary TP adjustment, which is subject to dividend withholding tax at 20%. Since the deemed dividend is not a dividend as defined in the Income Tax Act (ITA), any Double Tax Agreement relief that would normally be applicable to dividends will not be applicable to the secondary TP adjustment.

Also, understatement penalties may be applicable to the under-declaration of tax payable due to the primary and secondary TP adjustments. Understatement penalties are levied in terms of Section 223 of the Tax Administration Act (TAA) at a rate of between 0% and 200%. The applicable rate is dependent on the circumstances that gave rise to the understatement, such as omission, incorrect disclosure or misrepresentation, and whether the taxpayer has previously been guilty of any of the above. In practice, a percentage of between 10% and 50% seems to be standard.

## The Final Phase

Upon receipt of the objections to the audit report from the taxpayer, the FIRS may refer such objections to the Decision Review Panel ("the Panel") which is set up for the purposes of resolving any dispute or controversy arising out of the audit exercise. However, where the FIRS and taxpayer fail to reach a mutually beneficial agreement, the taxpayer may seek redress at the tax appeal tribunal for a re-assessment of the TP issues and the FIRS' decision and adjustments. This is typically not a common practice by most taxpayers, but encouraged to seek a fair judgement for all parties.

Likewise in South Africa, a taxpayer may object to the revised assessment and, if the objection is not allowed, proceed to appeal the matter. The taxpayer has the option to choose to enter an Advance Dispute Resolution (ADR), where SARS and taxpayers engage in discussions regarding the dispute without bias. It is interesting to note that the option to engage in ADR at the level of the objection has only been recently given. If the ADR fails, then the matter proceeds to the Tax Court.

## Conclusion

The comparison between the TP audit process in Nigeria and South Africa has highlighted the common goal of ensuring that all cross-border intragroup transactions satisfy the arm's length principle and profit is not being shifted to other tax jurisdictions. It describes the great length at which the tax authorities .

(FIRS and SARS) are willing to spend valuable time and resources to ensure that the tax base of each jurisdiction is not eroded, thereby protecting the African landscape. Therefore, taxpayers are encouraged to ensure that all transactions with related parties are at arm's length, properly documented by maintaining a contemporaneous TP documentation that is complete, correct, and consistent with the required TP disclosures—while not forgetting the need to keep all relevant supporting documents in the event of a TP audit.

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